



SUGGESTED SOLUTIONS

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QUESTION 1 SECTION A PART 1

Offer of purchasing units

(3 marks)

During the interim count, the auditors were invited to purchase housing units at 40% discount, that is, at 60% of the recommended price.

Professional guidance on accepting goods states that such benefits should only be accepted on normal commercial terms or at a modest benefit. What constitutes modest benefit will be a matter of judgement for the auditor

It will be necessary to consider whether such an offer is extended to staff of BSC, and if such benefit is not made to staff then the offer should have been accepted by the auditors. What is modest benefit should also be considered in terms of materiality to the auditor and the company. It is perhaps reasonable to suggest that the implications of this offer may not be material to BSC, but without a doubt should be material to audit staff.

It would also be appropriate to consider the timing of the offer. This was made during an interim audit and may interfere with the auditor's independence requirement –“the auditor must be seen to be independent.” One could argue that such an offer may affect the subsequent performance of the auditors.

Action to have been taken

(2 marks)

Given the materiality and timing of the offer, the auditor should not have taken up the offer. The partner in charge should discuss this matter with management to explain the implications and also ascertain whether any such other benefits were offered to staff.

In the final analysis, much would depend on the professional guidelines provided by Gondwe and partners as part of its quality control procedures. It is common practice for firms to completely prohibit acceptance of certain gifts without clearance from head office. It is also possible to prescribe a monetary limit on the type and amount of gift that can be accepted.

Provision of other services

(3 marks)

The provision of non-audit services to audit clients is a hotly debated issue on the grounds that it potentially introduces certain threats to independence, being

- *Self review* by auditing financial statements and tax computations prepared by the same firm
- *Self interest* created by the fees to be obtained from provision of both audit and other services

- *Advocacy* created by the preparation of tax computations
- *Familiarity or trust* which will increase with more contact with the client

The provision of other services may be very lucrative such that it may become an important factor in the performance and opinions to be expressed on the audit. In addition, significant fees from the provision of other services may result in undue dependence on one client.

In the wake of the Enron Collapse in 2002, the US Senate passed the *Sarbanes-Oxley Act* that forbids provision, to audit clients of certain services including the preparation of financial services and other management functions.

Current practice in Zambia seems much less restrictive. The rules require that a partner should avoid getting involved in executive functions. It is common practice for audit firms to be involved in the preparation of financial statements and tax computations, especially for smaller audit clients.

<i>Action to have been taken</i>

(2 marks)

A careful assessment should be made to make sure that independence is no way impaired by the provision of such services. A different audit team may be involved in the preparation of financial statements. Whenever such services are provided, the client must be made to accept full responsibility for the financial statements so prepared

Total marks

(10 marks)

PART 2

1) Ordering – control procedures and control activities identified

- Segregation of duties relating to acquisition and ordering
- Central policy for choice of suppliers
- Evidence required of requirements for purchased before purchase is authorised (re-order quantities and re-order levels)
- Order forms prepared only when a pre-numbered purchase requisition has been received
- Use of pre-numbered order forms and authorisation of such order forms
- Safeguarding of blank order forms and review of orders not received or invoiced
- Monitoring of supplier terms and taking advantage of favourable conditions in terms of bulk orders and discounts)

2 marks for each point, maximum of five points = (10 marks)
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2) Receipt and invoices – Control procedures and control activities identified

- Examination of goods inwards for quality, quantity and condition
- Recording arrival and acceptance of goods on pre-numbered goods received notes

- c) Comparison of goods received notes with purchase orders
- d) Referencing of supplier invoices, numerical sequence and supplier reference
- e) Checking of supplier invoices for prices, quantities, and accuracy of calculation and to ensure that details match with order
- f) Recording return of goods on pre-numbered goods returned notes

2 marks for each point, maximum of five points = (10 marks)
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3) Recording and Accounting – Control procedures and control activities identified

- a) The following **control procedures should be on place on recording and accounting**
- b) Segregation of duties relating to the accounting and checking functions
- c) Prompt recording of purchases and purchase returns in day books and ledgers
- d) Regular maintenance of purchase ledger
- e) Comparison of supplier statements with purchase ledger balances
- f) Authorisation of payments in relation to limits and confirmation that goods have been received and accord with purchase order and are properly priced and invoiced
- g) Review of allocation of expenditure
- h) Reconciliation of purchase ledger control account to total of purchase ledger balances
- i) Cut-off accrual of goods received notes not matched by purchases at the year-end

2 marks for each point, maximum of five points= (10 marks)

Total marks

30 marks

QUESTION 1 SECTION B PART 3
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Relationships, ratios, and trends

Tests of details are usually planned on the basis that analytical procedures confirm expectations. It is preferable to perform analytical procedures early in the final audit so that any necessary changes to tests can be determined prior to commencing that part of the audit. Typical analytical procedures may include:

- Review and compare current and prior year balances, taking into account trends in purchases in relation to construction and maintenance provided over the period
- Determine expectations in terms of type and volume of likely payables
- Compute significant ratios such as gross profit and trade payables turnover or payment days. For example if gross profit is higher than expected, then one explanation could be an understatement of purchases (such as by a deliberate cut-off error) in order to boost profits.
- Obtain explanations for unexpected changes and corroborate any explanations.

- Comparing ratios of material expenses to sales in relation to the level of activity may also reveal some useful insights.

5 marks for each valid point, maximum of five points= (5 marks)
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Accounts payable balances selected for testing

Sampling criteria

As per the attached schedule, using a materiality of K200 million as the sampling interval and K20 million as the starting selection point, the following balances were selected:

NAME OF SUPPLIER	AMOUNT (K'000)
Diesel Electric	110,500
Toyota Zambia	155,000
Turnpan Zambia	455,550
Caterpillar Zambia	975,450
Garner Pty – RSA	100,750
Gabmans Ltd	45,840
BP Zambia	275,620
Bolts and Nuts Ltd	9,290
ERZ	123,780
Southern Cross Motors	215,800
Mazembe Haulage	568,340
ABC earthmovers	125,900
Pitts (Pty) Ltd	100,760
Total tested	3,262,580
Expressed as percentage of total	85.8%

2 marks for sampling plan, 3 marks for actual selections = 5 marks

Audit program for accounts payable

The audit program for accounts payable is constructed in two parts. The first part deals with purpose and objectives relating to applicable assertions. The second part deals with substantive testing.

PART A – PURPOSE AND OBJECTIVES – Audit assertions

The main assertions to be addressed are completeness, existence or occurrence, rights and obligations, measurement, valuation, presentation and disclosure

a) Completeness: To obtain reasonable assurance that

- i) All purchases and payments transactions that occurred during the period have been recorded
- ii) Payables include all amounts owed by BSC to suppliers of goods and services at the balance sheet date.

b) Existence or occurrence: To obtain reasonable assurance that:

- i) Recorded purchase transactions represent goods and services received
- ii) Recorded payment transactions represent payments made to suppliers and payables
- iii) Recorded payables represent amounts owed by BSC at the balance sheet date

c) Rights and obligations: To obtain reasonable assurance that:

- i) Recorded purchase transactions represent the liabilities of BSC
- ii) Payables and accruals are liabilities of BSC at the balance sheet date

d) Measurement, classification and valuation: To obtain reasonable assurance that

- i) Purchase transactions, payment transactions are correctly recorded in the accounting system
- ii) Payables and accruals are stated at the correct amount owed

e) Presentation and disclosure: To obtain reasonable assurance that:

- i) The details of purchase, payment transactions support their presentation in the financial statements, including their classification and disclosure
- ii) Payables and accruals and related expenses are properly identified and classified in the financial statements
- iii) Disclosures pertaining to commitments, contingent liabilities and related party transactions are adequate

1 mark for each valid point, maximum of 10 points = 10 marks

PART B – SUBSTANTIVE TESTING

Substantive procedures are covered under the following headings:

- Extraction of balances

<ul style="list-style-type: none"> • Selection of balances for testing • Reconciliation of supplier statements • Confirmations • Cut-off
1) Extraction of balances
<ul style="list-style-type: none"> a) Check from the purchase ledger accounts to the list of balances and vice versa b) Reconcile the total list with purchase ledger control account c) Cast the list of balances and the purchase ledger control account
2) Selection of balances for testing (See answer to ...above)
3) Reconciliation of supplier statements
<ul style="list-style-type: none"> a) For the selected supplier balances to major suppliers and including nil or negative purchase ledger balances within the sample b) Compare suppliers' statement with purchase ledger balances c) Generally, it is not considered necessary to confirm accounts payable directly as most of the evidence available is third party external evidence from the supplier
4) Confirmations
Generally, it is not considered necessary to confirm accounts payable directly. However, confirmation should be considered in the following circumstances where:
<ul style="list-style-type: none"> a) Suppliers' statements are for whatever reason, unavailable or incomplete. b) If there is any suspicion that the that the client is deliberately trying to understate payables c) The accounts appear to be irregular or if the nature or size of balances or transactions is abnormal.
5) Cut-Off
The procedures applied by the auditors will be designed to ascertain whether:
<ul style="list-style-type: none"> a) Goods received for which no invoice has been received are accrued b) Goods received which have been invoiced but not yet posted are accrued c) Goods returned to supplier prior to the year-end are excluded from inventories and payables
Following up on the cut-off details obtained at the year end, applicable substantive procedures are as follows:
<ul style="list-style-type: none"> a) Check from goods received notes with serial numbers before the year-end to ensure that invoices are either:

- b) Posted to purchase ledger prior to the year-end, or
- c) Included on the schedule of accruals
- d) Review the schedule of accruals to ensure that goods received after the year-end are not accrued.
- e) Check from goods returned notes prior to year-end to ensure that credit notes have been posted to the purchase ledger prior to the year-end or accrued.
- f) Review large invoices and credit notes included after the year-end to ensure that they refer to the following year
- g) Review outstanding purchase orders for indications of any purchases completed but not invoiced
- h) Reconcile daily batch invoice totals around the year-end to purchase ledger control ensuring batches are posted in the correct year
- i) Review the control account around the year-end for any unusual items

1 mark for each valid point, maximum of 10 points = 10 marks

Total marks

30 marks

QUESTION 1 SECTION B PART 4

1) Short term- construction contracts

a) 'Bill and hold' sales'

2marks

'Bill and hold' sales, in which delivery is delayed at the buyer's request but the buyer takes title and accepts billing. According to IAS 18, revenue should be recognised when the buyer takes title, provided:

- it is probable that delivery will be made;
- the item is on hand, identified and ready for delivery to the buyer at the time the sale is recognised;
- the buyer specifically acknowledges the deferred delivery instructions; and
- the usual payment terms apply.

Revenue is not recognised when there is simply an intention to acquire or manufacture the goods in time for delivery.

b) Units subject to conditions

2marks

For housing units constructed subject to conditions, revenue is normally recognised when the buyer accepts commissioning and inspection works are complete. According to IAS 18, revenue should normally be recognised when the buyer accepts delivery, and

commissioning and inspection are complete. However, revenue is recognised immediately upon the buyer's acceptance of delivery when:

- the commissioning process is simple in nature
- the inspection is performed only for purposes of final determination of contract prices

c) 'Lay away' sales

1 mark

Lay away sales under which the goods are delivered only when the buyer makes the final payment in a series of instalments. Revenue from such sales is recognised when the goods are delivered. However, when experience indicates that most such sales are consummated, revenue may be recognised when a significant deposit is received provided the housing units are on hand, identified and ready for hand-over to the buyer.

2) Consultancy and maintenance services
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1mark)

For all consultancy and maintenance services, revenue should be recognised over the period during which consultancy or maintenance services are performed. Any deposit received should be deferred and recognised over this period using the principle of accruals and matching.

3) Long term - construction contracts
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4marks)

IAS 11 on construction contracts prescribes that:

- Contract revenue and contract costs should be recognized in the income statement when the outcome of the contract can be estimated reliably.
- The revenue and costs should be recognized by reference to the stage of completion at the balance sheet date.
- When it is likely that contract costs will exceed contract revenue, then the entire loss must be recognized in the income statement immediately, regardless of the stage of completion

The percentage of completion of a contract at any balance sheet date is estimated on a cumulative basis. Therefore, changes in estimates are automatically accounted for in the period in which the change occurs and in future periods, which is in accordance with IAS 8, Accounting Policies, Changes in Accounting Estimates and Errors.

When the outcome of a construction contract can be estimated reliably, contract revenue and contract costs associated with the construction contract is recognised as revenue and expenses respectively by reference to the stage of completion of the contract activity at the balance sheet date. The recognition of revenue and expenses is based on the stage of completion of a contract. Under this method, contract revenue is matched with the contract costs incurred in reaching the stage of completion, resulting in the reporting of revenue, expenses and profit which can be attributed to the proportion of work completed. In the case of BSC, the stage of completion is determined by reference to the

proportion that contract costs incurred for work performed to date bear to the estimated total contract costs.

QUESTION 1 SECTION B PART 5
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a) Deferred tax provisions

5marks

Deferred tax amounting to K215 million as at 30th September 2008 has been calculated relating to accelerated capital allowances at a tax rate of 30% under the full provision method as required by IAS 12. This amount is material, given the materiality level of K200 million

IAS 12 requires that deferred tax is calculated at a rate of tax that is substantively enacted and expected to apply to the period when the deferred tax is to be settled. Substantively enacted generally means that it has been made into law, not merely suggested or announced.

In this instance, therefore, the directors have proposed to amend the provision to apply a tax rate that is not substantially enacted, but has merely been announced. If the directors do increase the liability, they will not be complying with strictly with the requirement of IAS 12. A discussion should be held with the directors to resolve the matter. However the additional increase is not material to the financial statements and may not affect the conclusion that deferred tax balance does not give a true and fair view.

b) No provision for warranties

5marks

The sales domestic housing units represent (...) which is ...% of the total revenue and is therefore material to the financial statements. As the warranty was only introduced nine months into the year and therefore would only apply to the sales in the last months of the year.

The conditions for recognising a provision in the financial statements in accordance with IAS 37 are that there should a present obligation as a result of a past event; it is probable that a transfer of economic benefits will be required to settle the obligation, and a reliable estimate can be made of the obligation

Accordingly, BSC should recognise a provision in the financial statements for the year ended 31 December if these conditions are met. If it is not possible to estimate the amount, a disclosure in the financial statements as contingent liability would be required.

If such a provision or disclosure is not made, then, depending on the materiality implications, the audit opinion would be qualified on the basis of disagreement.

c) IFRS 5 – Non-current assets held for resale**5marks**

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

However, by the end of the year, market conditions deteriorated further, and the assets were still not sold and they continued to be marketed at prices in excess of their current fair value. In that situation, the absence of a price reduction demonstrates that the assets were not available for immediate sale. Accordingly, the assets should be reclassified as held and used and should be accounted for in accordance with IAS 16

d) Publication of report on the internet**5marks**

Most companies are now publishing their financial statements including the auditor's report on their websites. This raises concerns with regard to the auditor's responsibilities to third parties within the context of the law of tort. Auditors should therefore check that the electronic version of the financial statements is identical to content to the manually signed accounts. In addition, some of the major firms are now including a disclaimer paragraph in an attempt to restrict liability to third parties.

Total marks**20 marks**

QUESTION 2 SECTION A PART 1
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General

3marks

In accepting an engagement auditors take on professional responsibilities to the public, the client and other members of the public accounting profession. The client's best interests must be served with competence and professional concern. In relation to other members of the profession, auditors have a responsibility to enhance the stature of the profession and its ability to serve the public. Auditors wishing to avoid legal liability would not associate with clients that pose a high risk of litigation. Therefore, a decision to accept a new client or continue a relationship with an existing one should not be taken lightly.

The decision to accept or continue an audit engagement depends on the client evaluation and ethical considerations. For Shonda Motors the following concerns may support a decision not to accept nomination as auditors:

- a) Client screening
- b) Professional clearance
- c) Independent and other ethical checks

1.1 Client screening

As well as contacting previous auditors many firms, particularly larger firms, carry out stringent checks on potential client companies and their management. The basic factors for consideration include:

a) Management integrity

3marks

Mr Hicks' attitude and conduct that includes imposing services on the auditors and threatening to spread false rumours suggest questionable integrity. The fact that control of Shonda Motors is dominated by Mr Hicks who is in a position to hold information exclusively support a greater likelihood that material errors and irregularities may occur in the accounting process from which the financial statements are prepared. Mr Hicks has not complied with legal requirements relating to the appointment of auditors in the past.

b) Engagement risks

3marks

The existence of complex financial systems and control weaknesses which have not been addressed suggest a high inherent and control assessment. This is made worse by the existence of unusual transactions, related party or other unexplained transactions controlled by Mr Hicks.

c) Engagement economics

2marks

It is possible that with Mr Hicks may place undue pressure on the auditors and impose unreasonable deadlines. A less than helpful staff would also delay the engagement.

d) Relationships

2marks

The outgoing auditors have experienced a breakdown in the relationship with Mr Hicks, it is likely also likely that we may suffer the same fate, especially that our firm is bigger and expected to be even more strict and more professional

e) Obtaining professional clearance.

2marks

It is clear that Mr. Hicks is less than willing to co-operate fully on this important aspect of client acceptance procedures. It is also possible that misleading information may exchange hands leading to mistrust and unnecessary tensions between the client and affected auditors

f) Independence and other ethical checks

3marks

We are likely to be requested to provide other services. This may seriously create conflicts and may increase our reliance on Shonda Motors for revenue. These are significant threats to our independence. We also suspect that we may face confidentiality problems with Mr Hicks

g) Engagement letter

3marks

It is in the interest of both client and auditor that the auditor sends an engagement letter, preferably before the commencement of the engagement, to help in avoiding misunderstandings with respect to the engagement. The engagement letter documents and confirms the auditor's acceptance of the appointment, the objective and scope of the audit, the extent of the auditor's responsibilities to the client and the form of any reports. This is likely to be a source of concern and misunderstanding given Mr. Hicks insistence that this should be general rather than specific.

On the other hand, the following positives provide arguments for accepting the nomination

1. Ability to perform the audit.**1mark**

Our audit firm is much larger and has the resources to perform the work properly, as well as any specialist knowledge or skills that may be required.

2. Client screening**1mark**

As a larger firm, we are likely to have the capability of influencing Mr Hicks and persuading him of the benefits of a more ethical style of business. This will benefit the company's shareholders.

3. Fees**1mark**

This is a lucrative client and would provide significant source of revenue for our firm

4. Provision of other services**1mark**

As a larger firm, we are in a position to provide a wider variety of other services and we have the capacity to separate audit teams from those providing other services

Total marks**25marks****PART 2****Recommendations on corporate governance**

Corporate governance is the system by which companies are directed and controlled. It is the ethical behavior by directors or those charged with governance in the creation of wealth for all stakeholders. It is about how these persons:

- Provide stewardship over the business of an entity to achieve corporate objectives
- Balance the corporate objectives with the expectations of society; and
- Provide accountability to stakeholders

For Shonda Motors, a number of deficiencies are apparent and the following recommendations would help to improve its corporate governance practice. These recommendations are based on what is considered best international corporate governance practice.

a) Mr John Hicks is the chairman and chief executive officer**2marks**

There should be clearly divisions of responsibilities between Chairman and Chief Executive. The board should meet regularly, and have a formal schedule of matters reserved to it for its decisions. The annual general meeting (the AGM) – Companies should propose resolutions at the AGM on each substantially different issue. The

Chairman should ensure that members of the audit, remuneration and nomination committees are available at the AGM to answer questions. Notice of AGMs should be sent in good time

b) Appointment of directors

2marks

Appointment of directors should involve other members of the board and the appointment should be approved by shareholders in an AGM. The appointment should be based on specific terms of reference and their performance should be reviewed periodically.

c) Non-executive directors/No special responsibilities

2marks

For a company the size of Shonda, it is necessary to constitute committees of non-executive directors to deal with appointments and remuneration and the all important matter relating to financial statements and audit. Non-executive directors should comprise at least a third of the board.

The combined code requires that companies should have a committee of the board called the audit committee. In terms of structure, this would consist of at least three non-executive directors with written terms of reference which deal clearly with its authority and duties

The audit committee should oversee the appointment of auditors, the establishment of internal audit and the implementation and review of internal controls, including dealing with management letters

d) Accounting systems and internal controls
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2marks

The directors should implement adequate accounting and internal controls. The directors should review the effectiveness of internal control systems, at least annually, and also review the need for an internal audit function. Given the size of Shonda Motors, an internal audit department should be established.

e) Frauds

2marks

As part of corporate governance, it is important risk that is managed. It is generally the responsibility of management to assess risks and design operating systems to reduce risks relating to fraud and error.

Total marks

10marks

Action on possible tax fraud

There appears to be fraud against Zambia Revenue Authority through falsification of accounting records and overstating expenses. It will be necessary to confirm that the falsification is deliberate and not an accidental consequence of a poorly designed computer system.

The first action is to raise the matter with management and request that they correct the fictitious records, make full provision for all taxes including any payments due for which Shonda Motors is potentially liable. In addition, the client will be encouraged to make full disclosure to the Zambia Revenue Authority.

If management refuse (As should be expected), the financial statements should be qualified as to the amounts of taxation not provided for, assuming that this is material. At this stage it would be inappropriate to spell out detailed reasons nor accuse the directors of impropriety.

As auditors, we are prohibited to divulge information about a client, unless in specified exceptions. However, there is no statutory duty of disclosure relating to the matter at hand as it is hardly a public interest issue. We are therefore probably constrained by our duty of confidentiality from raising the matter with the Zambia Revenue Authority. Accordingly, it will be advisable to seek legal advice as to any further action that should be taken.

If the directors refuse to make full disclosure voluntarily to the Zambia Revenue Authority, we should consider resigning from the audit.

2 marks for each valid point, maximum five point -Total marks= 10marks

SECTION B

(Answer in the ORANGE answer book)

QUESTION 2 SECTION B PART 1
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RISKS

<u>Industry</u>	
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KDM is involved in retailing and motor industry. These industries are susceptible to changes in customer as they are fashion based. New developments may result in order models, products and services becoming obsolete. In addition, mining depends on availability of emeralds, a situation that may not be sustainable	2
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<u>Results</u>	
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| <ul style="list-style-type: none"> Losses before tax have more than doubled. It is possible that some of the | |
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<p>increased expenditure is a result of the integration program and that in future benefits are expected to accrue. If this is not the case, KDM may face serious problems in future.</p> <ul style="list-style-type: none"> Customer numbers have increased but revenue per customer has decreased significantly. The company needs to investigate the cause of this. For example, it could be due to reduced usage by customers or the effects of changes in charges perhaps as a result of acquisitions during the year. 	2
<p><u>Acquisitions during the year</u></p> <ul style="list-style-type: none"> The acquisition of Yeti Motors has been accounted for using proportionate consolidation. KDM owns 30% of the equity shares of Yeti Motors and based on voting control would appear to be in a position to exercise significant influence. Accordingly, Yeti Motors is an associate and should be consolidated using equity method of accounting from date of acquisition. For Budget chain stores, another investor has required Budget chain stores to follow policies that do not necessarily meet the approval of KDM. Clearly this investor has control over Budget chain stores. Accordingly, Budget should be treated as a simple non-current investment in accordance with IAS 32 and IAS 39. KDM appears to be growing using a diversification strategy with acquisitions in mining, motors and retail. Whilst the long term benefits of synergy may be felt, in the short-term the combination of the various businesses will result in additional costs. There is also the risk that KDM may experience integration problems given the different levels of knowledge and experience required in each industry There is no guarantee that the customers and staff of the acquired companies will be retained It is likely that KDM, Shonda Motors and Yeti Motors were in direct competition previously. It may therefore be difficult to integrate staff and company culture leading to a period of instability 	5
<p><u>Planned growth/Additional expenditure</u></p> <ul style="list-style-type: none"> Expansion and maintenance will be costly. KDM group will not be able to sustain growth unless the expenditure results in increased revenues and profits KDM will need to finance those activities. If the business increases its gearing considerably, it may find it difficult to service the debt and to raise further funds in the future KDM is more concentrated in the Motor industry. There is a possibility that market saturation may restrict future growth and drive down prices and therefore margins 	3
<p><u>Consignment inventory</u></p> <ul style="list-style-type: none"> The inventory is high risk because it is a complex accounting issue and has a material impact on the financial statements. Although legally KDM does not own the cars until three months after they have been delivered, KDM has 	

<p>never returned the cars and the directors are allowed to take any car for their own use out of each consignment. It therefore appears that the commercial reality is the consignment is a purchase from the date of delivery. There is therefore a risk that both inventories and liabilities may be understated.</p>	2
<p><u>Inventory valuation</u></p> <ul style="list-style-type: none"> In addition to the issue of whether to recognise the consignment inventory, the extensive range of parts held by KDM increases the risk of inventory valuation. This combined with the existence of trade-ins arrangements and ex-demonstration models present special measurement and valuation problems. 	2
<p><u>Warranties</u></p> <ul style="list-style-type: none"> Certain sales have warranties attached. This is another area which involves complex accounting. IAS 37 requires that a company should set up provision where there is a present obligation as a result of a past event from which it is probable that a transfer of economic benefits will be required to settle the obligation and a reliable estimate of the amount of the obligation can be made. IAS 37 gives warranties as an example of an instance when it is likely that a provision will be required. It will be important to ensure that any such provision is appropriately calculated. 	4
<p><u>Cash sales</u></p> <ul style="list-style-type: none"> The company has a high proportion of cash sales which increases the inherent risk of the audit. Cash sales are inherently more risky than credit sales as there is more scope for the misappropriation of cash and the understatement of income 	1
<p><u>Results</u></p> <ul style="list-style-type: none"> Losses before tax have more than doubled. It is possible that some of the increased expenditure is a result of the integration program and that in future benefits are expected to accrue. If this is not the case, KDM may face serious problems in future. Customer numbers have increased but revenue per customer has decreased. The company needs to investigate the cause of this. For example, it could be due to reduced usage by customers or the effects of changes in charges perhaps as a result of acquisitions during the year. 	2
<p><u>Related party transactions</u></p> <ul style="list-style-type: none"> The directors are related parties to KDM. They are allowed to use some of the cars imported for sale for their personal and business purposes. This constitutes a related party transaction, and, given the directors' position in the company, makes difficult to measure for inclusion in the financial 	2

statements.	
<u>Brand name</u> <ul style="list-style-type: none"> • Having a common brand under which all companies operate can be risky. In the event that there are quality problems in one company, this will be perceived to be pervasive throughout all the companies associated with the brand, creating serious going concern problems • The actual cost of developing and patenting the brand may need to be capitalised in accordance with IAS 38. 	2
Presentation	3
Total marks	30

Consolidation procedures

The consolidation procedures should cover the following key areas:

- Determining extent of influence/consolidation method
- Accounting policies
- Intercompany transactions
- Goodwill
- Consolidated reserves
- Investment in associate

a) **Determining extent of influence/Accounting method** **3marks**

The accounting or consolidate method should be determined on the basis of ability of one company to exercise influence over another company, in terms of influence or control over operating and financial policies. This is determined on the basis of:

- Number of shares
- Voting power attaching to those shares
- Influence over the appointment of members of the board
- Any other operational influence such as ability to impose such decisions

Based on this assessment, the accounting methods are as follows:

- Little/or no influence (Less than 20%), as in Budget chain stores = Trade investment at cost or as per IAS 39
- Significant (20% - 50%), as in Yeti Motors = Associate = Equity accounting consolidation)
- Dominant/Control (More than 50%), as in Kansenshi Emeralds = Subsidiary = Acquisition accounting

b) **Accounting policies and fair values** **2marks**

Information regarding accounting policies should be obtained as these will need to be brought into line as part of the consolidation process. It is more likely that the policies of

KDM will be different to the rest of the group, given the different industries in which they operate. If necessary, other auditors should be requested to perform and provide reconciliations so that consolidation adjustments can be quantified.

c) Intercompany transactions	2marks
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The way in which KDM identifies inter-company transactions and balances should be established together with performing regular reconciliations. A list of intercompany balances as at 31 March should be reviewed and confirmed to ensure that they cancel out. Any unrealised profits should be eliminated

d) Goodwill	3marks
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Goodwill should be calculated by comparing the cost of the investment with the fair value of the net assets of the Kansenshi Emeralds at the date of acquisition. Methods used to calculate fair value of net assets should be assessed. For example experts may be used to value certain type of assets.

Whether goodwill has subsequently been impaired should be assessed with any known factors being taken into account. Negative goodwill should be credited to the income statement immediately.

e) Consolidated reserves	1mark
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Only post acquisition reserves of Kansenshi and Yeti Motors should be consolidated after adjustments for any inter-company balances and unrealised profits

f) Investment in associate	1mark
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The investment in Yeti Motors should be disclosed separately and should comprise cost plus share of post acquisition reserves.

g) Consolidation	3marks
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- Kansenshi Emeralds should be consolidated using acquisition accounting. All post acquisition incomes and expenses (after adjustments for inter-company transactions) should be combined with those of the rest of the KDM group. Similarly all assets and liabilities as at the balance sheet should also be combined.
- For Yeti Motors, only share of post acquisition profits after tax should be combined with the rest of the KDM group. In the balance sheet, an amount representing cost and share of post acquisition profits will be disclosed.
- For Budget chain stores, this will be presented as a non-current asset investment at cost less any impairment as at the balance sheet date.

Total marks

15marks

PART 2

Auditor's responsibility for other information

2marks

ISA 720 requires the auditor to read the other information in documents containing audited financial statements to identify material inconsistencies with the audited financial statements. A material inconsistency is when other information contradicts information contained within the financial statements. It may raise doubt about audit opinions drawn from evidence previously assessed.

The auditor should consider whether other information or the financial statements requires adjustment as a result of the material inconsistency. This should be discussed with management and those charged with corporate governance.

If the financial statements need amending and the entity refuses to make adjustment, the auditor should express a qualified opinion. A material inconsistency is distinguished from a material misstatement of fact, which is when information unrelated to the financial statements is incorrectly stated or presented. If the auditor becomes aware of material misstatement of fact, the auditor should raise it with management.

If management does not amend a material misstatement of fact, the auditor should consider appropriate action. This is likely to be to include an emphasis of matter paragraph in the audit report.

Management report

4marks

- The management report contains the amount and reason for a material change in equity in the financial statements that has not been properly disclosed in the financial statements themselves. The management report and the financial statements are inconsistent.
- The revaluation of K4.5 billion is clearly material to the financial statements, as it represents 3.75% of total assets and 48.9% of profit before tax. It is therefore necessary to amend these financial statements. The disclosure is incorrect because the fair value adjustment should be against opening balance of retained earnings. The disclosure is also inadequate as it has been supplemented by unaudited report.
- The statement that the adoption of IAS 40 did not have a significant impact on the results is not consistent with the fact that the financial position has increased substantially as a result of it, and hence the financial statements note should be redrafted to make it seem less insignificant.

- This would necessitate the auditors qualifying their audit report for a material disagreement, unless the directors of Yeti Motors amend the financial statements, which they are likely to do. As the management report contains the correct information, it does not require amendment.

Chairman's statement	4marks
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- The Chairman's statement includes an assertion which is at best exaggerated, concerning the Yeti Motors position in market and its commitment to accountable ethical professionalism
- Ironically, the first claim questions the credibility of the second claim, as it is not ethical to make false claims about the company's position in the market
- The false claim appears to be a statement of fact and the auditors should discuss this with management and those charged with corporate governance and recommend that the statement be amended
- If the Chairman refuses to correct the claim, the auditor should include an emphasis of matter paragraph in their report to correct the position.
- This would constitute a qualification of the audit report. The auditors 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.

Total marks	10marks
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Total marks	100marks
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