SOLUTIONS TO QUESTION TWO

SECTION A

1) Ethical threats and mitigating safeguards

	(a) Explanation of Ethical Issue	(b) Discussion of mitigation action-Safeguard
1	**Familiarity:** A member's objectivity may be threatened or appear to be threatened as a consequence of a family or other close personal or business relationship. Mr. Mazima has been the engagement partner for KM plc for the previous six years and it is possible that he may have developed close connections with the client	Compulsory rotation is required for listed companies. However for companies like KM plc, JT & Co is advised to carryout annual reviews to ensure objectivity is not threatened and is advised that partners act for no longer than 10 years. JT & Co should consider allocating another engagement partner to KM plc.
3	**Professional competence and due care**: JT & Co have a continuing duty to maintain professional knowledge and skill at a level required to ensure that KM plc receives competent professional service based on current developments and practice. The assignment of Mr. Mazima's son seems questionable in this regard.	Where as there is nothing wrong with Bupe being assigned to this audit, JT & Co should ensure that he has requisite qualifications, skills and experience to undertake the tasks that will be assigned to him. In addition, closer supervision will be necessary given that he has just started his ZICA studies
5	**Gifts and hospitality:** This could be deemed a bribe and potentially the auditor may lose professional skepticism	Gifts should not be accepted unless modest and such gifts should be available to the company staff at the same time and on similar terms. It is not clear from the scenario whether a game drive is modest and is available to all staff. In any case JT & Co, should establish policies on gifts and hospitality and should be communicated to all staff
6	**Overdue fees:** The existence of significant overdue fees from an audit client or group of associated clients can be a threat or appear to be a threat to objectivity akin to that of a loan.	JT & Co must therefore ensure that overdue fees, along with fees from current work, could not be considered as a loan and should request that they be paid as soon as possible

2) Matters to consider and audit procedures for substantive testing

a) Development expenditure

MATTERS TO CONSIDER	AUDIT PROCEDURES

Accounting treatment
• Whether the development expenditure is correctly categorised as expenditure that qualifies under IAS 38
• Conditions to be satisfied include
  o The technical feasibility of completing the production process so that it will be available for use
  o The ability of KM plc to reliably measure the expenditure attributable to the intangible asset during its development
• The conditions should be reviewed each year and should be fulfilled each year.
• The impact of the development expenditure on the income statement and the statement of financial position. It should be expected that any expenditure not meeting the specified should be written off as incurred
• The expenditure meeting specified criteria should be capitalised as intangible assets. On completion of the process, the intangible assets should be amortised over the period it is expected to generate benefits.
	• Inspect the cash books and other supporting documents to total expenditure of K400m and confirm that it is in the nature of research and development expenditure
	• Through enquiries and review of relevant documentation, confirm that the K250m meets specified criteria
	• Re-compute the determination of the recoverable amount of K90m by comparing the net present value of benefits expected to be generated by the process with the fair value or net realisable of the completed production process
	• Review the income statement to confirm that the K150m has been written off
	• At the end of December 2010, review the statement of financial position to verify that the K250m has been duly capitalised as an intangible asset

Presentation and Disclosure • According to IAS 38, intangible assets should be presented under non-current assets, less any amortisation and less any impairment losses	• Review the statement of financial position to verify that the K250m has been properly been included as intangible asset under non-current assets. As the process is still under development, there should not be any amortisation

b) The leases (10 marks)

MATTERS TO CONSIDER	AUDIT PROCEDURES

Accounting treatment
• Whether the leases are correctly categorised as finance leases or operating leases. This depends on whether the risk and reward of ownership have passed to KM Plc (the lessee) from the lessor. The leases should only be recognised in the statement of financial position if KM plc has the risk and reward of ownership
• Indications of risk and rewards passing to KM plc would include
  o KM plc is responsible for repairs and maintenance
  o The lease period is for the most of the expected useful life of the assets
• The impact of leases on the income
	• Agreement to the cash book of amounts paid to the lessor, i.e. deposit and instalments paid before the year end.
	• A review of the lease contract including consideration of the major clauses of the lease which indicate whether risk and reward has passed to KM plc
	• Re-computation of the finance charge expensed during the year and agreement of the interest rate used in the lease contract
	• Re-computation of the depreciation charged, and agreement that the period used in the calculation is the shorter of the lease term and the useful life of the assets

statement must be considered. A finance charge should be calculated and expensed each accounting period, using the actuarial method of calculation (or the sum of digits) • In addition, leased assets should be depreciated over the shorter of lease and the economic life of the asset	
Presentation and Disclosure • The finance lease payable should be split between current and non-current liabilities in the statement of financial position	• A recalculation and confirmation of the split of the total finance lease payable between current and non-current liabilities • A confirmation of the adequacy of the disclosure made in the notes to the financial statements, and agreement of the future payments disclosed to the lease contract

Financial assets

MATTERS TO CONSIDER	**AUDIT PROCEDURES**
Accounting treatment • According to IFRS 9, financial instruments should be classified into one of three categories. KM plc has classified financial assets into the category 'financial assets at fair value through profit or loss" as they are considered to be held for trading investments • In order for this to be an acceptable classification of the investment • Investments classified in this way must be measured at fair value each year-end, with gains and losses taken into the statement of comprehensive income as part of the net profit for the year.	• A schedule showing all the investments held in the period, their purchase price and their end valuation • Agreement of the purchase prices of investments to supporting documentation, e.g. stock-broker's statements, vouching any payments to cash books, cheques etc • Agreement of the year end valuation for each investment to external sources of information, e.g. stock exchange prices and other relevant financial information such as the financial press • Re-computation, and confirmation of the gain recognised in the income statement.
Presentation and Disclosure • IFRS 7 contains extensive disclosures in relation to financial assets, including for example, a narrative description of how the risks in relation to the investment are managed and monitored	• A review of the proposed note to the financial statements confirming adherence to the disclosure requirements of IFRS 7, and recalculations of any numerical disclosures

SECTION B

3) Extent of reliance on analytical review procedures

a) There is likely to be more reliance on analytical procedures as this is an existing on-going client for which past verified and predictable information should be available
b) Analytical procedures may not be relied upon in respect of material items that may require 100% testing. For example disposals and depreciation charge for the year are likely to be tested in total. Analytical reviews may provide sufficient audit evidence on line items that are not individually material.
c) Substantive analytical procedures are best suited to large volume transactions such as turnover and certain administration and distribution expenses. If controls over the completeness, accuracy and validity of recording transactions in these areas are effective, then analytical review procedures showing that there are no unexpected fluctuations should reduce the need for detailed substantive testing
d) The extent of planned use will be dependent upon:
    a. Availability of relevant and reliable information
    b. Relationships expected between variables, for example material costs and revenue
    c. Information is homogenous and relationships are predictable

4) Analytical review

a) Summary table of trend movements and suitable ratios

Trends - Annual Movements

ITEM	CALCULATION	PERCENTATE (%) MOVEMENT
Turnover	29,350/101,600*100	28,9%
Purchases	23,200/78,300*100	29.6%
Distribution costs	2,640/4,980*100	53%
Wages/salaries	3,250/10,750*100	30.2%
Rent	230/120*100	191.7%
Rates	10/40*100	25%
Gas and Electricity	50/20*100	250%
Insurance	10/150*100	6.7%
Cleaning	10/20*100	50%
Miscellaneous	50/10*100	50%

RATIO ANALYSIS

	2011		**2010**	
	Calculation	**Ratio**	**Calculation**	**Ratio**
Gross Margin	30,140/130950*100	23%	23,570/101,600*100	23.2%
Operating Margin	11,900/130/950*100	9.1%	6,940/101,600*100	6.8%
ROCE	11,900/40,940*100	29.1%	6,940/30,040*100	23.1%
Asset Turnover	130,950/40,940	3.2	101,600/30,040	3.4
Current Ratio	39,940/10,270	3.9:1	25,950/17,960	1.4:1
Quick ratio	23,540/10,270	2.3:1	13,950/17,960	0.8:1
Inventory Days	16,400/95,560*365	62.6 days	12,000/76,030*365	57.6 days
Receivable days	22,040/130,950*365	61.4 days	13,530/101,600*365	48.6 days
Payable days	7,030/101,150*365	25.3 days	14,790/78/300*365	68.9 days

b) Internal report

To	:	N. Mazima – Senior Partner
From	:	K. Sampa – Senior audit Manager
Date	:	20 August 2011
Subject	:	Analytical review of KM plc to assist the planning of the year-end audit

As requested, please find a summary of the key audit risks of KM plc identified during the analytical review of the management accounts for the year ended 30 June 2011 and the audited financial statements for the prior year in preparation of this year's planning procedures

Turnover

Turnover has increased by 29% during the year to 30 June 2011. This significant increase may suggest a risk that turnover – and certain related balances – could be overstated

The increase in turnover has been partly fuelled by offering greater discounts totalling 4% of turnover in 2011 as opposed to 2% in 2010. This could imply an increased risk that closing inventory is overstated. Inventory should be valued at the lower of cost and net realisable value in accordance with IAS 2. The discounts offered must be taken into account when determining the net realisable value. Some products may be used as loss leaders in a drive to tempt new customers.

It also appears that extended credit terms have been offered due to the lengthening of the receivables collection period from an average 49 days in 2010 to an average 61 days in 2011

The overall increase in credit sales, coupled with the greater credit period increases the risk of non collection of receivables. However the bad debt provision had not been adjusted from the previous balance of K700 million), which represents 5% of total receivables in 2010 but only 3% of receivables in 2011. This suggests that the bad debt provision is understated and the trade receivables balance overstated. It also suggests that bad debt expenses in the income statement are understated.

The significant increase also suggests that we should pay close attention to the cut-off procedures adopted by the client and our testing of this process. There is no evidence to suggest that cut-off has been incorrectly performed but such a rapid increase in turnover may have put a strain on the company's sales recording system. It is therefore imperative to assess whether there has been any impact on the efficiency of the internal control system.

Distribution Costs

These have increased by over 53% during the financial year. It is difficult to identify the cause of the fluctuation without further information. However it is likely that KM plc has tried to increase their customer base in different geographical locations. Assuming all invoices are made in Kwacha, this should not greatly affect our assessment of audit risk.

Gas and Electricity Costs

These have increased by 250% during the financial year. I would have expected such costs to rise directly in comparison with production levels; however this does not appear to be case. There is a risk that these costs may be overstated.

It is unlikely that these balances are material to the financial statements. However enquiries should be made of management during the final audit to identify why the costs have risen so sharply.

Sale of Buildings

During the year land and buildings (they have been depreciated) with a net book value of K9,900 million have been sold for K15,000 million. At the same time the company's rental expenses have increased by 190%. There is no indication elsewhere in the income statement that the company has moved premises, such as removal costs, and is unlikely that the company would be able to increase production so much having sold half the building. It is therefore likely that the company has entered into a sale and lease back arrangement.

There are no finance lease liabilities on the statement of financial position. Hence it appears the lease is being treated as an operating lease. This represents the risk that the lease may have been misclassified and that non-current assets and finance lease liabilities are both understated on the statement of financial position. This would also have the knock effect that depreciation charges are understated in the income statement. This could be as much as K330 million per annum, which is the disposal proceeds of K15,000 million depreciated over the remaining useful life of 45 years.

Going Concern

During the year there appears to have been an improvement in the liquidity position of the company, with the current and quick ratios improving from 1.4 and 0.8 in 2010 to 3.9 and 2.3 in 2011 respectively

However, it should be noted that during the year, KM plc has raised a significant amount of cash from the disposal of buildings and the issuing of new shares. In total K22,000 million has been raised (15,000 disposal + K7,000 million) and it appears as though this has been used to pay significant external debts, most notably the bank loan and trade payables. The result is a healthier statement of financial position.

It should be noted though, that there is very little residual cash left over and the company appears to be having difficulty generating trading cash balances. Inventory days have increased from 58 days to 63 days. The increase in the operating cycle could be caused by offering extended credit in an attempt to woo new customers. However, the inability to generate cash balances could indicate problems ahead, particularly if the company is unable to meet loan and lease repayments. A failure to pay trade payables could also lead to a loss of supplier goodwill and have implications for future trade relationships.

Given the nature of the sale and leaseback, and the attempt to keep this debt off the statement of financial position, caution should be used when assessing the management's basis of preparing accounts. If the business is no longer a going concern, then the break up basis should be used.

c) Computation of materiality

Basis for computing materiality: Conclusion from audit risks identify in part (b)

The company has experienced a significant growth in turnover. However, this could come at the expense of greater bad debt risk and slower cash collection. This means the valuation of receivables and associated provisions is crucial. The use of a sale and leaseback mechanism also means the audit of non-current assets and leases is a high risk area. Finally, despite a healthy statement of financial position, it appears that KM plc has cash flow problems and this means care needs to be used in identifying the appropriate going concern basis.

This suggests that KM plc should be a classified as a high risk audit. This implies that a relatively lower materiality should be set. Accordingly, the materiality is set at K600 million which is approximately the average of the three lower threshold calculations computed below.

Computation of materiality

	Year ended 3.06.2011 (Kwacha Million)	**Year ended 30 June 3010 (Kwacha Million)**
Turnover	130,950	101,600
Profit Before Tax	11,900	6,940
Total Assets	51,210	48,000

	Year ended 30.06.2011		**Year ended 30.06.2010**	
Turnover *Calculation (K'million)*	0.5% *654*	1% *1,309*	0.5% *508*	1% *1,016*
Profit before tax *Calculation (K'million)*	5% *595*	10% *1,190*	5% *347*	10% *694*
Total Assets *Calculation (K'million)*	1% *512*	2% *1,024*	1% *480*	2% *960*