

QUESTION TWO

BACKGROUND

Pola Lime is a privately owned company with its head office in Lusaka. It is involved in the manufacture of bricks and other lime based products. It has several branches in all the major towns of Zambia. Chipata branch is the latest branch and was opened in 2004.

SUSPECTED FRAUD

A recent review of management accounts of the Chipata Branch has revealed unexpected trends in gross profit, material consumption and labour usage. At a recent board meeting, it was agreed that a professional accountant should be employed to undertake an investigation.

APPOINTMENT OF PROFESSIONAL ACCOUNTANT

Your name is Jonas Kafwimbe and you are the managing director of Tepwe & Co, a firm of accountants registered with the Zambia Institute of Chartered Accountants (ZICA)

Your firm has been requested to:

- a) Carry out an investigation as required by the Directors of Pola Lime Co. The Chipata Branch has been making losses for the past year. The Directors are concerned about the accuracy of the branch's most recent quarter's management accounts.
- b) To assist with the accounting matters outstanding.

Your staff have extracted the following working papers:

- Summarised income statements for three quarters ending 30th June for the Chipata Branch.
- Accounting matters outstanding

The summarised income statements for the last three quarters are as follows:

		Quarter to:	30 June 2010 K'Million	31 March 2010 K'Million	31 Dec 2009 K'Million
Revenue			429	334	343
			-----	-----	-----
Opening inventory			180	163	203
Materials			318	251	200
Direct wages			62	54	74
Less closing inventory			-162	-180	-163
			-----	-----	-----
			398	288	314
			-----	-----	-----
Gross profit			31	46	29
Less overheads			-63	-75	-82
			-----	-----	-----
Net Loss			-32	-29	-53
			-----	-----	-----
Gross profit percentage (%)			7.2%	13.8%	8.5%
Materials (% of revenue)			78.3%	70.1%	70.0%
Labour (% of revenue)			14.5%	16.2%	21.6%

Pola Lime's board believes that the high material consumption at the branch as a percentage of revenue for the quarter to 30 June 2010 is due to one or more of the following factors:

- under-counting or under-valuation of closing inventory;
- excessive consumption or wastage of materials;
- material being stolen by employees or other individuals.

The branch has a small number of large customers and many of its orders are based on customer specific requirements.

The selling price of the product is determined by:

- Estimating the cost of materials;
- Estimating the labour cost;
- Adding a mark-up to cover overheads and provide a normal profit.

The estimated costs are not compared with actual costs. Although it is possible to analyse purchase invoices for materials between customers' orders this analysis has not been done.

A physical inventory count is carried out at the end of each quarter. Items of inventory are entered on stock sheets and valued manually. The branch does not maintain perpetual inventory records and a full physical count is to be carried out at the financial year end, 30 September 2010.

The direct labour cost included in the inventory valuation is small and should be assumed to be constant at the end of each quarter. Historically, the cost of materials consumed has been about 70% of revenue.

The management accounts to 31 March 2010 are to be assumed to be correct.

Working paper (PI/Acc/Sept 2010) – Accounting matters outstanding
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Accounting treatment of specific items

The management accountant for Pola Lime is not sure how the following items should be treated in the financial statements. However, he is aware that

- financial statements should reflect the substance of transactions, and
- Revenue from “sale” of goods should only be recognized when certain conditions have been satisfied. Transfer of legal title to the goods is not necessarily sufficient for an enterprise to recognize revenue from their “sale”

During the year ended 30 September 2010, the following transactions took place for which the management accountant is not sure about their accounting treatment:

a) Transaction 1

On 1 March 2010, Pola Lime sold a property to a bank for K5 billion. The market value of the property at the date of sale was K10 billion. Pola Lime continues to occupy the property rent-free. Pola Lime has the option to buy the property back from the bank at the end of every month from 31 March 2010 until 28 February 2015. Pola Lime has not yet exercised this option. The repurchase price will be K 5 billion plus K50 million for every complete month that has elapsed from the date of sale to the date of repurchase. The bank cannot require Pola Lime to repurchase the property and the facility lapses after 28 February 2015. The directors of Pola Lime expect property prices to rise at around 20% each year for the foreseeable future.

b) Transaction 2

On 1 October 2009, Pola Lime sold one of its branches to Shawa Finance for K8 billion. The net assets of the branch in the financial statements of Pola Lime before the sale were K 7 billion. Shawa Finance is a subsidiary of a bank and was specifically incorporated to carry out this purchase – it has no other business operations. Shawa finance received the K8 billion to finance this project from the bank in the form of a loan.

Pola Lime continues to control the operations of the branch and received operating fees from Shawa Finance. The annual operating fee is the operating profit of the branch for the year ended 30th September 2010 less interest payable on the loan taken out by Shawa Finance. If the interest is more than the operating profit, then Pola Lime is expected to re-imburse Shawa Finance.

Any payments to or by Pola Lime must be made by 30th October following the end of the relevant period. In the year ended 30th September 2010, the branch made an operating profit of K 2 billion, interest payable by Shawa Finance on the loan for the period was K 800 million

SECTION A

- 1) Professional accountants are bound by professional ethics enshrined in fundamental principles issued by the Zambia Institute of Chartered Accountants (ZICA). In accepting this engagement, comment on the extent to which each of these principles apply to this engagement**
(12 marks)
- 2) Identify and describe:**
- a) The matters you should consider in order to plan an investigation of Pola Lime's losses
(10 marks)
 - b) The procedures you should carry out for each matter identified in (a)
(10 marks)
- 3) It is suspected that closing inventories may be undervalued.**
- c) Explain the matters you should consider to determine whether closing inventory at 30 June 2010 is undervalued; and
(10 marks)
 - d) Describe the accounting procedures you should plan to perform to quantify the amount of any undervaluation.
(10marks)

SECTION B

- 4) The Directors are also concerned about the relatively higher level of material consumption.**
- a) Identify and explain the possible reasons for the apparent high materials consumption in the quarter ended 30 June 2010; and
(10 marks)
 - b) Describe the accounting procedures you should plan to perform to determine whether materials consumption, as shown in the management accounts, is correct.
(8 marks)
- 5) Sale of goods and transactions**
- a) Explain the conditions that must be satisfied before revenue can be recognized from the sale of goods, supporting your answer with specific reference to International Financial Reporting Standards
(10 marks)
 - b) Explain how the sale of property in transaction 1 should be dealt with in the financial statements of Pola Lime for the year ended 30th September 2010
(10 marks)
 - c) Explain how the sale of the branch in transaction 2 should be dealt with in the financial statements of Pola Lime for the year ended 30th September 2010
(10 marks)

