QUESTION ONE

BACKGROUND

J&S Associates was established in Zambia over 10 years ago by Mrs Josephine Seyabu, who is the Managing Partner. Her husband, Mr Francis Seyabu is the Finance and Administration Manager. The two have maintained strong control over the firm.

The firm, which is registered with ZICA, offers quality procedural audits at low fees and this has worked very well. However, this procedural approach is proving to be expensive and is eroding the firm's margins, amid increased competition.

J&S Associates has three offices, in Livingstone, Lusaka, and Ndola. Each office is headed by a Partner, followed by two managers and six complimentary and supportive staff.

Mrs Josephine Seyabu and her husband have an office in Lusaka, with an accountant, secretary, messenger and driver. They rarely interfere with the day to day operations of the offices but normally focus on giving the required strategic direction and control. To maintain quality delivery, however, Mrs Josephine Seyabu periodically reviews working papers on a selective basis.

Mrs Josephine Seyabu is currently considering the following issues:-

i) Strategic alliance with K international;

ii) Reviewing the selected working papers for:

   a) Duda Plc,

   b) Zondi Ltd,

   c) Serge Ltd.

STRATEGIC ALLIANCE WITH K INTERNATIONAL

Mrs Josephine Seyabu strongly believes the declining profitability can be addressed by networking with reknown international auditing firms. She recently exchanged e-mails with one of the Partners of K International.

At this stage, the suggested strategic alliance is only known by Mrs Josephine Seyabu.

K International mainly operates in the northern part of London and was established 40 years ago. It has offices in over 32 countries including Zambia, and has developed a strong international brand name. The firm has over 50 highly skilled and experienced partners and offer both audit and non-audit services. The Zambian office is situated in Lusaka at ZBAC House, along Cairo road. It is headed by Mr Francis Seyabu's brother, Mr Luke Seyabu.

The partners of K International recently met in London to discuss the performance of the entire firm. The prolonged economic downturn especially in Europe has had an adverse effect on the firm's profitability. The partners are unanimously agreed on establishing a strong presence in Africa. The idea is initially to permit the Zambian International office, network with another local firm to enhance capacity and attract larger more profitable clients.

K International is generally seen as an ethical organisation and recently declined audit appointments in 5 companies citing ethical reasons.

You are one of the partners in J&S Associates and Mrs Josephine Seyabu has given you the following e-mails:-

i)

> To: Ken, K International
>
> From: Josephine Seyabu, J&S Associates
>
> Date: 25th March, 2013
>
> Subject: Strategic Alliance
>
> Ken, we are currently exploring ways of networking with reputable firms like yours. We are aware that your Zambian office audits a competitor to one of our clients (Bendu Plc). They also prepare Financial Statements for one of our audit clients (Umoyo Ltd).
>
> In January 2013, your Zambian office performed pension valuation for one of our clients. Their performance was commendable and the company has requested them to continue offering valuation services, especially in specialised areas.
>
> It seems the scope for cooperation already exists and we must take advantage of this to benefit both of us and improve profitability.
>
> I am having a meeting next week with all the partners and your urgent response will be highly appreciated. A formal expression of interest from yourselves will be required to enable us offer more information.
>
> Regards,
>
> Josephine.

ii) To: Josephine Seyabu, J&S Associates

From: Ken, K International

Date: 28th March, 2013

Subject: Strategic alliance

Josephine, thanks for your e-mail regarding the above mentioned. We welcome your proposal and are interested in proceeding further.

You are right that a number of common areas already exist between yourselves and our Zambian office. You will be delighted to know that one of our partners sit on the board of Zondi Ltd and is also a member of the national pension fund, which holds significant shares in Duda Plc.

We also confirm that we have been asked to offer evidence as an expert witness in a case involving one of your clients. Our Zambian office has been auditing Bendu Plc for over 6 years, and during a recent Annual General Meeting of Bendu Plc, we were reappointed as auditors for 2013.

Your e-mail came at the right time and was extensively discussed at our performance review meeting held in London recently. As a way of progressing the matter further, the partners want a bit of detail on the following:-

a) the commercial reasons for seeking such an alliance,

b) any ethical and professional issues arising, including

c) auditor liability implications.

Thanks, we look forward to your quick response.

Ken.

DUDA PLC

Duda Plc has been an audit client for the past 5 years. It got listed on the Lusaka Stock Exchange this year (2013). You have been the reporting partner for all the 5 years and you have continued to act in the same capacity for the year ended 31st December, 2013.

The draft Financial Statements show total assets of K18 million (2012 K16 million). The audit manager has made the following comment in a summary of one of the issues for your review:

"Duda Plc's Financial Statements show prepayment under receivables classified as a current asset with a value of K50,000. The only evidence we have requested and obtained is a written representation from management stating the following:

1) that the amount was an advance payment made to Alutuli Farms, which supplies vegetables to Duda Plc's canteen.

2) Duda Plc made the advance payment to ensure continued supplies to avert labour unrest.

3) Alutuli Farms is wholly owned by the Managing Director of Duda Plc.

4) Alutuli Farms has been a reliable supplier of vegetables and assurances have been received from the farm manager that deliveries will be made soon.

The prepayment was made in 2011 and no disclosure has been made about the same over the years, since it is considered immaterial.

Alutuli Farms do not prepare any books of account.

ZONDI LTD

The company's principal activity is selling second hand clothes. The draft Financial Statements for the year ended 31st December, 2012 show revenue of K900,000 (2011 K850,000), profit before taxation of K215,200 (2011 K198,100). The newly promoted audit manager has brought the following issues to your attention for review as directed by Mrs Josephine Seyabu:

a) Zondi Ltd owns a residential apartment above one of the shops. Until 30th June, 2012 it was let for K200 per month. Since 1st July, 2012 it has been occupied rent-free by one of the senior employees.

b) In May, 2012 the Managing Director dismissed the Chief Internal Auditor . The Chief Internal Auditor has since sued the company claiming K200,000 compensation. No reference has been made to this effect in the draft Financial Statements.

SERGE LTD

Serge Ltd is a company owned by the Chansa family. It supplies spares to the mining companies in Zambia. The manager responsible for the audit of Serge Ltd has brought the following issue to your attention:-

"On 1st January, 2012 Serge Ltd entered into a lease agreement with Spuuki Ltd, involving a second hand truck. This was meant to avoid the transport charges the company was incurring. The terms of the lease are as follows:-

A non-refundable deposit of K10,000 on inception;

Eight annual instalments of K20,000 payable in arrears

The fair value of the asset (equivalent to the present value of the minimum lease payment) on 1st January, 2012 was K150,000 and the asset has a useful life of 8 years.

The lease has been capitalised at fair value."

The manager has not been involved in any audit which includes any leasing transaction. He therefore needs detailed guidance on the leasing transaction for Serge Ltd.

SECTION A

1. Respond to the e-mail on behalf of Mrs Josephine Seyabu:

a) Explaining the commercial reasons why firms seek strategic alliances.

(5 Marks)

b) Clearly explaining ethical and other professional issues raised in the scenario regarding the strategic alliance. Your answer should outline the threats arising, any factors you have taken into account, and if relevant, any safeguards you could apply to eliminate or mitigate against the threats.

(24 Marks)

c) Commenting on the liability implications for network models, and stating whether the current status is sustainable given the current legal activity.

(3 Marks)

2. Explain the guidance given by ZICA to reporting partners when an audit client becomes a listed entity, and state briefly whether the guidance does address the practical challenges which exist in the Zambian context.

(3 Marks)

3.a) Suggest further audit procedures that should be carried out in respect of the prepayment recognised in the Financial Statements for Duda Plc as at 31st December, 2013 and discuss the quality control issues raised by the audit manager.

(6 Marks)

b) An audit firm's overriding desire for quality in the modern era necessitates the development and implementation of effective policies and procedures for ensuring excellence in its staff.

Explain the practical challenges faced in Zambia by auditing firms in this area.

(9 Marks)

Total 50 Marks

<u>SECTION B</u>

4.a) Comment on the matters that you should consider and state the audit evidence that you should expect to find, in undertaking review of the residential apartment for Zondi Ltd.

(11 Marks)

b) State how contingent liabilities should be disclosed in the Financial Statements.

(8 Marks)

c) Describe the audit work you will advise your newly promoted audit manager to carry out in order to determine whether the company will have to pay damages to the Chief Internal Auditor and the amount of damages and cost which should be included in the Financial Statements.

(6 Marks)

5.a) Distinguish between an operating lease and a finance lease.

(7 Marks)

b) Outline the key issues the auditor will take into account when considering fair value measurement.

(8 Marks)

c) List the audit issues you would consider when reviewing the working papers on leasing for Serge Ltd. (No calculations required).

(10 Marks)

Total 50 Marks

QUESTION TWO

BACKGROUND

You are a senior partner in Buumba & Co, a firm of ZICA accountants. Buumba & Co is a medium- sized firm which specializes in auditing milling and bakery companies. It also provides other non-audit services. It is fully licensed by ZICA.

The firm has two offices, one in Lusaka and the other in Kitwe. The Lusaka office services clients in Central, Western, Southern, Eastern, and Lusaka provinces, while the Kitwe office services clients in Copperbelt, Muchinga, North western, Luapula, and Northern provinces. Each office is headed by 3 partners and 6 managers.

You are the reporting partner responsible for the audit of Kafeka Milling Ltd and Rufina bakery. Both have been audit clients for several years. You are currently reviewing the following:-

a) The draft audit planning memorandum for Kafeka Milling ltd
b) Going- Concern status of Rufina Bakery ltd
c) New Alutuli farms' deferred tax
d) Current issues on E-commerce and the IAASB guidance on smaller audits.

KAFEKA MILLING LTD

Kafeka milling Ltd is a private company run by four brothers, Francis, Mathews, Luke and Abraham. The milling company was founded in 1970 by their father, Evaristo Mandembwe, who started life as a miner in Kitwe.

The company has undergone massive expansion using retained earnings, and funds provided by the Citizen Economic Empowerment Commission (CEEC). It also has a valid Zambia Development Agency (ZDA) certificate which entitles it to a number of tax incentives. The company has two manufacturing facilities in Lusaka and Kitwe respectively.

The Kitwe plant is an old plan which was renovated 3 years ago. The Lusaka plant is a modern manufacturing plant which was completed 2 years ago. It's capacity is twice the size of the Kitwe plant. However, due to intense competition in Lusaka, the plant had been operating at only 40% capacity up to mid 2011. This adversely affected profitability.

At the beginning of 2011, the eldest brother, Francis, who is the company's chairman and chief executive officer reluctantly agreed to a proposal by his three brothers to open a warehouse at Kasumbalesa border post, meant to facilitate exports into the Democratic Republic of Congo (DRC). The youngest brother, Abraham, who is a qualified chartered accountant with ZICA was tasked to oversee the project.

The Kasumbalesa warehouse was completed in June 2011 and has improved capacity utilization. This has had an impressive impact on profitability. The company now operates at 90% capacity and the profit in 2012 has increased by 600% compared to last year (2011). Almost 70% of the company's production is currently exported to the DRC.

The draft audit planning memorandum for Kafeka Milling, amongst other things, highlighted the following:-

1. A government official visited the Copperbelt province following complaints of mealie-meal shortage in spite of government's provision of cheap maize through Food Reserve Agency (FRA). He held meetings with various stakeholders, including millers, then proceeded to Kasumbalesa border post. He was surprised to see the number of trucks which were crossing into the DRC with bags of mealie-meal.

   On 31 August 2012, Kafeka Milling Ltd received a notice from government that it was under investigation, along with other milling companies for alleged collusion, smuggling, corruption and price fixing activities. The government has warned that if found guilty, significant financial penalties, including withdrawal of licence will be imposed on the company. The company has engaged 3 legal experts that are vigorously defending the case.

2. The company recently established an internal audit department to improve the governance framework within the company. A chief internal auditor has just been recruited. Management has asked him to establish appropriate governance structures as a matter of urgency. The general public and customers in particular are not happy about the reported investigations, which have been widely reported in national newspapers. At this stage, it is vital that the company regain public confidence and trust.

3. Last year, the accounting system and controls were assessed as strong. Management has confirmed that there have been no changes to the accounting systems and controls in the financial year. For this reason, we do not need to carry out walkthrough tests, compliance tests or even review of the documentation on our permanent audit file, on the systems and controls.

RUFINA BAKERY LTD

Rufina Bakery is one of the leading bakeries in Zambia. It started operating 15 years ago and recently underwent modernization using a bank loan and periodic excesses on bank overdrafts. The bank loan and bank overdrafts are secured on the company's current and non- current asset. The company recently applied for another loan but the bank put it on hold awaiting an independent review of the going concern status of the company.

Management has prepared the following summary for last 5 years (each ended 30 September):-

Statement of comprehensive income (Summary)

	2008	2009	2010	2011	2012
	K '000	K '000	K '000	K '000	K'000
Revenue	400	525	900	1460	1620
Costs of sales	310	500	822	1175	1346
Gross profit	90	25	78	285	274
Other expenses	53	28	120	180	203
Finance cost	5	12	63	97	121
Net profit/ (loss)	32	(15)	(105)	8	(50)

Statement of financial position (Summary)

	2008	2009	2010	2011	2012
	K '000	K '000	K '000	K '000	K '000
ASSETS					
Non- current Assets	110	170	680	740	700
Current Assets					
Inventory	90	183	200	315	470
Receivables	120	271	342	356	400
Total Assets	320	624	1,222	1,411	1,570
EQUITY AND LIABILITIES					
Equity shares	30	30	30	30	30
Retained earnings	184	169	64	72	22
Non- current Liabilities	-	-	600	600	600
Current liabilities Payables	66	362	433	574	702
Bank Overdraft	40	63	95	135	216
Total Equity and liabilities	320	624	1,222	1,411	1,570

NEW ALUTULI FARMS LTD

New Alutuli farms Ltd draft accounts for the year ended 31st December, 2013 show profit before tax of K2,000,000, total assets of K20,100,000 and a deferred tax balance of K229,800.

The following details have been provided:-

a) The rate of tax applicable to farming entities in Zambia is 10%.
b) At the period end, New Alutuli Farms Ltd has a combined harvester with a carrying amount of K15,120,000 and a tax base at that date of K8,400,000
c) The deferred tax balance in the draft accounts is for last year. No deferred tax adjustment has been made for the current period.

CURRENT ISSUES

The audit manager in charge of quality has been appointed by ZICA to present a paper on E-commerce and IAASB guidance on smaller audits.

The presentation will be made at a CPD workshop being organised by ZICA which will be held Livingstone. The workshop will take place a day before the Annual General Meeting.

She would like to have your thoughts on the two areas.

SECTION A

1. As a reporting partner, what can you use to notify fellow partners of the concerns emerging from dealings with clients, regulatory authorities or exchanges.

(2 Marks)

2. Identify and explain any fraud risk factors that the audit team should consider when planning the audit of Kafeka Milling Ltd.

(28 Marks)

3.a) Advise whether Kafeka Milling Ltd could be accused of engaging in money laundering according to "the prohibition and prevention of money laundering Act, 2001"

(4 Marks)

b) Suggest the basic elements that should exist in Kafeka Milling Ltd anti - money laundering program.

(6 Marks)

4.a) Advise the company on the appropriate governance structures to implement.

(6 Marks)

b) Discuss whether the recommendation of the audit manager not to carry out walkthrough tests, compliance tests or review of documentation on the system and controls is appropriate.

(4 Marks)

Total 50 Marks

SECTION B

5.a) Identify and explain, with supporting calculations, the factors which may indicate that Rufina Bakery Ltd may not be a going concern.

(15 Marks)

5.b) Suggest the enquiries which should be made and the procedures to perform in order to decide whether to make reference to the going concern status of Rufina Bakery Ltd, in the audit report on the financial statements.

(10 marks)

5.c) Discuss the different ways in which your audit report might refer to the going concern status of Rufina Bakery Ltd.

(6 Marks)

6.a) Identify the audit issues in New Alutuli Farms Ltd.

(4 Marks)

6.b) Suggest the audit procedures which should be performed in respect of the amounts relating to the deferred tax in the financial statement of New Alutuli Farms Ltd.

(4 Marks)

7.a) Discuss specific business risks which relate to E-commerce and outline the audit considerations to be undertaken when assessing the increasing risk of cyber incidents.

(7 Marks)

7.b) Advise the audit manager in charge of quality on the issues to be included in the presentation on the IAASB guidance on smaller audits.

(4 Marks)

Total 50 Marks

FULL AUDIT

SOLUTIONS

QUESTION ONE

SECTION A

1. To: Ken, K international
   From: Josephine Seyabu, J &S associate
   Date: 7th April, 2013
   Subject: Strategic alliance

Ken,

As you may be aware from our earlier correspondence, the main reason for seeking a strategic alliance with yourselves is primarily to address the declining profitability. However, we are also mindful of other benefits which may accrue such as:-

a. It is a quick way to grow
b. There can be synergistic gains e.g. through sharing assets, skills or knowledge.
c. Learning from each other etc.

We are also mindful that ethical and professional issues may arise from the proposed strategic alliance. Tabulated below are the relevant issues we feel might arise:-

Issue/(threat) arising	**Explanation**	**Factors considered**	**Possible safeguards**
i) Resistance by senior members of staff	The alliance (especially acquisition) may result in loss of control. The dilution in control may impact negatively on operations, including independence and quality.	Senior members of staff are likely to resist this strategy, and ensure it fails so that they maintain the status quo.	The suggested strategic alliance should no longer be a secret. All senior management must be informed and the benefits clearly explained, so as to win their support.
ii) Audit approach	The two firms are likely to have different audit approaches.	J & S Associates currently uses a procedural approach as opposed to the recommended risk-based according to International Auditing Standards (ISAs). Considering the size and experience of K International, it is likely that the firm uses the risk- based approach.	Plan for an early switch from procedural to the recommended risk based approach.
iii) Low fees	J & S Associate has a deliberate strategy off low- balling.	K International may be charging “premium” fees in line with their reknown brand name.	Discussions should be held to harmonize this, and quality should not be adversely affected.

iv) Retrenchment of staff	Some members of staff may not be required. Retrenchments may not be handled professionally.	Given the reduced profitability, the firms may not have resources to meet the separation package.	Engage an expert to advise on the legal and financial implications.
v) Cultural clash	"African" culture is likely to differ from "European" culture. This can also impact on ethics.	Work culture, attitude, time management, including reward systems are likely to be a source of conflict.	Engage employees in developing acceptable work culture, rewards system etc. A change agent may be required.
vi) K International's head of the Zambian office	The Zambian office is headed by Mr Francis Seyabu's brother, Mr Luke Seyabu. This may result in familiarity threat.	Both occupy very senior positions. Depending on how they relate to each other, the alliance could be positively or negatively affected	It may be advisable to transfer Mr Luke Seyabu to another office to ensure any possible negative impact (if any) is avoided
vii) Unethical behaviour	It appears the key driver for the strategic alliance for both firms is improving declining profitability. Pressure to turn around this picture may encourage firms to engage in unethical behavior.	This may be short-termism and in the long term, the alliance may not be sustainable, due to reputational risk.	A meeting of senior managers to incorporate other strategic objectives especially non-financial will be necessary. This must be held at the earliest possible time.

viii) Audit of competitor to Bendu Plc	Conflict of interest is likely to arise, since the “combined” firm will be auditing two competing firms. Objectivity and confidentiality may come into question.	Whether both clients will be comfortable with the strategic alliance is a key issue.	Ensure the strategic alliance is properly disclosed, and use separate engagement teams.
ix) Preparation of financial statements for Umoyo Ltd	This is likely to result in self-review threat.	Possible risk of “combined firm” not identifying any shortcomings in their own work for fear of penalty (either financial or reputational).	Use of different engagement teams, and avoid making management decisions.
x) Pension and other valuation services for audit client	Valuation services are highly subjective and this may result in self-review threat.	Materiality of the valuation to the financial statements is key	If material, the firm should not carry out the audit. However, if immaterial, the firm could use different personnel for the valuation and the audit
xi) Partner sit on board of client	The partner is likely to participate in management decisions and his objectivity may come into question.	Consider role performed in the company	Perform only secretarial, i.e. essentially administrative, otherwise there may be need to resign from the board.

xii) Member of national pension fund which holds significant shares in Duda Plc	This constitutes a self interest threat and may adversely affect objectivity	Materiality of the share holding	It may be advisable to resign position.
xiii) Role of expert witness	Request to offer evidence as an expert witness. Objectivity may come into question and this is likely to lead to advocacy threat.	Evaluate the risk involved especially reputational risk and objectivity.	Make disclosure to audit committee or possibly consider withdrawal from the engagement if risk to independence is too high.
xiv) Long association with Bendu Plc	Objectivity will come into question. This will result in familiarity threat.	Audit composition over the years.	If possible consider rotating senior personnel.

We are aware that several accountancy firms have also moved towards network models over recent years. This is where member firms are part of a larger structure, often sharing a name (or using a similar name) and professional resource. As part of a global network, member firms have been able to sell services based on the value and reputation of their global brand name. However, in recent liability cases, some network firms have claimed the network is not liable for negligence of an individual member firm even though they appear to be operating under the same brand.

It is possible that the network model may disappear or be modified in future years. The current situation where network firms advertise under one brand and then claim they are separate firms when things go wrong may not be sustainable given the outcome of current legal activity.

I hope all the issues have now been clarified. However, do hesitate to contact me, should you need further clarification. If there are no other issues, kindly inform me and start working on draft agreements. We should aim at finalizing this before the end of the second quarter.

Thanks,
Josephine

2.When an entity becomes a listed entity, the length of time the individual has served the client as key audit partner should be taken into consideration. If this is five years or less when the client becomes a public interest entity, the partner may continue to serve the client as key audit partner for seven years less the number of years already served. If the individual has already served as key audit partner for six or more years when the client becomes a public interest entity they may continue in that role for a maximum of two additional years.

In Zambia, most firms are small and rely on the reputation of some key person(s). Strict adherence to the above is not practicable. Other safeguards need to be considered e.g. using an independent partner to review work.

3.a)The following are the suggested further audit procedures:
i)Obtain the relevant document outlining the terms of the transaction.
ii)Discuss with management whether there are more transactions with Alutuli farms or other outstanding balances.
iii)Review the terms of the transaction, for any special conditions, and confirm classification is correct.
iv)Discuss recoverability of the amount with the managing director of Duda Plc and ensure a written representation is obtained from him.
v)Confirm that disclosure is in line with IAS 24.
vi)Ensure the managing director gives a specific date when the deliveries will be made or the amount refunded.
It is likely that the firm has poor quality control procedures. Related party transactions usually present a number of challenges. In a well planned audit, this is assigned to experienced members of the audit team. The chances are that over the years, junior members have been doing this work. The review of previous years were inadequate as it failed to identify the weakness of written representation as a source of evidence for the transactions and that materiality application to related parties is problematic. The transaction is likely to be material by nature and in most cases, only senior experienced auditor are able to think likewise. In Duda, the audit team considered materiality using valves, which was not appropriate [in this case **0.28%** ((50,000÷18,000,000) x 100%)].

3.b)Practical challenges faced in Zambia by auditing firms in ensuring excellence in its staff include:-

i)Recruitment - most auditing firms have weak recruitment policies. In some cases recruitment is not based on merit.
ii)Compensation - the compensation levels are not as competitive as they should be. Most clients cannot afford high audit fees, this in turn restricts the ability of audit firms to award competitive perks.
iii)Performance evaluation - this is normally used as an academic exercise and the results are simply used for salary adjustments. The evaluation in some cases is based on loyalty rather than performance.
iv)Promotion – in most cases, any vacancy which arises is usually advertised in the press, and outsiders with the required experience usually gets the job. This demotivates staff.
v)Career development - training budgets in most auditing firms are limited. Staff are indirectly made to use their own resources.

SECTION B

4.a)Matters to consider include:

i. Risk- the risk that the transaction is not adequately disclosed in the financial statements
ii. Materiality - challenges in applying materiality to the transaction
iii. Accounting treatment - IAS 24 requires related party transactions to be disclosed in the financial statements as they are material by nature

Audit evidence includes:

i. Title deeds to confirm rights and obligations.
ii. Rental agreement to confirm charge of K 200 per month.
iii. Written representation from the senior employee occupying the apartment.
iv. Physical inspection report to confirm existence.
v. Written representation by the directors of Zondi to confirm transaction and accounting treatment and disclosure is in line with IAS 24.

4.b) Contingent liabilities should not be recognized in financial statements but they should be disclosed. The required disclosures are:-

- i. A brief description of the nature of the contingent liability
- ii. An estimate of its financial effect
- iii. An indication of the uncertainties that exist
- iv. The possibility of any reimbursement.

4.c) The following are the audit tests to be carried out:-

- i. Obtain the chief internal auditor's contract of employment
- ii. Review the contract and if necessary obtain legal advice on the likelihood of the claim succeeding
- iii. Enquire from management on whether they have accepted the claim
- iv. If management has accepted the claim, then ensure that both legal costs and compensation are accrued.
- v. If management has not accepted the claim, then ensure only the legal costs are accrued. The claim should be disclosed unless legal advice indicates that the chief internal auditors chance of success is remote
- vi. Obtain written representation regarding the details relating to actual cases and other possible litigation disclosed.

5.a) A finance lease is a lease that transfers substantially all the risks and rewards incident to ownership of an asset. Title may or may not eventually be transferred.
An operating lease is a lease other than a finance lease.
IAS 17 identifies five situations which would normally lead to a lease being classified as a finance lease:-

- i. The lease transfers ownership of the asset to the lessee at the end of the lease term.
- ii. The lessee has the option to purchase the asset at a price sufficiently below fair value at exercise date, that it is reasonably certain the option will be exercised.
- iii. The lease term is for major part of the asset's economic life even if title is not transferred

iv. Present value of the minimum lease payments amounts to substantially all the asset's fair value at inception.

v. The leased asset is so sophisticated that it could only be used by the lessee without major modifications being made.

5.b)The key considerations the auditor will take into account when auditing fair value measurement are:-

i) the length of time any assumptions cover (the longer, the more subjective the value is)

ii) The number of assumptions made in relation to the item.

iii) The degree of subjectivity in the process.

iv) The degree of uncertainty associated with the outcome of events.

v) Any lack of objective data

vi) The timings of any valuations used

vii) The reliability of third party evidence

viii) The impact of subsequent events on the fair value measurement

5.c)The audit issues generally relate to financial statement risk, materiality and accounting treatment:

i. The key risk is the possibility of misclassification of the lease. Wrong classification will imply that the non-current assets and liabilities are overstated. The lease agreement will require a thorough review to ensure the classification is correct. The fact that the lease has been capitalized at fair value may be an indication that treatment as a finance lease may be correct.

ii. Materiality needs to be considered. As the truck is capitalized as a finance lease, the statement of financial position should include both a non-current asset and a liability. Total asset figures are needed to compute materiality. In addition, total profit figure will be required to determine the potential materiality of interest and deprecation charges.

iii. Accounting treatment- IAS 17 Leases, requires that a finance lease should be recorded in the statement of financial position of a lessee as an asset and an obligation to pay future lease payments. At the inception of the lease, the sum to be recorded both as an asset and as a liability should be the fair value of leased asset or, if lower, the present value of the minimum lease payments. Interest and depreciation charges should be recognized in the income statement.

For operating leases, the rentals should be written off as an expense on a straight line basis over the lease term even if the payments are not made on such a basis, unless another systematic and rational basis is justified.

Disclosures must comply with the requirements of IAS 17.

QUESTION TWO

SECTION A

1) The “risk alert letter”, which is a memorandum can be used to notify fellow partners of concerns emerging from dealings with clients, regulatory authorities, or stock exchanges. It ensures that:-

   i) Key audit risk areas are reviewed

   ii) Significant trends and irregularities are identified

   iii) Quality is maintained

   iv) Litigation risk is reduced

   v) Investor confidence is maintained, as it reduces manipulation.

2) The following are the risk factors that the audit team should consider when planning the audit of Kafeka milling Ltd.

Risk factors	Explanations
i) Domination of Management by a small group	- Kafeka Milling Ltd is basically a family company. This provides an opportunity to engage in fraudulent activities which may go unnoticed due to the high possibility of collusion among family members. Assets are likely to overstated and liabilities understated
ii) Nature of the industry	- Mealie-meal is the staple food of Zambia and therefore pricing is regulated. It is possible that the mealie-meal price could be below cost. In this case, the directors may overstate the profit, by valuing inventories at cost. IAS 2 states that inventories should be valued at the lower of cost and net realizable value
iii) Massive expansion	- It is likely that the massive expansion may not be matched by an improvement in the internal control components. This could mean that misstatements through fraudulent financial reporting and misappropriation of assets may go unnoticed
iv) Borrowed funds from CEEC	- Management is likely to be under pressure to meet the agreed financial targets. Hence performance may be exaggerated

v) ZDA certificate	- It is likely that the ZDA certificate could be misused. Management may try and use the certificate even for transactions which are unrelated to the business just as a way of accessing the stated incentives. This may result in an overstatement of assets due to the inclusion of unrelated assets over which the company has no control and expects no future economic benefit
vi) Intense competition	- This could place management under pressure to overstate performance and position of the company in an attempt to maintain investor confidence
vii) Significant increase in profit	- This could be as a result of under provision or non provision e.g. of receivable provision if any
viii) Kasumbalesa warehouse	- Kasumbalesa is a "porous" border post associated with rampant smuggling. The disclosures in the financial statements may not be balanced
ix) Investigations by the government	- It is possible that this may not be adequately disclosed. In addition, management may classify certain costs differently e.g. bribes to government official classified as travel expenses
x) Non-existence of governance structures	- Misappropriation of assets (e.g. cash) and fraudulent accounting (e.g. deliberate misapplication of accounting principles) may go unnoticed. It is unlikely that the newly recruited chief internal auditor has already addressed this

xi) Significant related party transactions.	- Since Kafeka Milling is a family business, it is likely that some related party transactions may go unnoticed e.g. they may not be identified or even if identified not all transactions will be adequately disclosed
xii) Possibility of large amount of cash on hand especially at Kasumbalesa	- Chances of cash being misappropriated or stolen are high, cash balances may be overstated in the financial statements.
xiii) Possibility of overriding controls.	- It is likely that management can override controls and in the process engage in fraudulent activities (e.g. banking some proceeds in a secret account to evade tax). This could result in revenue and bank balances being understated
xiv) Possibility of adverse relationship between the entity and employees.	- Most family businesses have poor relationships with employees. It is likely that employees in Kafeka Milling are not an exception. Demotivated employees can engage in misappropriation of assets (e.g. stealing inventory) and manipulating financial records in order to keep their jobs. Inventory may be grossly overstated, resulting in misleadingly high profits

3.a)The Act defines the crime of money laundering as:-

i) Engaging directly or indirectly in a business transaction that involves property acquired with proceeds of crime, or
ii) Receiving, possessing, concealing, disguising, disposing of or bringing into Zambia, any property derived or realized directly or indirectly from illegal activity or
iii) The retention or acquisition of property knowing that the property is derived or realized directly or indirectly from illegal activity.

The alleged collusions, smuggling, corruption and price fixing activates are all illegal activities and therefore clearly fall under the crime of money laundering. It is therefore likely that Kafeka Milling Ltd could be accused of engaging in money laundering.

3.b)The basic elements that should exist in Kafeka Milling Ltd's anti-money laundering program are:-

i) Dedicated resources
ii) Written policies and procedures
iii) Comprehensive coverage
iv) Timely escalation and resolution of matters
v) Explicit management support
vi) Sufficient training and education
vii) Regular review/audit of the program.

4.a)The appropriate governance structures to implement by the company are:-

i) Segregation between the roles of chairman and chief executive officer
ii) Non-executive directors – these should be employed on a part time basis and should not take part in the routine executive management of the company.
iii) Audit (and other) committees – members of sub-committees should be independent and knowledgeable.
iv) Internal audit - this should provide assurance on a number of issues e.g. the effectiveness of systems.
v) Risk management – this involves identifying potential risks and deciding on appropriate ways to minimise the risks.

b. The recommendation of the audit manager not to carry out walkthrough tests, compliance tests or reviews of documentation on the system and controls is not appropriate. ISA 315 "identifying and assessing the risks of material misstatement through understanding of the entity's internal controls" requires auditors to obtain an understanding of the entity's controls. Relying on last year's audit work and assurance from management is not recommended practice.

Audit work must be carried out this year to confirm that there are no changes as advised by management and the controls are still strong.

SECTION B

5. WORKINGS

Using the summaries of the financial statements provided for past 5 years, the following significant accounting ratios have been computed.

	2008	2009	2010	2011	2012
1. Gross profits margin (%)	22.5	4.8	8.7	19.5	16.9
2. Other expenses as a percentage of revenue (%)	13.3	5.3	13.3	12.3	12.5
3. Finance costs as a percentage of revenue (%)	1.3	2.3	7	6.6	7.5
4. Net profit margin (%)	8	(2.9)	(11.7)	0.5	(3.1)
5. Current ratio	1.98	1.07	1.03	0.95	0.95
6. Quick ratio	1.13	0.64	0.65	0.50	0.44
7. Gearing [Total debt÷ Total capital (%)]	15.7	24	88.1	87.8	94
8. Inventory days	106	134	89	98	127

9. Receivables days	110	188	139	89	90
10. Payables days	78	264	192	178	190

5.a)The factors which may be indicative that Rufina Bakery Ltd may not be a going concern are as follows:-

i) Normally, the gross profit margin is supposed to remain reasonably constant. The changes should minimal. Rufina Bakery Ltd's gross margin could be adversely affected by changes in the prices of raw materials e.g. flour, and possibly its inability to increase prices may be due political interference. The company could also be changing its suppliers given its bad payment record, as shown by the payable days. The present gross profit margin is insufficient to cater for the increased levels of expenses and finance costs.

ii) Other expenses have increased compared to last year though the increase is minimal (less than 2%). It will be advisable however, to further analyze the expenses in much detail so as to identify the levels of expenditure in key areas e.g. salaries and wages, training etc.

iii) The increase in finance cost is adversely affecting the profits available to shareholders. It is unlikely that the ordinary shareholders could be willing to invest more funds if called upon.

iv) The net profit margin has not been impressive. Out of the previous five years, 3 years have recorded losses. There is an urgent need to review this position and embark on a rigorous cost reduction programme.

v) The current ratio and the quick ratio have decreased by 52% and 61% respectively, over the last five years. The low liquidity ratios could mean the bakery is already technically insolvent and it's just a matter of time.

vi) Gearing has increased by more than 499% over the last five years. Equity has been reduced to a mere 6% of the total capital. The current levels of profitability and liquidity are grossly inadequate to sustain such high levels of debt. Management seem to be incapable of dealing with this situation.

vii) The inventory days, receivable days and payable days have increased by 30%, 1% and 7% respectively. The 30% increase in inventory may indicate poor inventory policy. Bakery products are generally perishables and having such a significant level of inventory may be indicative of deterioration in revenue, poor inventory control, expire or slow-moving inventory.

5.b) The suggested enquiries and procedures are as follows:-

i) Obtain the cashflow, profit and other relevant forecasts for next year.

ii) Analyse and discuss the forecasts with management to see if they suggest any improvement in the company's position.

iii) Obtain evidence to confirm whether the bank is prepared to continue supporting the company. If possible, arrange to meet the bankers.

iv) Examine correspondence files for a sample of payables to check whether they are putting pressure on the company to pay.

v) Analyse and discuss the entity's latest available interim financial statements.

vi) Discuss the situation with management and review any recovery plans which they may have in mind.

vii) Obtain appropriate management representations.

5.c)The different ways in which the audit report might refer to the going concern status of Rufina Bakery Ltd are as follows:-

i) The audit report would probably be modified by means of the inclusion of an "emphasis of matter" paragraph, highlighting the problem. This would only be possible however, if the matter were adequately disclosed in the financial statements.

ii) If the matter were not adequately disclosed in the financial statements, it might be necessary to issue an "except for" opinion, because the auditor would conclude that the financial statements were not free from material misstatement.

iii) An "adverse" opinion stating that the financial statement do not show a true and fair view at all because of the lack of disclosure might be necessary if we as auditors consider the matter to pervasive to the financial statements as a whole.

iv) In extreme circumstances, where it is clear that the company is not a going concern, and the financial statements are still prepared on a going concern basis, it would probably be necessary to issue an " adverse opinion"

6.a)The audit issues relate to financial statement risk, materiality and accounting treatment:-

i) Financial statement risks – the non-inclusion of the revised deferred tax liability could result in a misstatement of the profits and the liabilities. There is also a risk that the disclosures will be incorrect, and rate previously used was 15% while the correct rate to use is now 10%.

ii) Materiality - the adjustment of deferred tax would result in the following balances:-

Deferred tax liability	K 672,000 (W1)
Debit in the income statement	K 442,200 (W1)

The change in liability represents 21.1% of profit before tax and 2.2% of total assets and is material to both the income statement and the statement of financial position

iii) IAS 12 "income taxes" requires that deferred tax should be recognized as income or expense in the net profit/(loss) in the statement of profit/(loss). IAS 12 adopts the full provision method of accounting for deferred tax. IAS 12 requires deferred tax assets and liabilities to be measured at the tax rates expected to apply in the period when the asset is realized or liability settled based on the tax rates and laws enacted (or substantively enacted) at the end of the reporting period, hence IAS 12 requires the liability method to be used.

Workings

1.	K	K
Tax base of asset	8,400,000	
Carrying amount	15,120,000	
6,720,000 x 10%		672,000
Brought forward liability		229,800
Increase in liability		442,200

6.b)The audit procedures to be performed on the deferred tax amount include:-

i) Discuss with management why they have not adjusted the deferred tax balance and ensure they do so in line with the provisions of IAS 12.

ii) Obtain a copy of the deferred tax workings with supporting schedules detailing the carrying and the tax base figures

iii) Check the arithmetical accuracy of working and check that the tax rate used is 10%

iv) Consider the assumptions made in the light of your knowledge of the business and any other evidence gathered during the course of the audit to ensure reasonableness.

v) Agree the opening balance to the prior year financial statements.

vi) Review disclosure notes to ensure they are in line with IAS 12 provisions.

7 a)The specific business risks which relate to E-commerce are as follows:-

i) Loss of transactions integrity - E-commerce to a large extent relies on the integrity of the individual users.

ii) Pervasive e-commerce security risk - hackers do present a particular security risk.

iii) Improper accounting policies, for example, capitalization of website development costs - accounting for intangible assets normally creates problems.

iv) Non-compliance with tax, legal and regulatory requirements- it is easy to engage in tax evasion and other illegal activities since in most cases transactions leave no audit trail.
v) Over-reliance on e-commerce - any disruption in power supply can have disastrous effect on the company.
vi) Systems and infrastructure failures- these are a reality and most organizations do not have the capacity to adequately deal with systems and infrastructure failures.

The following are the audit considerations to be undertaken:-

i) Has management established an information and internet security policy?
ii) How does the entity identify critical information assets and the risks to these assets?
iii) Does the entity have cyber insurance?
iv) Is there a process for assuring security when linked to third party systems?
v) What controls are in place to ensure that employees only have access to files and applications that are required for their job.
vi) Are regular scans carried out to identify malicious activity?
vii) Are procedures in place to ensure that security is not compromised when the company's systems are accessed from home or on the road?
viii) What plans are in place for disaster recovery in case of an incident?

7.b)In general terms, the IAASB takes the view that "an audit is an audit", and that all audits should be conducted in accordance with the same auditing standards. In August 2009, the IAASB issued a question and answer publication, applying ISAs proportionately with the size and complexity of an entity, focusing on matters relevant to the audit of SMEs in the context of implementing the new clarity ISAs. The IAASB reiterated that the text of the ISAs is authoritative and must be followed, even in the audit of SMEs. However, the IAASB did state that the work that an auditor will need to do in order to comply with an ISA will vary- a small, simple entity being likely to require less work than a large and complex one. The auditor needs to use professional judgment in applying the ISAs, in order to determine the procedures that are necessary to comply with their requirements.

To take a specific example, the IAASB stated that the requirement in ISA 315 to obtain an understanding of the entity and its environment is relevant to smaller entities, but that because smaller entities are typically simpler it will be much easier to obtain this understanding.