Zambia Institute of Chartered Accountants

COMPETENCE PRACTICE EXAMINATION

PRACTISING CERTIFICATE

JUNE 2013

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 $2^1/_2$ 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. You name must NOT appear anywhere on your answer booklet.

7. This is an open book examination.

QUESTION ONE
KAWINA PARTS LTD (KAP)

BACKGROUND

Kawina Parts Ltd (KAP) was founded by the company chairman, Best Kawina along with the help of the Directors, his wife Connie Kawina and two sons, Pluto and Regis. The company is managed by the Directors and a management team which includes a Financial Controller, Chief Accountant, Purchasing Manager, IT specialist, General Manager, marketing Executive, Accountants, Stores Controllers, Human Resource Manager and Lodge Managers. The total number of employees in 2013 is 42

Established as a limited company in 1990, KAP has grown and positioned itself as one of the leading provider of spare parts to the motor industry with ten branches throughout Zambia. The biggest branch which houses the head office is located on Cairo road, Lusaka, the capital of Zambia.

The Ndola branch opened in 1998. This was followed by the Kitwe branch in 2000. The next branch to open was in the tourist capital of Zambia, Livingstone, in March 2003. Another branch opened in December 2007 in Makeni.

PROSPECTS AND PERFORMANCE

KAP intends to open other branches in Kapiri and Solwezi within the next year. KAP's aim is to have the Kawina brand of service excellence in all the provincial centres of Zambia. Information on the company's financial performance is available as follows:

STATEMENT OF INCOME FOR THE YEAR ENDED 31st MARCH 2013		
	KR'000 (DRAFT) 2013	**KR'000 2012**
Revenue	4,593	4,082
Cost of sales	(3,799)	(3,187)
	----------	----------
Gross profit	**794**	**895**

Administration costs	(500)	(476)
Distribution costs	(250)	(250)
	----------	------
Net profit	**44**	**169**
	========	=======
STATEMENT OF FINANCIAL POSITION AS AT 31ST MARCH 2013		
	KR’000 (DRAFT) **2013**	**KR’000** **2012**
Non-current Assets (at net book value)	1,800	2,250
Current Assets		
Inventory	650	915
Receivables	50	125
Cash in Hand	250	795
	---------	----------
Total Assets	**2,750**	**4,085**
	=======	=======
Capital and Reserves		
Share Capital	500	500
Accumulated profits	1,450	2,025
	--------	---------
Total Shareholder’s funds	**1,950**	**2,525**
Non-current liabilities	500	1,300
Current liabilities	300	260
	------------	------------
Total Equity and Liabilities	**2,750**	**4,085**
	=========	=========

The motor spare parts industry has recently become very competitive and has seen a moderate growth of 7% over the last year.

Additional information relating to the financial statements:

(i) Non-current assets mainly related to land and buildings. Ten delivery vehicles are owned with a net book value of KR150, 000. Four of these vehicles have been not been in use for the whole year.
(ii) One of the directors purchased a large farming estate situated in Mkushi during the year. This was partly financed by an advance from the company.
(iii) Each branch is responsible for its own planning and control. Acquisition is done centrally from head office
(iv) A computerized inventory control system was in introduced during the year. Inventory balances are now obtainable directly from the computer system. KAP operates a perpetual inventory system, with year-end full inventory counts undertaken at two branches selected on a random basis.

INTERNAL AUDIT

In order to monitor the effectiveness of internal controls at the various branches, Mr. Kawina has proposed that an internal audit department should be set up. This will consist of a chief internal auditor, one senior auditor and two assistants.

The financial controller will be responsible for recruiting all staff into the internal audit function. The chief internal auditor will be reporting to the financial controller and will agree the scope of work with him. It is expected that the internal audit staff will be spending 50% of their time carrying out internal audit assignments and 50% of their time working in the finance department.

The internal auditors will be given freedom to choose and follow standards in accordance with their professional training.

AUDITORS

Your name is Jani Bupe and you have been the manager responsible for the audit of KAP for the last four years. Given the perpetual inventory operated by KAP, it is your firm's practice to perform preliminary interim audits on selected revenue and expenditure items. You also use this opportunity to hold discussions with senior management on various issues raised in previous audits.

TRAINING AND DEVELOPMENT

As part of your training and development, trainee auditors are periodically required to report on their experience in the firm. Such reports are then used as a basis of quality monitoring and control. You have received the following e-mail from your senior partner, Norman Sepi.

To: Jani Bupe, Audit Manager

From: Norman Sepi – Senior Partner

Subject: Briefing report re trainee experiences

Please find attached **(attachment 1)** a report received from one of our trainees, Judith Bowa. As you know Judith joined our firm two years ago and she is one of the potential employees identified as a candidate for fast-track development.

Attachment 1

I have only worked on two audits prior to being assigned to the audit team of KAP. I was expecting to attend a meeting at the start of the audit, where the partner and other senior members of the audit team discussed the audit, but no meeting was held. In addition, the audit manager has been away on holiday for three weeks, and left a senior in charge. However, the senior was busy with other assignments, so was not always available.

I was given the task of auditing the non-current assets, with disposals during the year. I also attended the inventory count at the two branches, which was quite complicated, as KAP's inventory system is still in the process of being fully developed and implemented. I tried to be as useful as possible during the count, and I helped some of the client staff count some of the spare parts. As I had been to the inventory count, I was asked by the audit senior to challenge the finance controller regarding the adequacy of the provision against inventory, which the senior felt was significantly understated.

Lastly we found that we were running out of time to complete our audit procedures. The audit senior advised that we should reduce the sample sizes used in our tests as a way of saving time. He also suggested that if we picked an item as part of our sample for which it would time consuming to find the relevant evidence then we should pick a different item which would be quicker to audit.

It is clear from this report that we need to improve our management of audits, with special attention paid to quality control.

Regards,

NS

OTHER MATTERS ARISING

a) Purchase of vehicles

During the audit of property, plant and equipment it was discovered that controls over capital expenditure transactions had deteriorated during the year. Authorisation had not been obtained for the purchase of some office equipment for KR9, 000. No material errors in the financial statements were revealed by audit procedures performed on property, plant and equipment.

b) The Kawina Brand

Mr. Kawina has spent a lot of time and effort in creating and selling the "Kawina" brand. For the year ended 31 March 2013, the "Kawina" brand was estimated at KR100, 000 and is included in non-current assets in the statement of financial position. Audit working papers show that the matter was discussed with the financial controller, who stated that the KR100, 000 represents the present value of future cash flows estimated to be generated by the brand name and should be included as an asset.

c) Inventories

Problems were experienced in the audit of inventories as follows:

- Your firm did not receive a copy of inventory counting procedures prior to attending the count at the two branches and this caused some delay in undertaking the inventory counts
- It took two weeks for the information relating to the final inventory valuation to be provided to your firm because the accountant who had prepared them had misled them
- When the inventory valuation was finally presented, it was discovered that some of the items counted had been omitted

d) Typing financial statements

The finance director of KAP has requested that your firm type the financial statements in a suitable form to be presented to shareholders at the forthcoming company general meeting. The finance director also commented whether your firm can be allowed to use a liability disclaimer in your audit report.

e) Market share

You have noted that included in the financial statement is the chairman's statement which asserts:

"KAP has now achieved a position as one of Zambia's largest spare parts supplier to the motor industry, with a dedicated commitment to accountable and ethical professionalism."

However publicly available information shows that there are at least seven spare parts suppliers to the motor industry in Zambia which are at least four times the size of KAP in terms of both annual revenue and market share. The chairman is of the view that his statement should not be taken seriously as it has no impact on the financial statements.

Requirements:

SECTION A – 50 MARKS

1) Identify and explain the ethical and professional concerns regarding the management of the audit of KAP for the year ended 31st March 2013. (15 marks)

2) With regard to the planning of the audit of KAP's financial statements for the year ended 31st March 2013, prepare a planning memorandum that should include:

   a) Your determination of indicative planning materiality, including justification (10 marks)
   b) Your identification of audit areas with higher risk of misstatement (18 marks)
   c) Your audit approach and extent of control testing on the inventory system (7 marks)

SECTION B – 50 MARKS

3) It is common practice for auditors to issue a management letter to those charged with governance
   a) Identify the main purpose of including "findings from the audit"(management letter points) in a report to those charged with governance (3 marks)

   b) From the audit of KAP Ltd:
      i) Recommend the matters that should be include as findings from the audit in your report (4 marks)
      ii) For each matter, explain the reason for its inclusion (8 marks)
      iii) For each matter, explain the impact on your audit report (8 marks)

4) With regard to the request to type financial statements and use of a liability clause

a) Discuss the ethical issues raised by the request for your firm to type the financial statements (4 marks)
b) In the context of a standard unmodified report, describe the content of a liability disclaimer paragraph and discuss the main arguments for and against the use of a liability disclaimer paragraph (8 marks)

5) Evaluate the effectiveness of the proposed internal audit function at KAP Ltd and advise how KAP should proceed with the setting up of the internal audit department (15 marks)

SUGGESTED SOLUTIONS TO QUESTION 1

SECTION A

1) Ethical issues

The comments made by Judith Bowa indicate that the audit has not been properly planned or supervised. Both ISQCI *Quality Control for Firms that Perform Audits and Reviews of Historical Financial Information and Other Assurance and Related Service Engagements*, and ISA 220 *Quality Control for Audits of Historical Financial Information* provide guidance in this area. There are many indicators of poor quality control which are evaluated below:

(i) No audit planning meet was held at the start of the audit

A meeting is important as this where the audit partner should direct the audit assignment by explaining to the members of the audit team their responsibilities, the nature of the client's business, and significant risk or fraud indicators identified, and the detailed approach to the audit. If no meeting is held at the start of the audit, then it is unlikely that members of the audit will understand the audit strategy, the objectives of the work they have been asked to perform or how tasks have been allocated amongst members of the team. The audit partner should lead the meeting, as it is their responsibility to ensure that the audit is directed, supervised and performed in accordance with professional and regulatory standards

(ii) Audit manager and supervisor are not always available

All audit assignments should be properly supervised. In the absence of a manager and supervisor, the more junior members of the audit will not be able to resolve problems which arise, and the longer there is a lack of supervision, the more problems will accumulate. Without supervision, the audit plan may not be properly followed, and inappropriate modifications may be made to audit program.

(iii) Junior was given the tasks of auditing non-current assets and inventory

It seems that audit work was not properly delegated amongst members of the audit team. An inexperienced audit junior should not be given relatively complex procedures to perform. Both non-current assets and inventory can be challenging to audit, and involve the use of judgment (For example impairment considerations and estimation of net realizable values). In addition, a new inventory system has been put in place. It is unlikely that a junior who has only been on two audits will have enough knowledge and experience to fully understand the complexities of the accounting and auditing issues involved. Tasks associated with non-current assets and inventory should be allocated to a more experienced member of the team, leaving more straight forward tasks for the junior.

(iv) Junior helped with the count procedures during the inventory count

The junior did not understand the objectives of the inventory count. Test counts should have been performed by the junior, in order to gather audit evidence for the completeness and existence of the inventory items, but members of the audit team should not "help-out" the client's staff with counting. Instead, the junior should have observed the client's staff and assessed whether the count was being performed in accordance with count instructions.

(v) Junior asked to challenge the finance director

It is not appropriate for an inexperienced junior to challenge a senior member of client's management. Contentious issues should be discussed with the client by the audit manager or partner, as they have a more appropriate level of authority and will be in a better position to explain why the provision is considered to be inadequate. This is an inappropriate delegation of tasks within the audit team

(vi) Inadequate time to complete necessary audit procedures

It seems that either not enough time was allowed to complete the necessary audit procedures, or that in the absence of much direction and supervision, the audit procedures have been performed inefficiently. One of the key aspects of supervision is to keep track on the progress of the audit engagement. The audit plan should initially determine appropriate timescales and deadlines, and if it transpires that more time is needed, this should be discussed with the client.

(vii) Modifications to planned audit procedures

The audit procedures were changed in response to lack of time. It is not acceptable to cut corners by reducing sample sizes or changing the items selected for the sample. Modifications should be discussed by senior members of the audit team, and should only occur for genuine reasons. The danger is that reduced sample sizes or changing the items selected for testing will not provide sufficient, reliable audit evidence as the sample selected may no longer be representative of the population as a whole.

(viii) Conclusion

Poor quality control means that this audit engagement has not had appropriate direction and supervision. The evidence gathered may be inappropriate and inadequate for the purposes of issuing an audit opinion. This could result in an incorrect opinion being issued. A detailed hot and cold review should be performed to determine if any areas need extra audit work performed, and to consider what measures the firm should take to improve its quality control monitoring procedures.

2) Planning Memorandum

Client: **Kawina Lodges Limited (KAL)**

Year ended: **30th September 2012**

Prepared by: **Jani Bupe, Audit Manager**

Audit Planning Memorandum

Characteristics of the entity

Kawina Parts Ltd (KAP) was established as a limited company in 1990 and has grown and positioned itself as one of the leading lodges with ten branches throughout Zambia. It has an estimated workforce of 42 personnel with a more centralized system of management and control.

Key dates

Key dates in the audit timetable are:

- Interim audit
- Final audit
- Meeting with senior management
- Financial statements approved by management

Specific dates are to be confirmed

a) Materiality determination

Materiality is determined based on risk assessment associated inherent and control risks. These risks are assessed based on the understanding of internal and external factors affecting the entity, as well as assessment of risks associated with accounting and control systems. International guidelines are used in determining materiality levels using the following parameters:

Parameter	KR’000		
Revenue (0,5% - 1%)	4,593	0.5% = 23	1% = 46
Profit before tax (5% - 10%)	44	5% = 2.2	10% = 4.4
Total assets (1% - 2%)	2,750	1% = 28	2% = 55

Materiality guidelines provide that where the risk is considered to be high, the materiality levels should be lower. As per the risk assessment provided below, there appear to be a higher risk of misstatement for both income statement and the statement of financial position. Accordingly, materiality is determined as follows:

- It would be not appropriate to use profit before tax as a basis for materiality. The revenue and expenditure levels have generally risen but profitability has gone down from the previous year.
- The parameters of revenue and total assets basically give similar values, with the revenue base providing lower indicators.
- Given the potential for relatively higher risk of misstatement, materiality is set at 23 million, being the lowest amount based on either revenue or total assets.

b) Risk assessment

A review of the draft financial statements for KAP indicates the following potential risks:

Possible misstatement of cost of sales
Sales increased by 12% but cost of sales have increased by around 19%. There is a risk that cost of sales may be overstated.

Inventory valuation
Inventory on the statement of financial position is down significantly on last year indicating that there could be valuation or quantity errors

New inventory system
Following the installation of the new inventory system, KAL has adopted a continuous inventory count system. Such a system requires more accurate recording and reporting and for every item to be counted at least once. As the system is new, the potential for errors may be considered to be relatively higher.

Trade receivables
Trade receivables have increased by about 50%, significantly more that the increase in sales. This indicates that the company may have debt collection problems. Additional testing may be required on after date cash collections to check for bad debts

Non-current assets
Non-current assets have fallen by K450 million, which is significant given that most non-current assets are land and buildings. Depreciation computations should be thoroughly checked. In addition, the reason for the sale of any assets must be ascertained.

Possible vehicle impairment
Four vehicles have not been used during the year. This is an indication that an impairment review should be undertaken and any possible write downs effected.

Non-current liabilities
Non-current liabilities have also fallen by K800 million. While not necessarily linked to the fall in non-current assets, there is a possibility that non-current assets may have been sold to pay off the liabilities

Going concern
There may be going concern questions to be raised if the overall profitability continues to fall, combined with a fall in cash in hand.

Related party transactions
One of the directors purchased a large farming estate in Mkushi utilizing an advance obtained from the company. This is a related party transaction. It is possible that there may be other related party transactions that should be identified and verified for proper disclosure

c) Audit Approach and extent of testing on the inventory system:

Audit testing will focus on the use of compliance testing where possible. However changes have been made to the inventory system limiting extent of compliance testing. Client systems have changed in the year with a new computerized inventory control system. Three actions are necessary in respect of this system:

- Audit initial installation of the new system including transfer of balances. One of the reasons for the low inventory value could be omission of the inventory balances on transfer
- Test count inventory at the year-end and agree to the computerized inventory records (and vice versa) to test accuracy. Note that the client will not be counting inventory at the year-end but relying on the computerized system.
- Test check bookings into and out of inventory from the purchases and sales systems.

SECTION B

3) Management letter

a) Purpose of including findings from the audit in a report to those charged governance

Guidance on "findings from the audit" from the audit or management letter points can be found in ISA 260 *Communication with those charged with governance* and ISA 265 *Communicating deficiencies in internal control to those charged with governance and management*

The purpose of such communication is:

- To ensure key findings from the audit have been brought to the attention of those charged with governance and that this has been documented
- To provide recommendations to those charged with governance so they can take appropriate action and fulfill their responsibilities, for example in improving internal controls

b) Findings from the audit

Capital expenditure controls

Purchase of an asset costing KR225,000 has not been authorized indicating a deficiency in the controls over non-current assets

Reason for inclusion

The office equipment is not material for the purpose of the audit (KR9/2,750 = 0.3% of total assets) However, the breach in control should still be brought to the attention of those charged with governance as it represents a business risk to KAP Ltd. The risk of fraudulent purchases is greater where there is a lack of controls over purchase of non-current assets. This should be explained in the report to those charged with governance of KAP along with recommendations of how the controls over capital expenditure could be improved

Impact on the report

This issue is not material in monetary terms, but should be considered for materiality in qualitative terms. Absence of authorization in the purchase of non-current assets may imply control weaknesses in other areas. However, unless test of controls are extended to other transactions, there is no immediate impact on the report because the amount involved is not material. If the amount was material, this could be taken as insufficiency evidence to satisfy the occurrence assertion and may lead to an “except for” qualified opinion.

Internally generated brand name

An internally generated brand has been recognized on the statement of financial position. This is in contravention of the treatment permitted under IAS 38 Intangible assets. The asset is material as it represents 3.6% of total assets (KR 100/2,750))

Reason for inclusion

There is a material misstatement in the financial statements, which, if unchanged, would result in a modified opinion. Under 260, the auditor should communicate any expected modifications to the audit report to those charged with governance. The report to those charged with governance should explain the IAS 38 requirements, including impact on report if the financial statements are not adjusted. Once the full facts have been given, KAP should be given an opportunity to amend their financial statements and discuss the correct treatment of internally generated brands

Impact on the report

If the financial statements are not adjusted, audit report should be modified with an “except for” opinion due to material misstatement. The report should clearly explain the permitted IAS 38 treatment and why KAP is in breach of it

Paperwork delays

Documentation of inventory was not available for the auditors on a timely basis. This seems to have been a consequence of poor organization

Reason for inclusion

Those charged with governance at KAP should be made aware that the audit was delayed as a result of the late receipt of the inventory documentation. It may be necessary for the firm to bill for the extra time. In future, management should make an effort to ensure that documentation is, as far as possible, readily available to the auditor.

Impact on audit

There is no immediate impact on the audit report

Market share assertion

The Chairman's statement includes two assertions which are at best exaggerated, concerning KAP market position and its commitment to accountable and ethical professionalism. Ironically, the first claim makes the second claim appear untrue, as it is not ethical to make exaggerated claims about the company's operations

Reason for inclusion

This claim is demonstrably untrue. The information being exaggerated is a material misstatement of fact and this is why this statement should be discussed with those charged with corporate governance with a recommendation that it should addressed.

Impact on report

This matter would not constitute a qualification of the audit report. The auditor should also consider whether this material misstatement of fact has any implications for any audit evidence obtained from the Chairman during the course of the audit.

If the Chairman refuses to play it down, the auditor should consider obtaining legal counsel, and as measure of last resort consider resigning

4) Typing financial statements and disclaimer paragraph

a) Preparation of financial statements

Preparation of financial statements for clients is allowable. However a self-review threat exists where an audit firm prepares financial statements and the audits them. There is also the risk that the audit firm may undertake or perceived to undertake a management role. Safeguards should be in place to ensure that the risk is reduced to an acceptable level in this situation. For example staff members other than the audit team should be responsible for typing the financial statements.

The ZICA code of ethics prohibits the preparation of financial statement for listed clients. However KAP is not listed.

b) Liability disclaimer paragraph

It should be borne in mind that an agreement with a client designed to exclude or restrict a member's liability will not always be effective in law.

(i) Content

- The report is intended to be used only by the company's members as a body
- The report is not to be relied upon by an third party
- Not required by any auditing standards therefore no prescribed content

(ii) Advantages

- Reduces exposure of the audit firm to liability claims from anyone other than the company or the company's body of shareholders
- Could help to bridge the expectation gap by clarifying the responsibility of the auditor
- Audit firms can manage their risk exposure in an increasingly litigious environment

(iii)Disadvantages

- Every legal case is unique, and although a disclaimer might protect the audit firm in one circumstance, it may not offer any protection in another
- This could encourage low quality audits as there should be no need for a disclaimer if the audit is of a high enough quality

5) Effectiveness of proposed internal audit function

Reporting system

The chief internal auditor will be reporting to the financial controller. This limits the effectiveness of the internal audit reports as the financial controller is also responsible for some of the financial systems that the internal audit will be reporting on. It is possible that the internal auditor may "soften" or limit criticism in reports to avoid confrontation with the financial controller.

Advice

To ensure independence, the chief internal auditor should report to the chairman or a committee of directors not involved with financial systems.

Recruitment of staff

The internal audit members of staff are to be appointed by the financial controller. The financial controller may appoint personnel who are less likely to criticize his work. Additionally, the internal audit staff may wish to secure their employment by not criticizing the financial controller.

Advice

Perhaps the chairman and other directors not involved with the financial systems should be responsible for appointment of internal audit staff.

Scope of work

The scope of work of the internal audit is to be decided by the financial controller in discussion with the chief internal auditor. This will mean that the financial controller may try and influence the chief internal auditor regarding the areas that the internal audit department is auditing, possible directing attention away from any contentious areas that the director does not want to be audited

Advice

To ensure independence, the scope of work of internal audit department should be decided by the chief internal auditor, perhaps with the assistance if the chairman and a committee of directors not involved with financial systems

Audit work

As the internal audit will be spending 50% of their time in the finance department implying that they will be reviewing their own work. This limits independence as the internal auditors may overlook or fail to identify errors or deficiencies in those areas. This is a self-review threat

Advice

If possible the internal audit team should do not have operational responsibility. However, if this not possible, the internal audit should work should be arranged in such a way that no member of the team reviews areas where they have operational responsibility.

Variation of standards

The internal audit team will be given freedom to choose and apply auditing standards they are familiar with. This could lead to inconsistency in the way internal audit will be performed across different assignments, and can lead to manipulation of internal audit objectives.

Advice

KAP should determine specific policies and procedures to be followed by internal audit. For example the International Standards for the Professional Practice of Internal Auditing issued by the Global Institute of Auditors should be adopted

QUESTION TWO

FINCA INVESTMENTS LTD (FIL)

1. BACKGROUND

Finca Investments Ltd is a small-medium sized Zambian based company specialized in the assembly and construction of various furniture utilizing both mechanized and traditional methods of excellence. Drawers and boxes are joined with stopped dovetail and through dovetail joints, difficult to make, but extremely strong carcasses. Frames and legs are joined with mortice and tennon joints that are machined using the best Italian made machines to ensure a perfect snug that guarantees the integrity of joint that is made. Such accuracy could never be achieved by hand. Unlike for other manufacturers all pieces are solid wood right through. Fittings are of the highest quality. Hinges are solid brass, and drawer slides are of the finest imported roller bearing construction.

Recently Finca tendered and was awarded a contract to assemble and construct various pieces of furniture for the Ministry of Education. This was facilitated by a donor funded grant provide by the USAID to provide furniture to newly constructed schools. As a medium sized private company, the directors have never seen the need to have their financial statements audited, as they consider that audit fees quoted in the past appeared too high for a small private company such as Finca. However, as a condition of being awarded the grant, Finca is now required to have their financial statements audited. The audits are planned to start from the financial statements for the year ended 31ST March 2013.

2. APPOINTMENT OF AUDITORS

Your name is Patrick Chansa. You are the senior manager in BPN Partners, a public practice firm registered with the Zambia Institute of Chartered Accountants (ZICA). Your firm has been appointed to audit Finca's financial statements for the year ended 31st March 2013. Your firm was preferred because:

- You currently audit two other clients in similar business as Finca's, also with financial years ending 31st March 2013.
- Your firm was assessed to be in a position to finish the audit within two weeks
- The Chairman of Finca recommended your firm's appointment on account of his prior social and business dealings with your senior partner.

  Your firm had an opportunity to attend the year-end inventory count which was held on 1st April 2013. Legal formalities relating to this appointment are still being finalized.

3. PLANNING AND AUDIT STRATEGY

As audit manager in charge of planning you have put together an appropriate audit team and have since undertaken preliminary planning procedures as below:

3.1. Understanding the business

You have obtained adequate knowledge of the business of Finca to enable you identify and understand the events, the transactions and practices that may have a significant effect on the financial statements. You have considered the general and industry factors affecting the furniture industry, including preliminary enquiries into the corporate governance structure and systems of Finca. You have concluded that inherent risk for Finca is relative low.

3.2. Understanding the accounting systems.

Your staff have obtained and documented an understanding of the accounting system and control environment of Finca sufficient to help you determine an appropriate audit approach. This has enabled you to understand:

- Major classes of transactions
- How such transactions are initiated
- Significant accounting records, supporting documents and accounts
- The financial and accounting process.

  The policies and procedures relating to the purchases and payables systems has been determined to be of key significance to the audit of Finca's financial statements for the year ended 31st March 2013.

3.3. Use of Computer Assisted Audit Techniques (CAATs)

Given that the purchases and payable system at Finca is partly manual and partly computerized, you have considered the use of CAATs in your audit process.

4. AUDIT WORKING PAPERS.

As part of the planning process, your audit team has prepared working papers to assist you with the planning and execution of the audit. The following workings papers have been compiled:

NUMBER	DESCRIPTION	REFERENCE
1	**Accounting system**	**Finca/01/2013**
2	**Current liabilities**	**Finca/02/2013**
3	**Inventories**	**Finca/03/2013**

4.1. ACCOUNTING SYSTEM- Finca/01/2013

Finca's accounting systems are partly manual and partly computerized. In overview, the systems include:

- Design software
- A computerized database of suppliers (bespoke system written in-house at Finca)
- A manual system for recording goods inwards and transferring information to the accounts department
- A computerized payables ledger maintained in the accounts department (purchased off-the-shelf and used with no program amendments)
- Online payments to suppliers, also in the accounts department
- A computerized general ledger which is updated by the payables ledger

The desks and other furniture are assembled in batches of 100 to 500. When a batch is scheduled for production, a list of components is produced by the design software and sent, electronically, to the ordering department. Staff in the ordering department uses this list to place orders with the relevant suppliers, mainly based in the Middle East. Orders can only be sent to suppliers on the supplier's database. Orders are sent using electronic data interchange (EDI) and confirmed by each supplier using the same system. The list of parts and orders are retained on the computer in an 'orders placed" file, which is kept in date sequence.

Parts are delivered in the goods inwards department at Finca. All deliveries are checked against the orders placed file before being accepted. A hand-written pre-numbered goods received note (GRN) is raised in the goods inwards department showing details of the goods received with a cross-reference to the date of the order. The top copy of the GRN is sent to the accounts department and the second copy retained in the goods inwards department. The "orders placed" file is updated with the GRN number to show that the parts have been received.

Paper invoices are sent by all suppliers following dispatch of goods. Invoices are sent to the accounts department, where they are stamped with a unique ascending number. Invoice details are matched to the GRN, which is then attached to the invoice. Invoice details are then entered into the computerized payables ledger. The invoice is signed by the accounts clerk to confirm entry into the payables ledgers. Invoices are then retained in a temporary file in number order while awaiting payment.

After 30 days, the payables ledger automatically generates a computerized list of payments to be made, which is sent electronically to the chief accountant. The chief accountant compares this list to the invoices, signs each invoice to indicate approval for payment, and then forwards the electronic payments list to the accounts assistant. The assistant uses on-line banking to pay suppliers. The electronic payments list is filed in month order on the computer

4.2. CURRENT LIABLITIES – Finca/02/2013

The current liabilities are shown in the draft financial statements of Finca as follows:

	2013 **(KR)**	**2012** **(KR)**
Trade payables	884,824	816,817
Accruals	56,903	51,551
Provision for legal action	60,000	0
	------------	-----------
	1,001,727	868,368
	========	=======

Trade payables are in respect of goods received and invoiced from various suppliers. Accruals comprise estimated overhead costs incurred but not paid and for which actual invoices and bills had not yet been received by the year end. These include telephone and water bills estimated on the basis of the latest bills received.

The provision for legal action relates to a claim from a customer who suffered an injury while assembling a chair supplied by Finca. The directors of Finca dispute the claim although they are recommending an out of court settlement to avoid damaging publicity against Finca.

4.3. INVENTORY – Finca/03/2013

The value of assembled desks, chairs and other pieces of furniture (excluding that for the Ministry of Education) are shown in the draft financial statements of Finca as follows:

	2013 **(KR)**	**2012** **(KR)**
Inventories	4,550,400	3,780,990

For the year ended 31st March 2013, a full inventory count of assembled desks, chairs and other pieces of furniture was carried out at the year-end and the results of the count are considered satisfactory and there are no cut-off errors. Because of the limited time available between the year end and the completion of the audit, Finca has valued the inventory at cost by recording the selling price and deducting the normal gross profit margin. Inventory which the company believes to be worth less than cost has been valued at net realizable value. The selling price used is that on the item in the store when it was counted. The selling prices have remained constant during the year.

As for the year ended 31st March, 2012, it is not clear whether a proper inventory count was undertaken. Further discussions with management suggest that inventories for the previous year were valued on the basis of average cost. Accordingly, BPN partners were not able to obtain sufficient and appropriate evidence to confirm whether the opening balances were properly accounted for and adequately presented and disclosed.

Requirements:

Section A – 50 MARKS

6) In relation to the purchases and payables system in the financial statements of Finca

a) List the substantive audit procedures you should plan to perform to confirm the assertions of :

i) Completeness (8 marks)
ii) Occurrence (8 marks)
iii) Cut-off (4 marks)

For each procedure, explain the purpose of that procedure

b) Discuss the extent to which computer-assisted audit techniques (CAATs) might be used in your audit of purchases and payables at Finca (5 marks)

7) In relation to the current liabilities of Finca for the year ended 31st March 2013

a) Describe the control procedures that should be in place over the standing data on the trade payables master file in Finca's computer system.
(7 marks)

b) List the substantive audit procedures you should plan to be performed on the current liabilities of Finca for the year ended 31st march 2013. For each procedure, explain the reason for the procedure and the assertion being confirmed by that procedure. The mark allocation is as follows:

i) Trade payables (10 marks)
ii) Accruals (4 marks)
iii) The provision for legal action. (4 marks)

Section B – 50 MARKS

8) Identify and explain **SIX** ethical and professional issues that your firm should have considered before accepting the engagement to audit the financial statements of Finca for the year ended 31st March 2013. (12 marks)

9) In relation to opening balances

a) Explain the auditor's responsibilities that are specific to initial engagements
(6 marks)

b) Explain the consequences of applying such procedures to the opening balances of inventories appearing in the financial statements of Finca for the year ended 31st March 2013, explaining clearly impact of any matters arising on your audit report
(10 marks)

10) **With reference to working paper Finca 03/2013:**
Identify and explain the substantive audit procedures you should plan to carry out to confirm the following assertions:
a) Completeness of physical quantities for valuation purposes (6 marks)
b) Valuation and allocation (10 marks)
c) Cut-off (6 marks)

QUESTION TWO
FINCA INVESTMENTS LTD (FIL)
SUGGESTED SOLUTIONS

Section A

11) **Audit of purchases**
a) **Substantive procedures and purpose**

Completeness		
	Audit procedure	Reason for procedure
1	Obtain a sample of list of parts documents from the computer. Trace individual parts to the goods received note (GRN	Checks the completeness of liabilities
2	For a sample of GRNs from the goods inward department, trace to the invoice held in the accounts department	Ensures completeness of the recording of liabilities, GRNs with no matching invoice indicate a liability has been incurred. Unmatched GRNs should be included in the payables accrual.
3	Review the file of unmatched GRNs, investigate reasons for any old (more than one week) items	Ensures the completeness of recording of liabilities. Unmatched items prior to the year- end should be included in the payables accrual
4	Obtain a sample of paid invoices. Ensure that the GRN is attached	Confirms that the invoice should be included in the payables ledger, meeting the completeness assertion
5	For the sample of invoices, check details into the computerized payables ledger, ensuring the correct account has been updated and the invoice	Confirms the completeness of recording of payables invoices in the ledger

	amount is accurate	
6	For the sample of entries on the payables ledger, agree to the electronic payment list confirming that the supplier name and amount is correct	Ensures that the liability has been properly discharged by Finca and that the payments list is therefore complete.
Occurrence		
1	Obtain a sample of GRNs. Agree details to the list of parts documents on the computer	Ensures that the parts received had been ordered by Finca, giving evidence for the occurrence assertion
2	For a sample of entries from the payables ledger, agree details to the purchase invoice	Ensures that the liability does belong to Finca, meeting the occurrence assertion
3	For the sample of entries on each electronic payment list, agree details to the purchase invoice	Ensures that the payment has been made for a liability incurred by Finca, meeting the occurrence assertion.
4	Obtain the bank statements. Trace a sample of payments to the electronic payment list.	Confirms that the payment made does relate to Finca, confirming the occurrence assertion
Cut-off		
1	For entries in the list of parts where no GRN number has been entered, enquire with goods inwards staff why there is no GRN. Document the reasons obtained	Checks that goods have not been received but details not recorded. Possible cut-off error where goods have been received but GRN not raised
2	For a sample of GRNs in the week pre- and post- year-end, trace to the supporting invoice and entry in the payables ledger, ensuring recorded in the correct accounting year.	Confirms the accuracy of cut-off in the financial statements

b) Extent of use of Computer-Assisted Audit Techniques (CAATs)

Audit software may be used to identify old/obsolete balances in Finca's system, e.g. outstanding deliveries and payments not being made to suppliers. However, the usefulness of the testing is limited and it is possible that the computer system already provides similar controls

Test data input by the auditor would be useful in checking the online payments system, perhaps by setting up some "dummy" accounts and ensuring that payments are sent to the correct suppliers. Other controls over payments such as access controls are more likely to be tested manually by the auditor by the use of passwords and other physical controls.

Use of Computer-Assisted Audit Techniques (CAATs) may be limited at Finca due to the lack of integration of computer systems. For example, the suppliers' database is not connected to the payables ledger, limiting the use of test data to check transactions all the way through the purchases/payables system.

There is no indication provided in the scenario regarding the extent and effectiveness of computer controls. Controls would have to be identified and assessed for reliability prior to reliance being placed.

Given that some of Finca's system is bespoke, then it may not be cost effective to use CAATs given the time required to write specific data or program audit software to use on Finca's data.

Use of CAATs in the suppliers' database may not be effective given that the database does not input directly into any financial accounting system. Testing GRNs to purchase invoice to ledgers, etc will provide greater assurance of the completeness and accuracy of purchases than testing the suppliers' database.

12) Current liabilities

a) Control procedures on standing data.
Controls over the trade payables master file should include:

(i) Any amendment (addition, amendment or deletion) to the payables ledger should be authorized by a responsible official, for example the chief accountant

(ii) Authorisation can be by a manual form being signed or by the chief accountant having restricted access password to amend the standing data

(iii) The computer should reject deletion of a supplier account where there is an outstanding balance (debit or credit)

(iv) A record of amendments made to the payable ledger should be maintained within the ledger and reviewed on a regular basis by the chief accountant to ensure that the changes are bona fide

(v) The chief accountant should review the list of suppliers on a regular basis and delete those that are not used

(vi) A review of the computer control log regarding access to the payables standing data should be made on a regular basis and any unauthorized access identified and changes made under that access identified and if necessary reversed

(vii) A list of suppliers should be printed out occasionally and comparison made with authorized list of suppliers to identify any unauthorized suppliers added.

b) Substantive procedures:

(i) Trade payables		
	Audit procedure	Assertion and reason for procedure
1	Obtain a list of payable balances from the computerized payables ledger as at 30th Sept. 2012. Cast the list	To ensure that the list is accurate and that the total is represented by the individual balances – **the completeness assertion**
2	Agree the total of payables to the general ledger and financial statements	To confirm that the total has been accurately recorded and that the balance in the financial statements is represented by valid payables – meeting the **occurrence assertion**
3	Perform analytical procedures on the list of payables. Determine reasons for any unusual changes in the total balance or individual payables list	Provides initial indication of the accuracy and **completeness** of the list of payables
4	For a sample of payables on the list, agree to supplier statements at the year-end	Confirms that the payables balance is due from Finca meeting the **occurrence** assertion
5	For the sample of payables selected, reconcile to supplier statements	Ensures that the liability exist**(existence assertion)** and belong **(rights and obligations assertion)** to Finca at the year end
6	For invoices on the statements not in the ledger, agree invoices entered after the year-end. Check the date of goods receipt per the GRN attached to the invoice. Where goods received pre-year agree invoice to the payables accrual	Ensures that all liabilities were recorded at the year end, meeting the **completeness** and **cut-off assertions.**
7	Ensure that payables have been included in the financial statements under the heading of current liabilities	Confirms the correct **classification** (**classification and understandability assertion)** of payables in the financial statements

	(ii) Accruals	
1	Review the process of estimating the accruals by reviewing the latest bills and enquiring of changes in levels of consumption. Ensure the basis of estimate is reasonable.	To ensure that the accruals are have been calculated correctly and therefore testing for over or understatement of the accruals **(valuation and allocation assertions)**
2	Cast the list of accruals and agree individual amounts to the general ledger accounts	Confirms that the list is complete **(completeness assertion)**, the balances are accurately stated in the general ledger and contains no unusual or recording items which must be investigated
3	Compare individual accruals with amount in the prior year accounts	To account for unusual differences and identify omissions from the list in the current year **(Completeness assertion)**
4	Agree accruals to payments made after the end of the year, for example amounts paid for electricity and water to ZESCO and water utility companies	To confirm the accuracy of the amounts accrues and paid and to confirm that the accruals are genuine **(Occurrence and rights and obligations assertions)**
5	Review the payments at the year end to determine whether any accruals are required. Where the need for an accrual is identified, ensure this is included in the accruals list	To confirm **completeness** of the accruals listing
	(iii) Provision for legal action	
1	Discuss the provision with the Directors of Finca	To attempt to confirm whether the company is liable for the payment and confirm that an out-of-court settlement is appropriate – meeting the **existence** and the **rights and obligations assertion**
2	Obtain a letter from Finca's lawyers	To provide evidence on whether Finca is liable for payment and check the amount provided is approximately correct-meeting **the rights and obligations and valuation assertions**
3	Review any correspondence with the customer	To help determine Finca's liability and determine whether the customer may accept the out-of-court settlement – meeting the **valuation and existence assertions**
4	Obtain a letter of representation from the directors	To confirm that the directors are considering settlement out of court and to confirm the amount accrued – **meeting the rights and obligations and valuation assertions**

Section B

13) Ethical and professional issues

The following ethical and professional issues are relevant to the appointment as auditors of Finca's financial statements for the year ended 31st March 2013:

a) Fees and engagement economics

Generally, the expected fees from a new client should reflect the level of risk expected. They also offer the same sort of return of clients of this nature and reflect the overall financial strategy of BPN partners. The directors of Finca consider that audit fees are generally too high. This may bring about disagreements on the level of fees to be charged

b) Legal formalities yet to be formalized

For the appointment to be valid, Finca must ensure that the appointment of the auditors is formally endorsed by passing a resolution as required by the Company's Act. It is important that the legal formalities are completed otherwise the appointment may be contested

c) Potential conflict of interest- other clients in same business

BPN partners will generally want the relationship with a client to be long term. BPN presently audits two other clients in competition with Finca. It should be expected that in accepting such an appointment, BPN should openly discuss potential conflicts, including confidentiality implications of auditing clients which are in competition. The appointment should be accepted once all parties concerned are satisfied that there would be no significant conflicts and other matters arising.

d) Timing and Resources- Ability to perform

The audit is expected to be completed in two weeks, Finca should assess whether it has resources to perform the audit properly, especially that two other clients have a 30th March 2013 year-end. The impact of these existing engagements must be estimated in terms of staff time and the timing of the audit. As Finca's directors are already concerned about cost, this may be another source of contention

e) Ethical check – previous social and business dealings

The chairman of Finca and the senior partner of BPN have had previous social and business dealings. Before a new audit is accepted, BPN is required to ensure that there are no ethical problems likely to cause conflict with the ZICA's ethical code. These previous dealings may have created a close relationship between the two senior officials so as to threaten the independence of BPN, especially if the senior partner is to be involved in the audit

f) Client screening

BPN is required to carry out client on new clients to ensure that they are not associated with clients exposed to negative publicity and circumstances. This is part of risk management. Matters to consider here include:

- The integrity of the management and directors of Finca, particularly that Finca, being a small-medium sized company, is likely to be controlled by one or few dominant personalities.
- Evidence of questionable and doubtful accounting policies, especially that Finca is being audited for the same time
- Significant related party or unexplained transactions.

g) Letter of engagement

Finca has not been audited before and it appears the Directors seem to have a "low" perception of the value of an audit. This situation provides scope for argument about the precise extent of the respective obligations of the Finca and its directors and the responsibilities of BPN Partners. It is therefore imperative that a letter of engagement is constructed, discussed and agreed with the client.

14) Opening balances

a) Auditor's responsibilities specific to initial engagements

For initial engagements, the auditor should obtain sufficient appropriate audit evidence that:

- The opening balances do not contain misstatements that materially affect the current period's financial statements
- The prior period's closing balances have been correctly brought forward to the current period (or where appropriate, have been restated)
- Appropriate accounting policies are consistently applied or changes in accounting policies have been properly accounted for (and adequately presented and disclosed)

b) **Procedures applicable to the opening balances of inventories**

The matters arising from opening inventories at Finca are as follows:

(i) It is not clear whether a proper inventory count was undertaken.

(ii) Inventories for the previous were valued on the basis of average cost. For the current year another valuation method (the retail method was used)

(iii) Accordingly, BPN partners were not able to obtain sufficient and appropriate evidence to confirm whether the opening balances were properly accounted for and adequately presented and disclosed.

Impact on report

As the auditor is unable to obtain sufficient appropriate evidence concerning the opening inventory, they may need to modify the audit opinion.

It appears BPN is not able to obtain reasonable assurance that the opening inventories were not properly accounted for. Accordingly, since the effect of a misstatement in the opening balances is not properly accounted for and adequately presented and disclosed, BPN partners should express a qualified (except for) opinion or an adverse opinion due to a misstatement, as appropriate.

Since current period's accounting policies have not been consistently applied in relation to opening balances and the change has not been properly accounted for and adequately presented and disclosed, the auditor should similarly modify the opinion due to a misstatement (except for or adverse opinion as appropriate)

However, if a modification regarding the prior period's financial statements remains relevant and material to the current period's financial statements, the auditor should also consider modifying the current auditor's report accordingly.

15) Working paper Finca 03/2013 - Substantive audit procedures to confirm:

a) Completeness of physical quantities for valuation purposes

(i) Check the cut-off with details of the last numbers of goods delivered notes during the year and after the year end,

(ii) Test that the final inventory sheets have been properly prepared from the count records. In particular the record of inventory take forms issued and returned must be checked.

(iii) Follow up notes made at the attendance.

(iv) Check final inventory sheets for pricing, extensions, casting, summarizing, and officials' signatures.

(v) Inform management of any problems encountered in the inventory take for action immediately and for subsequent counts.

b) Valuation and allocation

The method of valuation is allowed by *IAS 2, Inventories*, but is usually is applied to large retail concerns which stock thousands of low value items, for example supermarket chains. This method is only permitted when it can be shown it gives a reasonable approximation of the actual cost. The following substantive procedures should be planned to be performed:

Gross profit margin and cost

(i) Obtain a schedule of the client calculations of the gross margins. Re-compute the mathematical accuracy and assess the reliability of all sources of information used in the calculations
(ii) Where the normal gross profit margin has been used, enquire and assess as to the reasonableness of the figures by comparing it with the monthly management accounts for the year and previous' year financial statements
(iii) Test a sample of items to confirm that gross profit does not vary too much across all items of assembled items.
(iv) Select a sample of high value inventory items and check reasonableness of the gross profit estimate by re-computing the gross profit for each of those lines. Sales prices should be compared to inventory sheets and to sale prices at the year end.
(v) Cost should be checked against supplier invoices. Compare cost on these invoices with the cost computed by eliminating gross margin to confirm that the acceptability of the procedure.

Net realizable value

(i) Inventories which may be less than cost include:
- Slow moving items
- Obsolete or superseded items
- Damaged items
- Discontinued stock items

(ii) Inventories being put on sale or expected to be put on sale in future
(iii) Enquire of the assembled items have not been sold for a long period of time
(iv) Discuss with the management the current position regarding slow moving items and their plans and expectations in respect of products that may be discontinued
(v) For items in (i) above, determine the actual selling prices from recent sales invoices. For items still selling, invoices will be recent, but for slow moving and obsolete items the invoiced prices will be out of date and allowance will have to be made for this
(vi) Estimate the value of any marketing, selling and distribution expenses using the most recent available figures as part of the process of re-computing net realizable value (NRV)
(vii) Compare selling prices and estimated net realizable values and confirm that where NRV is lower than cost, appropriate write downs have been taken into account.

c) Cut off

According to the purchases and payables system at Finca, parts are delivered in the goods inwards department at Finca. All deliveries are checked against the orders placed file before being accepted. A hand-written pre-numbered goods received note (GRN) is raised in the goods inwards department showing details of the goods received with a cross-reference to the date of the order. Therefore appropriate cut-off procedures would include:

(i) Inquiry and confirmation that movement of inventories was restricted during the inventory count.

(ii) Inquire and review GRN's to confirm that they are maintained in numerical sequence

(iii) Select say five good received notes before the year end and another five after the year end (Following the numerical sequence)

(iv) Inspect inventory records to confirm that :

- Those good received before the year are included in inventories for the year
- Those goods received after the year end are not included in inventory

(v) Enquire to establish whether Finca was holding goods sold and not collected by customers as at 31st March 2013. These should not be included in the count.