QUESTION TWO

KUMANYA MINES

Historical Background

Kumanya Mines plc (KM plc) is a leading international mining group, combining KM plc, a London listed public company headquartered in the UK, and KM Limited, which is listed on the Lusaka Stock exchange, with executive offices in London and Lusaka. The two companies are joined in a dual listed companies (DLC) structure as a single economic entity, called the KM Group.

To deliver superior returns to shareholders over time, KM takes a long term and responsible approach to the Group's business. This means concentrating on the development of first class ore bodies into large, long life and efficient operations, capable of sustaining competitive advantage through business cycles. In a recent press release, the group executive director asserted that:

"We are a world leader in finding, mining and processing the Earth's mineral resources. Our products help fulfil vital consumer needs and improve living standards. We operate, and eventually close, our operations safely, responsibly and sustainably.

KM operates as a global organisation, sharing best practices across the Group. Our values - accountability, respect, teamwork and integrity - are expressed through our business principles, policies and standards. We set these out in our worldwide code of business conduct,

The way we work. *Our values underpin the way we manage the economic, social and environmental effects of our operations, and how we govern our business.*

Wherever KM operates, health and safety is the first priority. All our Group businesses put sustainable development *at the heart of their operations, working as closely as possible with host countries and communities, respecting their laws and customs. For KM it is important that the environmental effects of its activities are kept to a minimum and that local communities benefit as much as possible from operations."*

Acceptance and Audit Planning

Your name is Kelvin Sampa and you are a senior manager in the audit firm JT & Co, an audit firm registered with the Zambia Institute of Chartered Accountants (ZICA). Your firm has recently been re-appointed to audit the financial statements of KM plc for the year ended 30th June 2011, and this is the first time that you have been involved in the audit of KM plc.

You have been asked to start the audit planning for KM plc, by Mr N Mazima, the senior partner in JT & Co. Mr Mazima has been the engagement partner for KM plc, for the previous six years and so has a sound knowledge of the client. Mr Mazima has informed you that he would like his son Bupe to be part of the audit team this year. Bupe is currently studying for his first set of technician papers for his ZICA qualification.

In an initial meeting with Mr. Bruce White, the finance director of KM plc, you learn that the audit team has, on previous audits, been taken on a boat cruise as part of the entertainment. You learn that Mr. White has become aware that this could appear to be an attempt to influence the opinion of the audit. Instead the Mr. White has arranged for a game drive with Lukasha Safaries. As this is cheaper than the boat cruise, Mr. White hopes that this would be acceptable

As senior manager, you have comprised the audit team and determined the basis on which materiality should be assessed. In addition, you have provided guidelines for the approach to substantive testing, emphasising the use of analytical procedures wherever practicable.

The Audit Team

The audit team is comprised as follows:

Name	Responsibility
Mr. N Mazima	Senior Partner
Mr. K. Sampa	Senior Audit Manager
Mrs. B. Kabanga	Senior auditor
Mr. T Chalwe	Auditor
Miss. J. Lunda	Audit Assistant
Mr A. Kasolo	Audit Assistant

Materiality

Materiality considerations during audit planning are extremely important. The assessment of materiality at this stage will be based on the most recent and reliable financial information. Assessing materiality will help to determine an effective and efficient audit approach.

For the audit of KM plc for the year ended 30th June 2011, materiality assessment is intended to help the audit team to decide:

- How many and what items to examine
- Whether to use sampling techniques
- What level of error is likely to lead to a modified audit opinion

Materiality is determined using the following guidelines

CRITERIA	QUANTITATIVE GUIDELINE
Turnover	0.5% - 1%
Profit before tax	5% - 10%
Total assets	1% - 2%

Substantive Testing

Substantive testing is to be based on determined audit objectives and procedures for obtaining audit evidence, clearly focused on relevant assertions. In developing the substantive audit programme, the following model was generally followed:

- Agreeing opening balances with previous working papers
- Reviewing the general ledger for unusual records
- Checking schedules provided by the client to and from accounting records to ensure completeness
- Carrying out analytical review
- Testing transactions in detail
- Testing balances in detail
- Reviewing presentation and disclosure in the financial statements

Analytical review

It is planned to use analytical review procedures at the planning stage of the audit in conjunction with risk analysis and materiality as a means of identifying key audit areas. As well as helping to determine the nature, timing and extent of other audit procedures, analytical procedures may also indicate aspects of the business of which the JT & Co was previously unaware.

The purpose of undertaking analytical procedures will be to see if developments in the client's business have had the expected effects. Particular interest will be focused in changes in audit areas where problems have occurred in the past.

However, a decision has to be made whether using analytical reviews during the audit of the financial statements for KM plc for the year ended 30th June 2011 will be effective and efficient in reducing detection risk for specific financial statement assertions.

Working papers

The following working papers have been prepared by the audit team:

WORKING PAPER REFERENCE	DESCRIPTION	PREPARED BY:
KM/JN2011/001	Financial Statement Extracts	Mrs. B Kabanga
KM/JN2011/002	Substantive testing	Mr. T Chalwe

Working paper KM/JN2011/001 – Financial statement extracts

INCOME STATEMENTS FOR THE YEAR ENDED:

	Note	30.06.2011 (Draft) (K'million)	30.06.2010 (Audited) (K'million)
Turnover		130,950	101,600
Sales discounts		(5,250)	(2,000)
		-----------	----------
		125,700	99,600
Cost of sales		(95,560)	(76,030)
		-------------	------------
Gross profit		30,140	23,570
Distribution cost		(7,620)	(4,980)
		-------------	------------
		22,520	18,590
Admin expenses	1	(10,620)	(11,650)
		------------	------------
Net profit before tax		11,900	6,940
		=======	========

STATEMENT OF FINANCIAL POSITION

Non-current Assets			
Tangible assets		10,730	21,300
Intangible assets		540	750
		---------	----------
		11,270	22,050
		----------	-----------

Current Assets

Inventory	16,400	12,000
Trade receivables (Bad debts provision of (K700 million in each year)	22,040	13,530
Other receivables	460	420
Cash	1,040	-
	---------	----------
	39,940	25,950
	----------	----------
Total Assets	51,210	48,000
	======	======

Equity and Liabilities

Ordinary share capital	17,000	10,000
Retained Earnings	18,940	10,040
	---------	---------
	35,940	20,040
Non-current liabilities		
Bank loan	5,000	10,000
	----------	---------
	40,940	30,040
Current liabilities		
Overdrafts	-	1,290
Trade payables	7,030	14,790
Other payables	320	200
Tax payable	2,920	1,680
	---------	----------
	51,210	48,000
	======	======

NOTES TO THE FINANCIAL STATEMENTS

NOTE1 – Administration expenses

Item description	30.06.2011 (K'Million)	30.06.2010 (K'Million)
Salaries and Wages	14,000	10,750
Depreciation	600	890
Amortisation	260	250
Rent	350	120
Rates	50	40
Gas and Electricity	50	20
Profit on disposal	(5,100)	(750)
Bad debts	80	70
Insurance	160	150
Cleaning	20	10
Miscellaneous	150	100
	---------	**----------**
	10,620	**11,650**
	======	=======

NOTE 2.
During the year, land and buildings with a net book value of K9,900 million was sold for K15,000 million. KM plc immediately leased back the asset over the remainder of the building's useful economic life.

Working paper KM/jn2011/002 – Substantive testing

a) Development Expenditure

KM plc is developing a new production process. During 2010, expenditure incurred was K400 million of which K250 million was incurred before 1 December 2010 and K150 million between 1 December 2010 and 31 December 2010. KM plc is able to demonstrate that, at 1 December 2010, the production process met the criteria for recognition as an intangible asset. The recoverable amount of the know-how embodied in the process is estimated at K90 million.

b) Leases

In July 2010, KM plc entered into five new finance leases ON buildings. The leases have been capitalised and the statement of financial position includes leased assets presented as non-current assets at a value of K3.6 billion, and a total finance lease payable of K3.2 billion presented as a non-current liability.

c) Financial Assets

Non-current assets include financial assets recognised at K1.26 billion. A note to the financial statements describes those investments as investments classified as "fair value through profit or loss", and the investment are described in the note as "held for trading". The investments are all shares in listed companies. A gain of K350 million has been recognised in net profit in respect of the revaluation of these investments

SECTION A

1) With regard to your acceptance to become the auditor of KM plc,

a) explain any FIVE ethical threats which need to be taken into account (10 marks)

b) For each ethical threat, discuss how the effect of the threat can be mitigated (10 marks)

2) In relation to the working paper (KM/JN2011/002**) state**

(i) The matters that should be taken into account

(ii) Explain the audit procedures to be carried out to obtain sufficient appropriate audit evidence

In undertaking substantive testing for the each of the following items:

a) Development expenditure (10 marks)
b) The leases (10 marks)
c) The financial assets (10 marks)

(Ignore materiality considerations)

SECTION B

3) Explain to what extent to which you would plan to place reliance on analytical procedures as audit evidence in the audit of financial statements for KM plc for the year ended 30th June 2011.
(10 marks)

4) With reference to working paper (KM/jn2011/001**),**

a) Produce a table that summaries the trend movements and suitable ratios to be used for the purpose of your analytical review. (10 marks)

b) Prepare an internal report for the senior partner that identifies and explains the audit risks discovered during your analytical review of the financial information that should be taken into account when planning the final audit of KM plc. (20 marks)

c) Compute a suitable level of materiality and justify the suitability of your assessment.
(10 marks)