

SOLUTIONS TO QUESTION ONE -audit

SECTION A

Question 1(a) & (b)

To : Catherine Limbo, Audit partner Date : 25th May 2011
 From : Peterson Mumba, senior audit manager
 Subject : Briefing notes re ethical and professional matters

As requested, please find my briefing notes on the ethical and professional matters arising from the audit of ZIL, including recommended safeguards. I have structured the notes in a tabular format that indicates the threat and safeguard side by side.

Item	Ethical and Professional issue (a)	Recommended Safeguard(s) (b)
(i)	<p>Provision of non-audit services – Recruitment Providing a recruitment service to a client is not specifically prohibited by ZICA. However, it is generated accepted that certain threats to independence could be created. In particular, the following potential threats should be considered:</p> <p>a) Self-interest threat and self review threat Earning fees based on a percentage of the salary of the person recruited creates a financial self-interest threat to independence. Chewe & Co may be tempted to recommend an individual to a client in order to earn the fee, and not consider whether that individual is suited to the role.</p> <p>There is also a self review threat that may occur as Chewe & Co may be seen to be taking management decisions for an audit client by providing such recruitment services. This threat is increased with the seniority of the individual being recruited, for example if Chewe & Co were to advise on a new finance director.</p> <p>b) Familiarity threat The provision of recruitment services will create a familiarity threat. During audits, Chewe & Co will have to assess the work of individuals they helped to recruit. The firm may be or may be perceived to be less likely to criticise or challenge such individuals because this could discredit their recruitment services</p> <p>c) Ability to perform and quality control Chanza only worked in recruitment for a year and seems to be the only employee with any experience. He may require further training in order to recruit professionals and update his skills.</p>	<p>This threat could be reduced by only providing services for the recruitment of junior staff members. The firm could also its role to reviewing candidates' CVs and recommend individuals to interview but the final decision of who to recruit should always rest with the client.</p> <p>Chewe & Co should also consider reputation risk resulting from low quality of recruitment services. This risk could be reduced by setting up the recruitment services as a separate company.</p> <p>Chewe & Co should consider whether it has the time and resources to enter into this new</p>

		area of business.
(ii)	<p>Payment of bonuses</p> <p>Chewe & Co must and must be seen to be independent. Independence may be impaired if the firm receives a financial reward from ZIL even if it received indirectly. Payments in this way are not normal professional practice. This may raise some suspicion that the payment is a bribe or pay-off for failing to report on matters that would otherwise have been noted. This calls into question the integrity of the audit team.</p> <p>If the audit team were aware of the potential receipt of the bonus, this increases the risk that they will not be seen to be independent. The bonus does not apply to those of manager status and above. However the fact that it has been limited to lower grade staff demonstrates that the situation is perceived to be a threat to objectivity.</p>	<p>The rationale behind allowing the bonus to less senior staff should have been considered by the ethics partner and his conclusions documented.</p> <p>The bonus forms part of the basic audit fee and should be treated as such for disclosure purposes. The full amount should be disclosed as audit fee in the books of ZIL. The bonus could have an adverse effect on the morale of other staff at ZIL. Those not involved in the audit may feel that they have been unfairly treated as they have not been given the opportunity to earn the extra income. This could lead to future staffing problems.</p>
(iii)	<p>Evening Meals</p> <p>The provision of evening meals constitutes hospitality. The acceptance of hospitality could impair the judgement of the firm or be perceived as having that effect. Hospitality may be accepted if it is of modest value.</p>	<p>The cost of providing evening meals is unlikely to be significant and in practice, chances of accepting this type of hospitality affecting key decisions made by the auditors is remote. It is unlikely that they have been offered a bribe but merely as a courtesy to the audit team.</p> <p>An alternative would be for the audit team to pay for their meals and recover the cost from ZIL. This would then be charged as part of the audit fee.</p>

Thank you.

PM

Question 2 – Environment impact assessment

a) Ethical and professional issues

The attitude of Mr. Regis Kalabasis to environmental legislation calls into question the integrity of management and the overall manner in which the company does business. This may affect the extent to which Chew & Co would be prepared to rely on written representations

The disregard for legislation increases audit risk and should have been taken into account as part of the overall risk assessment. In particular the control environment is affected. Due consideration should have been given to:

- The frequency of the illegal dumping and how long it has been going on for
- The potential impact of fines and penalties

- The possibility of any other type of action being taken against the company
- Whether there has been any attempt made by management to conceal information from the auditors and if so whether the risk assessment need to be revised
- The need to disclose the potential consequences of the illegal action

Chewe & Co should report to the audit committee or those charged with corporate governance. Matters that which should be reported include:

- The potential effect of any material risk and exposures such as pending litigation. (This could arise as a result of illegal dumping)
- Other matters warranting attention by those charged with corporate governance such as questions regarding management integrity

The matter has not been referred to in the report to the audit committee. This would be of some concern unless there is a valid reason for the exclusion. For example, the audit committee may already be aware of the situation as a result of information provided by the internal audit department.

The audit file should document the reasons behind the decision to leave this information out of the final report and should state by whom the decision was made.

b) Reporting ZIL to the Environmental Council of Zambia

According to professional requirements, information confidential to a client acquired in the course of professional work should not be disclosed except where consent has been obtained from the client or where there is a public duty to disclose or where there is a legal or professional right or duty to disclose. It should therefore be understood that Chewe & Co should only act for ZIL on the understanding that the ZIL will make full disclosure.

Chewe & Co has neither a general right nor duty to make unauthorized disclosures to the tax authorities, the police, or any other body. There are however circumstances (exceptions) in which the firm is free (voluntary) to disclose information regardless of his client wishes, and circumstances in which he has an obligation to do so.

Voluntary disclosure includes matter of public of interest, provided the following conditions are met:

- The auditor reports to an appropriate authority
- Members of the public are likely to be affected
- The matter is serious, and
- The matter is likely to be repeated

It is reasonable to suggest that the dumping of the drums and oil spill pose a public danger which may result in serious contamination of the water and it is serious. Additionally, given the attitude of Mr. Regis Kalabasis, this action is likely to be repeated.

On this basis, Chewe & Co should seek audience with ZIL to have this matter resolved, failure to which consideration should be given to volunteering this information to ECZ. However, Chewe & Co should be counselled to seek legal advice on this matter.

SECTION B

Question 3 (a) & (b)

	Business risk (a)	Financial statement impact/risks (b)
1)	Drop in demand: There has been a substantial drop in the number of tourists visiting the Copperbelt region whilst, at the same time, the prices of many of the foodstuffs and drinks used in its restaurants has increased. Added to this, the local economy has shrunk with several large employers reducing the size of their workforce.	<p>(i) The substantial drop in demand may question the going concern of ZIL. Accordingly, the financial statements of ZIL may be misstated if the going concern is properly assessed.</p> <p>(ii) Inventories may be overstated. The drop in sales also may also lead to inventory being valued at net realisable value which is likely to be lower than cost.</p>
2)	Restaurant managers doing too much: Also monthly accounting returns present an operational risk as they restrict the manager's ability to do the rest of their job and ensure the local restaurant operate efficiently. Ideally, management accounts should be done by accounting personnel	There is increased control risk that systems are weak due to the possibility of local staff circumventing company policy. There is also a risk that monthly reporting is inaccurate if it is rushed.
3)	Licences: The renewable licences present a compliance risk as, if they are not renewed, ZIL would be unable to continue legally in operation	Financial statement risks associated with licences are that these might be wrongly treated as expenses in financial statements, when in fact they should be capitalised as an intangible asset. As an intangible asset, there also risks that amortisation will not carried out correctly and that impairment reviews will not carried out or will be carried out wrongly and the asset will be carried at an inappropriately high value.
4)	Customer complaints: Customer complaints over opening times is an operational risk that may lead to ZIL losing more customers	The associated financial statement risk with customer complaints is going concern- that the business might falling and the financial statements therefore prepared on the wrong basis (disclosure risk)
5)	Staff issues and staff turnover. The staff turnover is an operational risk because the company cannot operate all its services without staff.	There is a risk that some of the training expenditure may be capitalised. Training costs must be correctly accounted as expenses
6)	Liquidity constraints: The cash flow problems are financial risk as ZIL may not have sufficient cash available to respond to its business needs, which could ultimately lead to failure.	Cash flow problems ultimately can result in going concern problems, which again creates disclosure risk if the financial statements are not prepared on the correct basis.
7)	Unfinished improvements: This is an operational risk as the restaurants cannot operate at expected levels until the improvements are completed. The completion is severely threatened by apparent cash-flow problems	Given the fall in demand, the value of the assets being improved may be impaired and there is a risk that the non-current assets are overstated.
8)	Insurance: The rise in insurance premiums indicates the number of claims being made, this represents an operational risk as ultimately	If ZIL is experiencing a large number of claims, this affects contingent liabilities and there a risk that disclosures in the financial statements are

	large numbers of claims may result in business closure	inappropriate
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Question 4 (a) and (b)

Risk No:	Key Assertion and justification (a)	Audit Procedures (b)
1)	<p>Valuation: In accordance with IAS 2, inventories should be valued at the lower of cost and net realisable value. The drop in sales suggests that this assertion is at risk</p> <p>Classification and understandability: The classification of ZIL as a going concern, including the provision of additional information about the going concern status of ZIL is important</p>	<p>Review the selling price after the year end and compare with the cost, taking into account any selling cost to confirm whether inventories are properly stated at the lower of cost and net realisable value</p> <p>Confirm that the uncertainty created by the fall in demand has been adequately addressed as a going concern threat. Review the financial statements to ensure proper disclosures have been made. It may also be necessary to provide an emphasis of matter paragraph in the audit report.</p>
2)	<p>Occurrence: Possible circumvention of internal controls suggest a high risk of undertaking transactions without due authorisation and approval and without following other laid down policies and procedures</p> <p>Cut-off: The centre managers are overburdened with monthly reporting and appear under pressure to present favourable results. It is possible that cut-off procedures may not be followed resulting in reporting sales in earlier periods</p> <p>Allocation: As the management accounts are done by centre managers instead of accounting personnel, possible accounting errors such as failing to distinguish between revenue and capital expenditure.</p>	<p>Select a sample of transactions covering purchases and sales and inquire whether they were undertaken in accordance with company policies and procedures by inspecting appropriate documents such as invoice and orders</p> <p>Obtain a sample of sales receipts on each side of the year end and ensure that they are maintained in date order and in numerical sequence. Inspect the accounting records to confirm that only sales receipts dated before 31 March 2011, are include in sales for the year ended 31 March 2011, and those dated after are not included.</p> <p>Review entries a sample of entries in expense and capital accounts and through enquires and inspection of appropriate documents, confirm that there are not capital items expensed or expense items capitalised.</p>
3)	<p>Allocation: Licences may be expensed instead of being capitalised as intangible asset</p>	<p>Inquire and review the accounting treatment of licences and confirm that it has been appropriately</p>

	Valuation: Licences may not be amortised in accordance with the requirements of IAS 38, <i>Intangible Assets</i>	capitalised. Re-compute the amortisation of licences over 24 months and that the 12 month amortisation has been properly allocated to the year ended 31 March 2011.
4)	Classification and understandability: There is disclosure risk that the financial statements may not be prepared on the appropriate basis	Enquire of management of what assessment they have made to confirm that ZIL is a going concern.
5)	Allocation: Training costs may be capitalised instead of being expensed.	Review all training expenditure and confirm that it has not been capitalised but expensed by inspecting the training expense account.
6)	Classification and understandability: Possible going concern problems create disclosure risk if the financial statements are not prepared on the correct basis.	Confirm that the uncertainty created by the fall in demand has been adequately addressed as a going concern threat. Review the financial statements to ensure proper disclosures have been made. It may also be necessary to provide an emphasis of matter paragraph in the audit report.
7)	Valuation: Fall in demand is a possible indicator of impairment and it is possible that the full value of the improvements may not be recovered in the future.	Inquire to confirm whether an impairment review has been undertaken and accounted for in accordance with IAS 36, <i>Impairment</i>
8)	Completeness: It is possible that some provisions and contingent liabilities may be omitted. Classification and understandability: There is a risk that disclosures relating to contingent liabilities may be misstated in the financial statements.	Review and confirm with management to establish whether adequate assessment of possible contingent liabilities and disclosed in accordance with IAS 37, <i>Provisions, Contingent Liabilities and Contingent Assets</i> Review the financial statements to confirm that adequate disclosure, if necessary, has been in accordance with IAS 37, <i>Provisions, Contingent Liabilities and Contingent Assets</i>