SOLUTIONS
QUESTION ONE

QUESTION ONE

PICK-and- BUY LIMITED (PaB)

SECTION A

1) Response to e-mail:

E-mail of briefing notes relating to audit risks for PaB

To	:	Mark Shula – Audit Partner
From	:	Susan Mbewe
Date	:	3rd May 2012
RE	:	Audit and business risks relating to PaB

Hello Mark,

I've drafted some briefing notes below that you can use at the audit planning meeting next week. As requested, I have split them between going concern risks and other financial statement risks, using suitable headings as below:

(i) GOING CONCERN RISKS

The main audit and business risk is that PaB may not be a going concern. Doubts over going concern arise from several factors:

a) The company has decided to close several of its stores.
Closure and contraction in operations may be regarded as evidence that the company may not continue in the foreseeable future. Planned closures also send negative signals to its suppliers who may be reluctant to extend credit to PaB.

b) The economy is entering a recession
This may result in higher costs of operations with falling demand

c) Profits have fallen significantly since last year
A continued fall in profits will question the recoverability of assets and the ability of PaB to generate enough cash to finance its operations and meet obligations falling due. This may well have resulted from worsening economic conditions and intense competition in the market.

d) Bank borrowings
The worsening financial performance of the company and planned store closures may result in the company's bank not being willing to lend the company any more money. The bank may even decide to call in any existing loans if covenants have been breached.

e) Website problems
The website has only recently been set-up and is already experiencing some technical and security issues. These could seriously damage PaB's reputation, particularly if credit card fraud has taken place and orders are not being fulfilled on time and correctly. There is risk that PaB will lose existing and potential new on-line customers to other competitors who have more efficient systems and can price their goods at a discount. There is also the risk tha the system failure may occur, again leading to orders not being completed and a loss in revenue from potential on-line customers

f) The company has decided not to pay a dividend
Inability to maintain a predictable dividend policy is not attractive to both existing and potential investors. This may be indicative of low profits and liquidity problems.

If the company cannot continue as a going concern, the financial statements would not give a true and fair view unless they are prepared on a break-up basis. Preparing financial statements on a break-up basis implies that assets would be stated at net realizable basis and all liabilities become immediately payable.

(ii) OTHER FINANCIAL STATEMENT RISKS

a) Provisions relating to stores closures
The company has announced its intention to close some of its stores. A provision for restructuring may be required in accordance with IAS 37 Provisions, contingent liabilities and contingent assets. As this is an area of management judgement that is likely to be material to the financial statements, the risk of understatement is high.

It is also possible that inappropriate costs may be included in the provision when only direct expenditure relating to the restructuring must be included. In addition, appropriate disclosures may not be made.

b) Impairment of assets
As a result of the store closures, the non-current assets relating to these may have suffered impairment. There is therefore the risk that these assets may be overstated in the financial statements, if they are stated at their carrying value rather than their recoverable amounts.

c) On-line ordering
The new website has been having technical problems. There is a risk that controls in this area are weak which may increase errors in respect of sales of on-line goods and their reporting in the financial statements. It is possible that the sales figures and related amounts may be misstated, thereby resulting in misstatement of profit and assets.

d) Web site costs

PaB has incurred significant expenditure on setting up its website so that customers purchase goods on-line. K340 million represents 3.7% of profit before tax so is material to profit, although it only represents only 0.3% of total assets. All the costs have been capitalized. Capitalization of these costs may not be appropriate. In addition, any capitalized costs relating to the website must also be amortized over its estimated useful life. The capitalization of these website costs may not be strictly in accordance with *IAS 38 Intangible assets*.

There is a risk that some of these costs should be expensed in the year, leading to understatement of expenses, overstatement of website costs capitalized and overstatement of profit.

e) Operating Segments

PaB sells goods in a number of distinct categories such as children's clothes, music, homeware, toys and books, and confectionery. These are likely to be operating segments if the meet the criteria of IFRS 8 Operating Segments. There is a risk that disclosures required by *IFRS 8 Operating Segments* may not be made (Operating segment profit or loss. Segment assets, segment liabilities, certain income and expense items, and disclosures about revenues derived from products and services).

The fact that the company now also trades on-line means that it may have to report segmentally on revenue, costs and assets and liabilities relating to sales from its websites, if the revenue from the web site constitutes 10% of the total revenue of PaB

f) Manipulation of figures

As PaB appears to be struggling, there is a risk that management may misstate figures in the financial statements so that the company appears to be in a better position that it actually is, in order to boost the share price or to gain more funding from its bankers.

g) Cash sales

As PaB is a retail business, there is likely to be a high proportion of cash sales. This increases the inherent risk of the audit because of the risk of misappropriation and understatement of income

h) Multiple locations

PaB has over 20 stores nationwide. This increases the risk of errors being made, and increases the number of locations that need to be visited for the purpose of audit testing, particularly in the area of inventory, cash and non-current assets.

Thanks
Susan

2) Ethical and other professional issues

a) The shares inherited in PaB Ltd (5 marks)

Jim the trainee has inherited some shares in a client that is audited by his firm and he is actually a member of the audit team that is involved in the audit of PaB. ZICA ethical guidance is very clear on situations such as this: a member of the assurance team should not own a direct financial interest or an indirect material financial interest in a client.

Jim has 10,000 in PaB, currently worth K28.5 million. This is not a large amount in the context of the company as a whole and as Jim is still a trainee, he is unlikely to be able to exert any influence on the audit. However there is a self interest threat present.

As Jim is part of the audit team of PaB, he ought to be taken off the audit and assigned elsewhere. Also, the firm should introduce procedures that require all new staff to complete a disclosure of shares held so that any potential threats can be identified before the staff are assigned to particular assignments. The other option would be to ask Jim to dispose of his interest in PaB.

b) The sales discrepancy (5 marks)

Jane has noticed a discrepancy between the output sales tax disclosed on the sales tax return and that according to PaB accounting system. This discrepancy, although not material to the financial statements, gives rise to the risk that deliberate tax evasion has occurred. Alternatively it could the result of a genuine error.

If fraud is suspected, this may cast doubt on the integrity of the management of PaB and other representations made to the auditors. Auditors are required to maintain professional skepticism throughout the audit.

Further audit work must be done to verify the correct figure relating to sales tax in the financial statements. The discrepancy should be discussed with the Finance Director of PaB to ascertain whether it is a genuine error or not, and what steps PaB is going to take in respect of the Zambia Revenue Authority. Choolwe and Partners have a duty of confidentiality to its clients. Whether the firm suspects tax fraud or not, they must not disclose the situation to ZRA without the consent of the client.

c) The secondment of Clare to Choolwe & Associates (5 marks)

PaB has seconded a qualified accountant to Choolwe and Partners, who previously has worked within the internal audit department. There is a risk here of self-review if Clare works on the audit of PaB as she may be reviewing work carried out in internal audit or elsewhere within PaB.

The Finance Director of PaB has expressed the desire for Clare to be included on the audit team. This poses both an intimidation threat as well as a self-interest threat – Choolwe Partners may be reluctant to go against his wishes as PaB is big client and Choolwe & Partners may carry out other non-audit work fo PaB as well. Choolwe & Partners would not want to lose this income.

However, it is up to the audit partners of the firm to decide the make-up of the teams of individual client audits, having considered any threats to independence and objectivity. In this case, it is clearly a threat to independence to have Clare on the audit team of PaB, so she should not be assigned to this client, despite the wishes of PaB's Finance Director. The Finance Director should be informed of the reasons for not including Clare on the audit team so that he understands the risk to the independence and objectivity of the auditors if she were one of the team members.

d) The opportunity to provide the internal audit service to PaB Ltd
(5 marks)

Providing internal and external audit gives rise to a significant self-review threat. Choolwe & Partners would need to consider the following ethical and professional issues:

- Choolwe & Partners should assess its ability to provide such a service in terms of professional competence and other resources such as staffing.
- Provision of such a service will result in additional income of K100 million per annum and this may pose an overdue dependence threat. A firm's independence is threatened, and should be reviewed if a listed audit client's (recurring) fees (from audit and other work) exceed 5% of total practice income.
- PaB should be made to acknowledge that they are responsible for establishing, maintaining and monitoring the system of internal control. It will also be necessary that PaB approves such internal audit work. It will be necessary to ensure that Choolwe & Partners does not take on a management role.
- As big as PaB is Choolwe & Partners would need to consider establishing separate teams to be used for each assignment, and that independent partner reviews take place.
- According to ZICA ethical and professional guidelines, a firm shall not undertake an engagement to provide internal audit service to an audited entity where it is reasonably foreseeable that the auditor would place significant reliance on the internal audit work performed by the audit firm

SECTION B

3) Matters to consider and audit evidence:

a) The capitalization of website costs **(10 marks)**

Matters to consider		Evidence
1	K340 million is more than 3.7 of profit before tax, making it material. It is only 0.3% of total assets	• As it is material, it should be expected that more sufficient and appropriate evidence should be obtained.
2	Obtain a schedule detailing the breakdown of the K340 million costs relating to the website	• Inspect source documents (purchase orders, invoice to ascertain the cost and allocation to website, including checking arithmetic accuracy • Verify that purchase procedures and approval requirements as appropriate •

3	Policy of capitalization and compliance with *IAS 38, Intangible Assets. IAS 38* require that web site development expenditure that meets specific criteria should be capitalized.	• Review the policy to ascertain whether reasonable and in accordance with *IAS 38, Intangible Assets* requirements. • Verify that IAS 38 conditions for capitalization have been met
4	IAS 38 require that capitalized intangible assets should be amortised over the estimated useful life	• Enquire of management of PaB and discuss how they assessed the estimated useful life of the website and ascertain that it is reasonable. • Review the calculation of the website and re-perform, to ensure it is accurate and complete. • It will also be necessary to obtain a management representation in this regard.
5	IAS 38 requires that intangible assets should be subjected to impairment reviews. On-line purchasing has not so far been as successful as anticipated because the company cannot really compete with the established on-line stores, both locally and overseas, that can offer similar goods for sale at vastly discounted prices. There have also been technical and security issues resulting in some orders not being fulfilled on time or not at all.	• Review and inquire with management any impairment review carried out in relation to the website, and if so, review the impairment test • Recompute any impairment, including verifying that the accounting treatment is correct.
6	IAS 38 prescribes how intangible assets should be presented and what other information should be disclosed.	• Inspect the financial statement to verify that the web site have been accurately presented as intangible asset • Related information about accounting policy and amortization should be disclosed in the notes

b) The announcement to close down some of the smaller stores

(10 marks)

Matters to consider		Evidence
1	As the amount relating to impact of closures has not been determined, it is not possible to assess whether it is material or not. However, given the number of closures and the over 100 job losses expected, the impact of the closures should be expected to be material.	• Accordingly, it should be expected that more sufficient and appropriate evidence should be obtained.
2	The anticipated closure was announced publicly as a formal plan to do so on 24th February 2012. This announcement created an obligating event to make provision in accordance with *IAS 37, Provisions.*	• Review and discuss with management. Management should determine and compute relevant amounts in accordance with IAS 37. • Review board meetings for management's plan relating to the stores closures and review the public announcement made by the

		management in respect of these closures • Ascertain that a provision can be made in accordance with IAS 37.
3	The provision should be made taking into account the job losses and other closure costs incurred and expected to be incurred, that have not been accounted for yet	• Obtain schedule of estimated costs included in the provision to verify that only those closure and job loss related costs have been included • Re-compute to verify accuracy and allocation
4	IAS 37 prescribes disclosures and other information that should be provided under such provisions	• Review the disclosures made in the financial statements to ensure that they are complete, accurate and in accordance with IAS 37.
5	The non-current assets associated with the stores that are to be closed should be subjected to impairment reviews and any impairment computed and accounted for in accordance with *IAS 36, Impairment*	• Obtain a schedule of non-current assets associated with the stores that are to be closed and discuss the results of any impairment reviews carried out by management on them. • Re-compute the actual amount and determine whether properly allocated and accounted for in accordance with IAS 36
6	It should be expected that some of the closure costs will be incurred after the year-end	• Inquire and review post year end costs incurred in respect of the closures to assess whether they are in line with management's estimates. • Obtain a management representation from in respect of the provision and verify adequate and complete.
		•

4) Discuss the reporting issues raised by each of the following matters, stating clearly the possible implications on your audit report on PaB Ltd:

a) Other information (10 marks)

The differences in the ratios computed based on the published annual report constitute a material inconsistency as they are concerned with the overall performance and financial position of PaB. According to ISA 720 *The Auditor's Responsibilities Relating to Other Information in Documents Containing Audited Financial Statements,* a material inconsistency is a statement in the unaudited reports that contradict and therefore undermine the contents of the audited financial statements.

The auditors should determine if the audited accounts or the published information needs amending. The auditors should seek to resolve the matter with those charged with corporate governance.

If, upon further examination, amendment is necessary to the audited financial statements and the entity refuses to make the amendment, the auditor should consider the implication on the audit opinion and whether a modification is necessary. If so this would usually be in the form of a qualified opinion.

If, however, the other information is incorrect and the entity refuses to amend it then, the auditor should consider including an **Other matter paragraph** in the audit report describing the inconsistency.

b) Provision for warranties (10 marks)

The amount of the warranty provision represents 5.4% of profit before tax (500/9,200*100%) and is 0.4% of total assets (500/115,000*100%). It is therefore material to profit but appear not material to total assets.

Under IAS 37 Provisions, contingent liabilities and contingent assets, a provision should be recognised if an entity has a present obligation as a result of a past event, it is probable that a transfer of economic benefits will be required to settle, and a reliable estimate of the amount can be made.

It will be necessary to consider how management has arrived at the figure of K978 million and whether the conditions required by IAS 37 have been met, taking into account potential increase from other products on which guarantees are provided. It should also be considered as to whether the provision has been set up with a view to window dressing the accounts, as the over provision is excessive.

As management has refused to adjust for the overprovision, a qualified (except for) would be issued in respect of this overprovision

c) Non-current assets held for sale (10 marks)

During the initial six month period, the market conditions that existed at the date the assets were classified initially as held for sale deteriorated and, as a result, the assets are not sold by the end of that period. BSC actively solicited but did not receive any reasonable offers to purchase the assets and, in response, reduced the price. The assets continued to be actively marketed at a price that was reasonable given the change in market conditions. Accordingly, the assets should be classified as held for sale during that period as the criteria as prescribed by IFRS 5 seemed to have been met

However, by the end of the year, market conditions deteriorated further, and the assets were still not sold and they continued to be marketed at prices in excess of their current fair value. In that situation, the absence of a price reduction demonstrates that the assets were not available for immediate sale. Accordingly, the assets should be reclassified as held and used and should be accounted for in accordance with IAS 16, *Property plant and equipment.* Depreciation of K124 million (620 * 20%) should be provided and the assets reclassified under non-current assets.
Although the 124 million is not material, PaB would not have complied with IAS 16 and IAS 1. On this basis, the audit report may be modified with an except for opinion for non compliance with the appropriate reporting framework.

SOLUTION TO QUESTION TWO
ELITE BOATS LIMITED (EBL)

SECTION A

Question (1)

a) **Identify and explain the ethical and other professional issues from each of the issues highlighted in the working paper**
b) **Recommended action to take**

	(a) Ethical and Professional issue	(b) Action to be taken
1)	**The ethical issues are those of independence and professional competence – Self interest and Self review threat** Professional guidelines permit the provision of accountancy services (prohibited for public entities) to private companies provided certain safeguards are put in place. However it is important that the service does not require the practice of making management decisions on behalf of the client. It is also possible that additional fees arising from the service may place KiLN too dependent on ELB	A fundamental ethical requirement is that if Sarah is to be assigned to this assignment, she must be competent to provide the required and should not be involved in the audit. The resulting fee increase should be reviewed to ensure that the total fees are within the 15% guideline threshold.
2)	**The ethical issue is that of confidentiality** Professional guidelines provide that the auditor is not allowed to divulge information obtained during the audit to a third party without the consent of the client. There are exceptions to this rule where the auditor is obliged to report to a third party and where the auditor can volunteer information.	The appropriate course of action would be for Sarah to draw the matter to the attention of the senior manager who should attempt to persuade management of ELB to take corrective action. As the tax authority is not one of the exceptions allowed by the profession, the matter should not be reported to ZRA. However future associate with EBL should be seriously considered if EBL insists on not taking corrective action.
3)	**The ethical issue here is one of gifts and Hospitality – self-interest** Professional guidelines provide that acceptance of gifts should be based on the firm's practice	The gift should not be accepted as it appears immodest (six tickets) and is outside the normal courtesies acceptable by profession rules

	management policies and procedures, as well as taking into the account the value, timing and intended purpose of the gift. The tickets are too many for one person and ELB is not in the business of providing tickets. Accordingly, acceptance of the tickets may give the impression that Sarah had not been impartial in performing her duties or that, in future, her objectivity may be questionable. .	
4)	**Outstanding fees and independence – self interest** Fees outstanding for longer than one year become non-current liabilities and strictly should be treated as a loan. This creates a financial interest and KiLN may be seen to desire to continue as auditors of ELB in order to collect fees owed.	A discussion should be held with EBL to explain the implications of outstanding fees both as a practice management and auditor independence issue. KiLN should consider rejecting future appointments if these fees are not settled in time.
5)	**The ethical issue here relates to intimidation –** Intimidation form client threatens the independence of KiLN. This situation is likely to degenerate into disputes between KilN and EBL. Such disputes will greatly undermine the appearance of objectivity.	Any intimidation breaks down the professional relationship that should exist between the client and the auditor. KiLN may need to seriously consider resigning from the audit.

Question (2)

a) Business Risks
b) Related financial statement risks

	(a) BUSINESS RISKS	**(b) RELATED FINANCIAL STATEMENT RISKS**
1	**Specialised market** EBL operates in a rapidly changing industry with constant product developments. They may not have the resources or expertise to keep up with the pace of change and development.	There is a possible risk of overstatement of inventory and work-in-progress where products become superseded as their net realizable value is more likely to be lower than cost. In the extreme, this could lead to going concern issues.
2	**Complex manufacturing process** EBL will have a combination of raw materials, work in progress and finished goods in inventory.	The calculation and valuation of work in progress and finished goods is likely to be subject to error and possible overstatement
3	**Plans to list on the stock exchange** The directors may have a greater incentive to window dress the financial statements to show a more	Such window dressing may result in overstatement of revenue, understatement of expenses, understatement of liabilities and overstatement of assets

	favourable position in order to increase proceeds to be generated from floatation	
4	**Overdraft facilities** Failure of the bank to provide overdraft facilities may increase the risk of failure for the overseas venture.	It is possible that EBL management may be under pressure to present financial statements in best light possible leading to manipulation and misstatement of assets, liabilities, incomes and expenses.
5	**Overseas markets** The new venture overseas may not be successful as the market attractiveness and potential may have been overestimated.	Accounting for foreign currency transactions involve complex rules of translation and may lead to increased error and misstatement
6	**Investment in the development of products – Research and Development** In order to maintain and sustain its competitive position in this industry, EBL is expected to make significant investments in the development of its products and in building its brands. There is no guarantee that these developments will always materialize into commercially viable products.	EBL will be faced with the challenge of distinguishing between research and development expenditure. For development expenditure to be capitalized it must meet the criteria specified in IAS 38, *Intangible Assets*. It is possible that some of the expenditure may be wrongly capitalized leading to overstatement of non-current assets.
7	**Development products – Amortisation and Impairment** IAS 38 requires that intangible assets with a definite economic useful life should be amortised. It is not easy to estimate accurately the useful economic lives of new products and related assets.	There is financial statements risk that these assets may be misstated due to inaccurate estimate of useful economic lives.
8	**Human resources and intellectual capital** EBL, like other firms in this industry has a great deal of human and intellectual capital based on years of experience. This intangible asset is very transient in nature and may not be easy to sustain.	EBL may be tempted to capitalize this expenditure contrary to accepted accounting principles, especially the definition of an asset. Capitalisation of this expenditure will lead to overstatement of assets.

9	**Dependency on one supplier** The work carried out by UPL represents the single most significant cost item in each boat. EBL's customers demand that their engines are prepared by this supplier. UPL is therefore able to seize a great deal of value and reduce EBL's profits.	In the worst case scenario, EBL could have going concern problems if UPL were to stop dealing with them as EBL may face difficulties in selling their boats.
10	**Customer behavioral change due to recession and existing of substitute products** Customers in this industry are now bargaining over the price of their boats. This represents a change in behaviour apparently driven by recession and a consequent unwillingness to spend freely. This has led to a fall in EBL's profitability	This has led to an apparent fall in the profitability of EBL. The recession may drive customers to seek less luxurious goods and opt for basic needs and services. This may cast doubts on the going concern of EBL. Unless the going concern position of EBL is sufficiently evaluated, this may lead to material misstatement as financial statements may need to be prepared on a break-up basis.
11	**New supplier of springs** The new supplier may not deliver the right quality of springs or at the right time.	Ultimately this could increase the risk that inventory is overstated due to poor quality springs leading to reduced selling prices.

SECTION B

Question (3)

In relation to the request for a due diligence on UPL

(a) Steps to take before accepting the assignment

I. Perform Client screening Procedures

As KiLN has been associated with this client, detailed client screening may not be necessary. In any case, the fact that KiLN has accepted to be auditors suggested that EBL is assessed is an acceptable client to be associated with. It will still be necessary to consider whether there are any other concerns relating to the planned acquisition of UPL that should be taken into account

II. **Review Objectivity and independence status**

Provision of a due diligence service is effectively provision of other services. This brings about the following potential threats to the objectivity and independent position of KiLN:

- Self interest threat arising from possible undue dependence on EBL. This additional service will generate additional income that may bring the total fees receivable from EBL above the 15% threshold

- Familiarity threat arising from increased association and interaction with the same client. This may lead to erosion of professional skepticism

III. **Consider Professional competence - Ability to perform**

KiLN is required to accept professional appointments for which they have the ability to perform and have requisite professional knowledge and skill. KiLN should evaluate their ability with regard to this due diligence appointment

IV. **Agreeing terms of engagement- Engagement Letter**

KiLN should the terms of the due diligence assignment with the management of EBL before commencing the assignment. The contents of the engagement letter are expected include:

- The objective of the due diligence assignment
- The responsibilities of KiLN
- The responsibilities of EBL management
- The basis upon the fees will be charged
- Any arrangement concerning the use of other personnel such as experts.

V. **Agreeing type of report**

Unlike the statutory audit report which is standardized, the content and format of the due diligence report may depend on the requirements of the client.

(b) Using the information obtained from the Motor Trade association, undertake an analytical of UPL and comment on the implications of its performance as an acquisition target. (10 marks)

<u>Analytical review – Performance analysis</u>

Measure	Industry Average	UPL
Average pre-tax profit margin	4.3%	$\frac{1,900}{24,550} = 7.7\%$
Average pre-tax return on capital employed	11.2%	$\frac{1,900}{(1,000+9,600)} = 17.9\%$
Average receivable days	65 days	$365 * \frac{1,460}{24,550} = 22$ days
Average payable days	28 Days	$365 * \frac{2,440}{13,980} = 64$ days
Average revenue per employee	K1,285 million	$\frac{24,550}{8} =$ K3,068 million

<u>Comments</u>

Most of the value offered by numerical analysis comes from making comparisons, either with similar companies or with preceding periods. In the absence of prior period information, it is impossible to discern all the significant trends. However it is possible, though limited, to perform a comparative review using the industry average information provided.

Comparison with the industry

Profitability – Pre-tax Return on Capital Employed (ROCE) and pre-tax profit margin

In those performance figures for which we have industry comparators, it is clear that UPL is outperforming the industry average by a comfortable margin. Pre-tax ROCE is over 50% higher, while pre-tax profit margin is almost 80% higher. Also revenue per employee are 2.4 times the industry average respectively.

These figures fit well with EBL view that UPL makes as much profit from an engine as EBL does from complete boat. UPL is not only creating a high level of value through skills of its employees, its strong bargaining position allows it to extract even more value from its downstream link to the customer, EBL

Receivable and Payable days

At 22 and 64 respectively, stand the industry averages, 65 and 28, on their heads. UPL does not appear to be a company that is likely to have difficult in paying its bills as they fall due. Rather, it seems likely that its bargaining power both as a supplier and as a purchaser enables it to follow a very aggressive cash management policy, using cash from its purchases and credit from its suppliers as significant contribution to its working capital

UPL receives engines from EBL for modifications and performance upgrades. This may well involve the installation of very expensive components and sub-assemblies. Whether bought-in or made in house, these are likely to be produced in small batches; the batch sizes will be the result of a reasonable compromise between production and inventory costs. Delivery of bought-in-items is also likely to be subject to long lead times. Both of these factors will lead to rather higher inventory than might be achieved in more routine manufacturing.

Other observations

UPL's overall high performance is further indicated by its relationship with EBL. UPL dominates this relationship, refusing to enter into an exclusive contract to supply EBL or even to negotiate over price. It can do this because of the esteem in which it is held by EBL's customers. This esteem is indicative of highly effective marketing of the kind that is based on personal recommendations and a reputation for consistently high quality. The UPL brand is a very valuable asset and very solidly based.

Question 4

(a) Explain whether the event is adjusting or non-adjusting according to IAS 10 Events After the Reporting Period, stating clearly the accounting treatment applied (8marks)

According to IAS 10, *Events After the Reporting Period*, an adjusting event is an event that provides additional information relating to the conditions existing at the end of the reporting period and require that such events should be adjusted for. On the other hand, a non-adjusting event does not provide additional information relating to the conditions existing at the end of the reporting period, and does not require adjustment but may not to be disclosed if material

Event 1

The discovery of faulty springs after the year provides additional information relating to the valuation of the pumps that existed at the year end. Accordingly, the value of pumps sis overstated and should be reduced to the lower of cost and net realizable value in accordance with IAS 2, *Inventories.* An adjustment for this decrease in value must be in the financial statements.

Event 2

The release of the dye occurred after the year-end of the reporting period. This event could not be foreseen at the reporting and therefore does not provide additional information relating to the conditions existing at the reporting date. It is therefore a non-adjusting event and no adjustment should be necessary

However the investigation by the Environmental Council of Zambia (ECZ) could result in a legal claim against the company for illegal pollution. If this is considered material, it will need to be disclosed

(b) Explain relevant audit procedures and actions that should be carried according to ISA 560 (Redrafted) Subsequent Events.

(12 marks)

Event 1

Audit procedures should include:

- Obtain documentation from the insurers confirming their estimate of the value of the pumps and that no further insurance claim can be made for the loss in value
- Contact lawyers/administrators of the spring supplier to confirm no refund can be expected for the defective springs
- Obtain the amended financial statements and ensure that the directors have included K225 million as at the end of the reporting period and that the year-end value of inventory has been decreased to K225 million on the statement of financial position, statement of financial position note and the income statement
- Review inventory lists to ensure that the defective springs were not used in a any other pumps and that further adjustments are not required to any other inventory
- Obtain additional management representation point confirming the accuracy of the amounts written-off and confirming that no other items of inventory are affected
- Finally, assessing the effect on the audit opinion after the decision of the directors regarding the inventory value is known. A qualified opinion may be required where appropriate adjustments are not made to the financial statements.

Event 2

Audit procedures should include:

- Obtain any documentation on the event, for example board minutes, copies of environmental legislation and possibly interim reports from the Environmental Council of Zambia to determine the extent of the damage

- Inquire of the directors whether they will disclose the event in the financial statements
- If the directors plan to make disclosure, consider, whether disclosure is necessary and inform the directors accordingly
- Where disclosure is not made and the auditor considers disclosure is necessary, modify the audit opinion on the grounds of disagreement and explain the reason for the qualification in the report. This will be for lack of disclosure (not provision) even though the amount cannot yet be determined
- Alternatively, if the auditor considers that the release of the dye and subsequent fine will affect ELB's ability to continue as a going concern, the matter will need to be drawn to the attention of the readers/members in an emphasis of matter paragraph.