

SOLUTION TO QUESTION ONE  
Zodacom Mobile Ltd (ZML)

**SECTION A**

**1) Acceptance procedures – matters to consider**

**a) Changes to the letter of engagement**

The engagement letter specifies the nature of the contract between the audit firm and ZML. A new letter should have been issued given that:

- Since the last audit, new legislation relating to the mobile industry has been passed
- ZML expects Chanza and associates to provide other related and assurance services.

**b) Ability to perform**

It is against ethical and professional rules to accept an engagement for which the professional firm is not qualified or does not have the requisite resources to perform the engagement with due care and skill. The fact that the audit was delayed and reporting deadlines exceeded may indicate that the firm did not properly assess the resource requirements for this assignment

**c) Engagement economics**

The audit firm is in business and it is important that the engagement is commercially profitable in terms of fees. The imposition of 20% increase in fees may need to be considered in this context

**d) Provision of other services – Objectivity**

The audit firm is expected to assess its objectivity towards an assignment. Provision of other services may create self interest and self review threats and need to be carefully assessed

**e) Possible limitation in scope**

The assertion by ZML that the audit firm need not review internal controls in the purchasing system may suggest a limitation in scope. It is the auditor's responsibility to determine which areas would be subject to detailed testing and not the client.

**2) Use of experts,**

**a) Safeguards to professional competence**

Professional requirements specify that the following safeguards should be applied to ensure that the threat to professional competence and due care is reduced to an acceptable level:

- The firm must be committed to acquiring the technical knowledge relevant to the mobile industry
- The firm should assign specific staff members who possess particular skills and experience relating to the mobile industry
- Consider the use of external experts
- Deliberating increasing the duration of the engagement to allow for learning time and gaining experience
- Ensuring that the documentation of the engagement is comprehensively reviewed once the fieldwork has been completed

**b) Enquiries to be in respect of the external valuer and reasons for the enquiry**

Enquiries would need to be made for two main reasons, firstly to determine the competence, and secondly the objectivity of the valuer

## **Competence**

Enquiries would include:

- Is the valuer a member of a recognised professional body, for example a nationally or internationally recognised institute of registered surveyors?
- Does the valuer possess the necessary licence to carry out valuations for companies?
- How long has the valuer been a member of the recognised body, or how long has the member been licensed under that body?
- Does the valuer have specific experience of evaluating properties for the purpose of including their value within the financial statements?
- Is there any evidence of the reputation of the valuer, e.g. professional references, recommendations from other companies for which a valuation service has been provided?
- How much experience, if any, does the valuer have with ZML?

Using the above enquiries, the auditor is trying to form an opinion as to the relevance and reliability of the valuation provided.

## **Objectivity**

Enquiries would include

- Does the valuer have any financial interest in ZML, e.g. shares held directly or indirectly?
- Does the valuer have any personal relationship with any director or employee of ZML?
- Is the fee paid for the valuation reasonable and a fair, market based?

With these enquiries, the auditor is gaining assurance that the valuer will perform the valuation from an independent point of view. If the valuer had a financial interest in ZML, there may be an incentive to manipulate the valuation in a way best suited to the financial statements of the company.

Equally if the valuer had a personal relationship with a senior member of staff at ZML, they may feel pressured to give a favourable opinion on the valuation of the properties.

The level of the fee paid is important. It should be commensurate with the market rate paid for this type of valuation. If the valuer was paid in excess of what might be considered a normal fee, it could indicate that the valuer was encouraged, or even bribed, to provide a favourable valuation.

## **c) Audit procedures**

Audit procedures should focus on the appraisal of the work of the expert valuer. Procedures could include the following:

- Inspection of the written instructions provided by ZML to the valuer, which should include matters such as the objective and scope of the valuer's work, the extent of the valuer's access to relevant records and files, and clarification of the intended use by the auditor of their work.
- Evaluation, using the valuation report, that any assumption used by the valuer are in line with the auditor's knowledge and understanding of ZML. Any documentation supporting assumptions used by the valuer should be reviewed for consistency with auditor's business understanding, and also for consistency with any other audit evidence.
- Assessment of the methodology used to arrive at the fair value and confirmation that the method is consistent with that required by IAS 40.
- The auditor should confirm, using the valuation report, that a consistent method has been used to value each property.
- It should also be confirmed that the date of the valuation report is reasonably close to the year-end of ZML.
- Physical inspection of the investment properties to determine the physical condition of the properties supports the valuation.

- Inspect the purchase documentation of each investment property to ascertain the cost of each building. As the properties were acquired during this accounting period, it would be reasonable to expect that the fair value at the year end is not substantially different to the purchase price. Any significant increase or decrease in value should alert the auditor to possible misstatement, and to lead to further audit procedures.

## SECTION B

### 3) Conclusions about planning procedures and recommendations

	(a) Conclusions about planning procedures	(b) Recommendations
1	<b>Planning Meeting</b> It is possible that the field work may have started before the planning was properly reviewed and approved by the partner.	The planning should be documented fully and approved by the partner before the start of the fieldwork.
2	<b>Going Concern /letter of support</b> ZML has very little headroom in its overdraft and apparently has no other borrowing facilities. Apart from the letter of comfort, there is no plan to deal with this apparently serious issue. Besides the fact that the parent is listed overseas does not, of itself, mean that the comfort letter is valid evidence that ZML is a going concern.	The fact the parent is listed overseas does not, of itself, mean that the comfort letter is valid evidence that ZML is a going concern and there may be an increased level of risk, because of the parent's listed status. The letter of support is additional evidence that should still be assessed for sufficiency and appropriateness, alongside other evidence relating to the going concern status
3	<b>Subsequent events</b> The audit report was signed on 15 <sup>th</sup> April, where as the subsequent events checklist was completed on February 15 <sup>th</sup> , implying that there may be events that have not been taken into account in the report	The subsequent event review should be updated to the date of signing the audit report. The review should arguably be more rigorous and comprehensively documented because of the lack of financial facilities and the raised risk of going concern.
4	<b>Non-current assets</b> The section of the file demonstrates a lack of clarity in the approach to the audit and firm's basic procedures for initialling and dating working papers have not been observed, albeit in what may be a relatively low-risk area	Although non-current assets may be considered low risk, the total is material even if the current year's additions may not be in themselves. Accordingly, there should be a planned approach for the substantive work on non-current assets. The work must be properly reviewed to ensure that audit objectives are achieved
5	<b>Receivables</b> The uncleared amount may not be material as such, but it may well be in excess of the tolerable error threshold	The item should have been followed up and other evidence obtained and, if this was impossible, the potential mis-statement should have been calculated in theoretical terms to see if the mis-statement in the financial statements as a whole might have been material.
6	<b>Reporting and overall implications</b> There is a risk that the audit report (on the assumption that an unmodified opinion was given) might have been wrong because of the going concern and receivable questions	Laid down procedures need to be followed for the planning meeting, subsequent events, non-current assets working papers and receivables sample. Training implications need to be considered

#### 4) Report so society

There is an assumption that this other information is to be included in a document containing audited financial statements (the annual report). 'To be dealt with' presumably means 'to be read' with a view to identifying significant misstatements or inconsistencies. However, ZML may be intending to publish it as entirely separate report and require an assurance service (other than audit) such as an independent verification statement on performance standards.

#### 5) Appraisal of appropriateness of audit opinions

##### a) ZML

###### (i) Heading

- The opinion paragraph is not properly headed. It does not state the form of the opinion that has been given nor the grounds for modification.
- The opinion 'the financial statements do not give a true and fair view' is an adverse opinion
- The 'provision should be made', but has not, should be clearly stated as non-compliance with IAS 36. The title IAS 36 *Impairment of Assets* should be given in full
- The opinion should be headed 'Adverse Opinion'.

###### (ii) Content

- The effect and the reason for impairment should be summarised in the audit report instead of making reference to notes
- The effects have not been quantified, the maximum possible loss is the carrying value of the affected assets
- The wording is confusing. There must be sufficient evidence to support a claim of material misstatement.
- It is not clear why the failure to recognise impairment warrants an adverse opinion rather than 'except for'. The effects of non-compliance with IAS 36 are to overstate the carrying amounts of non-current assets and to understate the loss. The matter does not appear to be pervasive and so an adverse opinion looks unsuitable as the financial statements as a whole are not incomplete or misleading.

###### (iii) Prior year

- As the 2009 auditor's report, as previously issued, included an adverse opinion and if the matter that gave rise to the modification:
  - Is unresolved; and
  - Results in a modification of the 2010 auditor's reportthe 2010 auditor's report should also be modified regarding the corresponding figures
- The 2010 auditor's report does not refer to the prior period modification nor highlight that the matter resulting in the current period modification is not new.

##### b) Chawama Holdings

###### (i) Adverse opinion paragraph

The title of the opinion paragraph clearly states that it is an adverse opinion. For the sake of clarity it may be better just to state that the opinion is adverse rather than go into the reason for the opinion in the title, i.e. remove the wording 'arising from disagreement about application of IAS 37'

Normally the reason for any modification to the audit report affecting the opinion is explained in a separate paragraph immediately preceding the opinion paragraph. Here the reason for the modification is explained within the opinion paragraph which could be confusing for the readers.

ISA 705 *Modifications to the Opinion in the Independent Auditor's Report* states that a clear description of all of the substantive reasons for any modifications to the opinion should be included in the report, including where applicable, an estimate of the financial effect.

Other deficiencies in the report include:

- The title of IAS 37 should be given in full as *IAS 37 Provisions, Contingent Liabilities and Contingent Assets*
- Without any figures to quantify whether effects are material or pervasive, it is not clear whether the adverse opinion is appropriate or an except for opinion may be more appropriate
- The report appears contradictory, as it states that the omission has caused a material misstatement, implying that an except for opinion rather than an adverse opinion would be more appropriate.

## **(ii) Emphasis of matter paragraph**

The paragraph appears to be describing a breach of financial reporting standards. IAS 33 Earnings per Share requires that listed companies must disclose basic and diluted earnings per share figures, including comparatives, on the face of the financial statements. The fact that the directors have decided not to disclose is a clear misapplication of the standard. Earnings per share is material by nature, so its omission represents a material misstatement in the financial statements.

Other deficiencies of the report include:

- The opinion should be a qualified 'except for' due to material misstatement and a paragraph discussing the misstatement should be inserted above the opinion paragraph, including an estimate of the financial effect
- The emphasis of matter paragraph cannot be used to highlight situations where the directors have decided not to include a matter in the financial statements. The paragraph is reserved for use to explain significant uncertainties or going concern issues, and its use in this situation is entirely inappropriate.

## **c) Trade Pings**

### **(i) Suitability of the report**

- The report drafted is a 'disclaimer' of opinion, which is appropriate if the effect of being unable to obtain sufficient appropriate evidence is considered pervasive

### **(ii) Principal relevant to forming an appropriate opinion**

- The fact that some accounting records were not available means that the scope of the audit has been limited. Although this has been stated in the report, users of financial statements will not know which accounting records were missing, or why, or the accounting period covered.
- Management is expected to make estimates and judgements with regard to the reconstruction of financial information and make appropriate disclosures in the financial statements.
- An unmodified opinion provides reasonable assurance that the financial statements are free of misstatement caused by fraud or error. Even if the amount of reconstruction was extensive the auditor would most likely modify their opinion 'to be on the safe side'. Error is generally quantifiable. The former CEO's actions (and timing) may suggest fraudulent reporting which may not be quantifiable (in the absence of accounting records).

- Depending on the amount of reconstruction undertaken the potential misstatement though material may not be pervasive. The report supposes that matter to be pervasive in disclaiming an opinion on the financial statements as a whole.
- The prior period audit opinion (unmodified) may not have been appropriate. The accounting records that were taken would have provided evidence about balances as at September 2009. The auditor should reconsider the extent to which the CEO contributed to sufficient evidence in forming the prior period opinion.
- The fact that the prior year's opinion was unmodified does not preclude a disclaimer of opinion on the comparative information.