COMPETENCE PRACTICE EXAMINATION

FULL AUDIT

DECEMBER 2012

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

PICK-and- BUY LIMITED (PaB)

1. BACKGROUND - Extracts from PaB permanent audit file

PaB is a long established company that operates over 20 stores in Zambia, and is a well known name on high streets. Its shares are traded on the Lusaka Stock Exchange

The stores sell a variety of different products including the following:

- Children's clothes
- CDs and DVDs
- Toys and Books
- Confectionery
- Stationery
- Home items (such as kitchenware, bed linen, bathroom accessories etc)

PaB has traditionally been a company associated with customers with lower incomes.

Audited extracts from the financial statements for the year ended 31 March 2011 are as follows:

	(K' million)
Revenue	55,000
Operating expenses	38,000

Profit before tax	17,000
	======
Total Assets	139,000

2. PLANNING

You are Susan Mbewe, an audit manager with Choolwe & Partners, an accounting and auditing firm registered with the Zambia Institute of Chartered Accountants (ZICA). You have been assigned to the audit of PaB for the year ended 31 March 2012. PaB is one of your big clients and this audit assignment is new to you, although your firm has been auditing the company for a number of years now

You have just received the following e-mail from Mark Shula, who is the audit partner in charge of the audit of PaB.

To	:	Susan Mbewe
From	:	Mark Shula
Date	:	4TH April 2012
RE	:	Audit of PaB Ltd

Hi Susan,

As you know, we need to start planning the audit of PaB Ltd. We have an audit planning meeting next week and I would like you to draft some briefing notes for me, evaluating the main going concern risks and financial statement risks to be taken into account. Your briefing notes should clearly: **(i) Identify and discuss those conditions that appear to affect the going conern of PaB and (ii) Identify and discuss other financial statement risks** likely to have an impact on the audit for the year ended 31 march 2012.

Jane Kalya, who is the senior on the team, accompanied me to the meeting with the Finance Director of PaB last week and has made some notes of our meeting with him, which are attached to this e-mail **(Attachment 1).** There is also some back ground information on PaB on the permanent file which is on my desk. Use this information to help you, as I know that you are new to this client. My intention is to use your briefing notes when we discuss the audit at the meeting next week with the whole audit team.

You may also be aware that we have agreed on a secondment arrangement with one of the employees, Clare Chela from PaB. During the meeting the Finance Director requested we begin to include her on our audits as a way of providing on the job training for her.

Thanks

Mark.

3. **ATTACHMENT 1:** Notes of meeting between Mark Chibwe (Choolwe and Partners) and Finance Director of PaB

PaB is operating in "challenging" conditions – the economy as a whole is heading for recession, and profits have fallen since the previous financial year. The company is also facing intense competition from other stores in its various locations which have diversified in order to try and increase their profits and market share.

PaB Ltd has therefore decided to keep up with other big retailers. Customers can now purchase items on the company's website, which was set up in January 2012. The costs incurred in setting up the website amounted to K340 million, all of which have been capitalized. On-line purchasing has not so far been as successful as anticipated because the company cannot really compete with the established on-line stores, both locally and overseas, that can offer similar goods for sale at vastly discounted prices.

There have also been technical and security issues, resulting in some orders not being fulfilled on time or not at all. Due to falling profits and increasing costs, the company has decided to close down a number of its smaller stores and announced publicly a formal plan to do so on 24th Feb 2012. There are likely to be over a hundred job losses as a result. The costs involved with the store closures have not been accounted for yet.

PaB has decided not to pay a dividend this year.

Draft key figures for the year ended 31 March 2012

	(K' million)
Revenue	46,500
Operating expenses	37,300

Profit before tax	9,200
	======
Total Assets	115,000

4. AUDIT TEAM

In consultation with the audit partner, you have comprised the audit team as follows:

NAME	RESPONSIBILITY
Mark Shula	Audit partner
Susan Mbewe	Audit manager
Jane Kalya	Audit Senior – field work supervisor
Jim Sontwe	Audit assistant
Lisa Bowa	Audit assistant

5. ETHICAL MATTERS

You have been asked by the partner to review several ethical issues relating to the audit of PaB.

5.1. Jim Sontwe is a new trainee who joined Choolwe & Partners early in 2012. You have just found out from Lisa Bowa that Jim has been boasting about having recently inherited 10,000 shares in PaB from his late uncle. The current market price of the shares in PaB is K2,850 per share.

5.2. During the audit of PaB, Jane kalya was auditing the sales tax liability for the year-ended 31 March 2012. She noticed a discrepancy between the amount of sales tax declared on the tax form submitted to the Zambia Revenue Authority (ZRA) as having been charged on PaB’s sales, and that according to PaB’s accounting system. The discrepancy of K118 million represents sales tax under-declared to ZRA.

5.3. Clare Chela has recently joined Choolwe & Partners on a one year secondment from PaB. Clare is a fully qualified ZICA graduate, having started at PaB as a school leaver a number of years ago, and most recently was a member of the PaB newly set up internal audit function. The Finance Director of PaB, who was instrumental in arranging for the secondment, is keen that Clare is part of the audit team of PaB, and has expressed his thoughts to Mark Shula, the audit partner. Clare only worked in the internal audit department of PaB for six months and has no formal internal audit qualifications.

5.4. The internal audit department at PaB is not fully functional. In the meantime, PaB has decided to outsource the internal audit function as it does not presently have the capacity or resource to set up an in-house department. PaB Ltd will be putting this to tender and it is hoped that Choolwe & Partners will tender for this work. This work would result in addition income of K100 million per annum.

6. COMPLETION REVIEW

6.1. You have just reviewed the other information to be included in the PaB annual report and have found several inconsistencies between the financial ratios to be published in the annual report and those that you have calculated based on the figures stated in the draft financial statements for the year-end. The financial ratios to be included in the annual report paint a more optimistic picture of the PaB's liquidity that those calculated based on the figures in the draft financial statements. PaB appear indifferent to the matter.

6.2. The financial statements of PaB Ltd have traditionally included a provision for warranties of K985 million, but audit work performed by Jane Kalya, the audit senior has provided evidence that this provision should be reduced by about K500 million, as the PaB no longer provides guarantees on some of the appliances. You have reviewed the audit senior's work and are happy with her results and conclusions. You have discussed the issue of the provision with the directors of PaB Ltd but they are refusing to reduce the amount of the provision, on the basis that it might still be required, as it is possible that there might be increase in claims from other products on which guarantees are provided.

6.3. PaB decided to sell some non-current assets and these were classified as held for sale as from September 2011. During the five months to February 2012, PaB 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 is reasonable given the change in market conditions. However, by the end of the year, market conditions deteriorated further, and the assets were not sold by the end of year. PaB believes that the market conditions will improve and has not further reduced the selling price of the assets. PaB continues to classify the assets as being held for sale as at 31 March 2012, at a carrying value of K620 million. Such assets are normally depreciated at 20% using the reducing balance method.

SECTION A

1) Respond to the e-mail from your partner on matters relating to:

a) Going Concern Risks (7 marks)

b) Other financial statement risks (maximum 7 risks) (21 marks)

c) Presentation (2 marks)

2) Identify and explain the ethical and professional issues relating to:

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

b) The sales discrepancy (5 marks)

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

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

SECTION B

3) Describe the matters to consider and the audit evidence you should expect to find in your review of audit working papers relating to:

a) The capitalization of website costs (10 marks)

b) The announcement to close down some of the smaller stores (10 marks)

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

a) Other information (10 marks)

b) Provision for warranties (10 marks)

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

QUESTION TWO

ELITE BOATS LIMITED (EBL)

7. BACKGROUND

Elite Boats Limited (EBL) is a specialist boat manufacturer, based in Zambia. Three ex-employees of a major boat manufacturer founded EBL in 2002 as a private limited company. Until recently, EBL has never required finance to aid its expansion, and remains a private company owned by three founders. The three who are all engineers decided to leave their former employer in order to establish a business producing hand-built high performance sport boats for wealth customers. The manufacturing process is complex and involves several stages. The other major boat manufacturers are not able to supply such boats, as their systems are based on the assumption that they will produce each boat in sufficient numbers to benefit from significant economies of scale.

EBL has always been profitable, and has grown significantly in recent years. It is now the second largest specialist boat manufacturer in the SADC region and employs 300 staff at its head office and factory near Lusaka.

In order to expand its market, EBL has recently begun exporting their products to selected markets in the rest of Africa. In order to finance this venture, EBL has recently applied for an overdraft facility. The bank has indicated that this decision would be finalized once the current audit is complete and audit report issued.

Given the past successes scored by EBL, the directors are considering the possibility of listing the company on the Lusaka Stock Exchange.

8. THE SPECIALIST BOAT INDUSTRY

The customers who buy specialist boats are very status-conscious, and want a boat that is totally unique. They are prepared to pay a high price for their new boat, in comparison to "top of the range" models from the major manufacturers, but require extremely high quality and service levels in return. At present there are fewer than ten specialist boat manufacturers in the SADC region, and only three of these (including EBL) produce sports boats. The others specialize in general boats and fishing boats. As the sport boats are manufactured to customer specifications, there has historically been little competition between the various specialist sports boats manufacturers.

EBL, in common with other specialist boat manufacturers, has invested a significant sum in creating the design of its two boat models. It also spends a large proportion of its annual budget on sales promotion and marketing. This includes placing expensive advertisements in up-market boat magazines, and attending many boat shows and exhibitions. EBL also has a reputation for paying higher than average salaries to its senior designers and production staff. As a result staff turnover at EBL is virtually non-existent.

Customers who are often loyal to a particular manufacturer, can specify modifications to the basic design, such as minor changes to the body-shape of the boar, or major changes to the engine performance and driving characteristics of the boat. The directors of EBL have always assumed that their customers are not particularly price-conscious, as they are often wealth individuals with high disposable incomes. For these customers, the alternative to buying a boat from EBL might be to purchase fancy sports cars or private planes

EBL manufactures most of its components of its boats in-house. The main exceptions are electrical and control equipment. The only major bought-in component is the boat's engine, which EBL buys from a major boat manufacturer and then sends (subcontracted) it to Unique Parts Limited (UPL) for special modification and performance upgrades. While the engine is relatively expensive, it is the work of UPL that represents the single most significant cost of producing each boat. EBL has, on occasions, paid UPL the equivalent of 25% of the final sales price of a boat.

EBL has also negotiated a contract with a new supplier for specialized springs

9. THE BOARD MEETING

At the most recent board meeting of EBL, the directors discussed the worsening financial position of the company. Having spoken to the Sales Manager they came to the conclusion that, with the economies of Zambia and the SADC region drifting into recession, customers had recently become more aggressive in negotiating down the purchase price of their sports boats. This had put pressure on the profit margin of EBL for the first time in its history. The directors therefore felt it was necessary to commission an independent review of the industry.

The finance director provided the following summary of EBL's performance:

K'million	**2010**	**2009**	**2008**	**2007**
Revenue	117,500	111,200	100.600	101.000

Pre-tax profit	8,800	14,300	15,500	20,100
Dividend paid	800	5,000	5,000	5,000

The directors were particularly alarmed that UPL, the engine modification sub-contractor, seemed to be making almost as much profit on one of the engines as EBL was on the whole boat. The Purchasing Manager of EBL said that it was impossible to negotiate a lower price with UPL, as most of EBL's customers specified that their boat must have its engine prepared by UPL. At present, UPL does not supply engine modifications services to any of EBL's competitors, but there is no contractual obligation to prevent it from doing so. The Purchasing Manager reported that EBL has no long-term supply contract with UPL, and the owner manager of UPL had declined the offer of such a contract, believing that to enter into such an agreement would not be in the best interest of himself and his seven staff.

10. UNIQUE PARTS LTD

The purchasing manager has obtained the following information relating to Unique parts Limited (UPL).

Extracts from the financial statements of UPL

Statement of income

	2010
	K 'Million
Revenue	24,550
Cost of sales	13,980
Other costs	8,670
Profit before tax	1,900
Profit after tax	1,330
Dividends paid	650

Statement of financial position

	2010
	K' Million
Non-current assets	8,940
Inventories	2,320
Receivables	1,460
Cash	320
Payables	2,440
Equity share capital	1,000

Retained earnings	9,600

Information obtained from the Boat Trade Association

Boat component and service suppliers:	
Average P/E ration (for those suppliers with quoted share prices)	7.5
Average annual growth rate in reported post tax profits (2000 – 2010)	2.5
Average pre-tax profit margin	4.3%
Average pre-tax return on capital employed	11.2%
Average receivable days	65 days
Average payable days	28 days
Average revenue per employee	K1,285 million

11. STRATEGIC PROPOSAL

A further review of EBL's situation with UPL has been undertaken. A business consultant was engaged and has made several recommendations including submitting a takeover bid for UPL. It is considered that UPL is an attractive takeover target

12. AUDITORS AND PROFESSIONAL ADVISORS

Your name is Marshall Chanda and you are the senior manager in KiLN & Partners. KiLN is firm of chartered accountants and management consultants registered with the Zambia Institute of Chartered Accountants (ZICA). Your firm has been re-appointed as auditors for the second year to audit the financial statements of ELB for the year ended 31 March 2012. You have been designated senior manager of this assignment.

Your firm has also been approached to consider providing a due diligence service relating to the proposed takeover of UPL.

13. REVIEW OF AUDIT WORKING PAPERS – ETHICAL MATTERS FOR THE ATTENTION OF THE SENIOR MANAGER

As senior manger on the audit of EBL, the following matters have been noted for your attention by the audit senior Sarah Chupo.

a) The management accountant of EBL resigned two months ago and has not yet been replaced. As a result EBL's current transactions have not been fully processed in the accounting records. In order to comply with a loan agreement, EBL needs to prepare interim financial statements for the year ended 31 March 2013, but this cannot be done until the books are updated. The managing director of EBL has proposed that Sarah should help them out because she is familiar with the accounting system of EBL

b) During the audit of the financial statements for the year ended 31 March 2012, Sarah discovered that EBL had materially understated net income on the previous year's income tax return. EBL is unwilling to take corrective action. Sarah is not sure whether this matter should be reported to the Zambia Revenue Authority (ZRA)

c) On completion of the field work for the current audit, Sarah was offered six free cinema tickets by the managing director of EBL. It was explained that this gesture was meant to show EBL's appreciation of a job well done.

d) The audit fees for the year ended 31 March 2011 are still outstanding. Fee notes raised in relation to the current audit have also not been settled. It is clear from the cash flow statement of EBL that the company is in unfavourable cash and financial position

e) The managing partner of KiLN is not very pleased with the EBL's unwillingness to settle audit fees, inspite of several e-mail reminders sent to the managing director. The managing director of EBL has recently expressed the view that KiLN should not be considered for re-appointment as auditors if they continue "forcing" the issue of audit fees.

14. SUBSQUENT EVENTS

The audit of EBL for the financial year ended 31st March 2012 is nearly complete and the financial statements and the audit report are due to be signed in the following two weeks or so. However the following additional information on two material events has just been presented to your firm.

Event 1, occurred on 10th June 2012

The springs in a new type of booster pump developed to enhance the performance of selected boats have been found defective. These pumps were due to be marketed in the next few weeks. The EBL's insurers estimate that inventory to the value of K750 million has been affected. The insurers also estimate that the booster pumps are now only worth K225 million. No claim can be made against the supplier of these springs as this company is in liquidation with no prospect of any amounts being paid to third parties. The insurers will not pay EBL for the fall in the value of inventory as the company was underinsured. All the pumps affected were in the store house at the end of the year and no movements have been recorded post year-end.

Event 2, occurred on 5 July 2012

Production at one of the plants was halted for one day when a truck carrying dye used in colouring the boat panels reversed into a metal pylon, puncturing the vehicle allowing dye to spread across the factory premises and into a local river. The Zambian Environmental Management Agency (ZEMA) is currently considering whether the release of dye was in breach of environmental legislation. The EBL's insurers have not yet commented on the event.

SECTION A

1) **In relation to the working paper on ethical matters for the attention of the senior manager:**
   a) Identify and explain the ethical and other professional issues from each of the issues highlighted in the working paper

   (10 marks)

   b) For each issue recommend an appropriate course of action that your firm should take

   (5 marks)

2) **As part of the planning of the audit of EBL:**
   a) Identify and explain TEN business risks affecting EBL Ltd.

   (20 marks)

   b) For each risk in (a) state and justify the related financial statement risk

   (20 marks)

SECTION B

3) **In relation to the request for a due diligence on UPL:**
   a) List and briefly describe FIVE steps you should take before accepting the assignment

   (10 marks)

   b) Using the information obtained from the Boat Trade association, perform analytical procedures for UPL and comment on the implications of its performance as an acquisition target. (15 marks)

4) **In relation to each of the subsequent events:**
   a) Explain whether the event is adjusting or non-adjusting according to IAS 10 Events After the Reporting Period, stating clearly the appropriate accounting treatment to be applied

   (8 marks)

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

   (12 marks)