

## SOLUTIONS TO QUESTION ONE – non-audit

### SECTION A

#### QUESTION 1

Items No:	Ethical and professional matter (a)	Suitable course of action (a)
1)	<b>No proper accounting financial statements have been prepared in the current year. Financial statements not agreeing with underlying records:</b> This exposes the reporting accountant to issuing an inappropriate opinion.	The reporting should bring this to the attention of management and remind them of the statutory obligation to maintain adequate accounting records. The letter of engagement should stipulate the respective responsibilities of management and the reporting accountant
2)	<b>Recent enquiries from ZRA and Pressure to finalise financial statements:</b> The delay is likely to attract the attention of ZRA to the financial statements, resulting in perhaps more detailed scrutiny than otherwise would be the case. This will result in increased exposure of the reporting accountants. The pressure to finalise financial statements may lead to mistakes and misstatements, resulting in financial statements not agreeing to the underlying accounting records in all material respects.	Discussions should be held with management to resolve this issue, including any expectations from ZRA. In addressing this exposure risk, the reporting accountant should plan to allocate more senior personnel to the taxation component of this assignment.
3)	<b>Taxation estimate and affordable tax charge:</b> It is not the responsibility of the reporting accountant to estimate the tax for the client. Whilst there are acceptable ways to avoid paying higher taxes, tax evasion is illegal. If the reporting accountant is expected to provide taxation services as well, this poses a self review threat.	Again management should be reminded of their responsibility to maintain adequate accounting records, including those relating to taxation and the need for tax planning to avoid paying higher taxes. The letter of engagement should clarify the respective responsibilities of management and the auditor
4)	<b>Deadline for completion of compilation of financial statements:</b> If the deadline is set without consulting the reporting accounting, it is possible that the reporting accountant may fail to meet the deadline set. This is raises a professional competence and due diligent threat and an intimidation threat.	The reporting accountant should assess the requisite qualification, skills and experience required by this engagement. If possible, the reporting accountant may need to allocate more senior staff in order to meet the deadline. This would at additional cost to the client and should be brought to their attention. Otherwise, if the deadline is too restrictive, the management should be requested to consider extending the deadline.
5)	<b>Fixed accountancy fee:</b> The fee may not be enough to meet the requisite economic requirements of the engagement in terms of qualification, skills and experience. This constitutes an engagement risk.	The reporting accountant should set fee based on requisite qualifications, skills and experience of staff, including reporting requirements. If this is not agreed with management, the reporting accountant should consider not taking the assignment

6)	<b>Accountant to suggest inventory figure:</b> It is the responsibility of management to provide all the information required for the financial statements. This may represent a management threat.	The reporting should bring this to the attention of management and remind them of the statutory obligation to maintain adequate accounting records, including those relating to inventory. The letter of engagement should stipulate the respective responsibilities of management and the reporting accountant
7)	<b>Director's transacting on behalf of company:</b> These are related party transactions for which extensive disclosures are required. There is also the risk of money laundering. Some of these transactions may not be recorded.	The reporting accounting should discuss this issue with management and remind them of their responsibility to identify and disclose related party transactions in accordance with IAS 24
8)	<b>Dominance by Mr Pulis:</b> This suggests lack of segregation of duties and there is increased risk of material misstatement through fraud and error.	The reporting accountant is expected to undertake this assignment with increased scepticism, ensuring that more care, skill and caution is exercised in agreeing figures to underlying records. This may entail allocating relatively more experienced senior personnel to the assignment. It will also be necessary to bring this lapse in internal controls to management.

**QUESTION 2****(a) Statement of cash flows for the year ended 31 December 2010**

<b>OPERATING ACTIVITIES</b>					
Profit before tax					-1,643,509
Add back depreciation					615,378
					-----
					-1,028,131
Increase in inventories					-5,591,742
Decrease in receivables					2,564,396
Increase in trade and other payables					8,510,420
					-----
					4,454,943
Taxation paid					-788,188
					-----
					3,666,755
					-----
<b>INVESTING ACTIVITIES</b>					
Purchase of non-current assets					-2,984,901
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<b>FINANCING ACTIVITIES</b>					
Increase in shareholder's loan					530,111
Decrease in long term loans					-843,213
Increase in other loans					356,616
					-----
					43,514
					-----
<b>Increase in cash</b>					<b>725,368</b>
<b>Cash and cash equivalents at the beginning of year</b>					<b>-1,049,836</b>
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<b>Cash and cash equivalents at the end of the year</b>					<b>-324,468</b>
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**(b) Usefulness of the cash flow statement**

A cash flow statement:

- Provides a better insight into the financial structure of an entity, including its liquidity and solvency.
- Provides enhanced information for the purposes of evaluation of changes in assets, liabilities, and equity of an entity.
- Enhances the comparability of reporting operating performance by different entities as it eliminates the effects of using different accounting policies
- Serves as an indicator of the amount, timing, and certainty of future cash flows.
- Directs attention towards the critical issue of entity's ability to generate cash as the survival of a company depends on the ability to generate cash.

However, caution should be exercised when using the cash flow statement because of the following limitations:

- Cash flow statements are based on historical information and therefore may not be up-to-date
- There is some scope for manipulation and window dressing of cash flows, e.g. a business may hold on to payments to suppliers until after the year end
- A favourable cash balance is not necessary indicative of good management. In any case cash flow is more necessary for survival in the short term and it may be more prudent to invest the available cash now to generate more profits in the future.

## SECTION B

### QUESTION 3

#### a) Revenue recognition

KCL recognises revenue in accordance with the accruals and matching concept. Accordingly, no profit is taken into account until the contract is completed, regardless of the value of work done at the statement of financial position in relation to the total contract price

According to IAS 11, *Construction Contracts*, Contract revenue and contract costs should be recognized in the income statement:

- When the outcome of the contract can be estimated reliably.
- The revenue and costs should be recognized by reference to the stage of completion at the balance sheet date.
- When it is likely that contract costs will exceed contract revenue, then the entire loss must be recognized in the income statement immediately, regardless of the stage of completion.
- The percentage of completion of a contract at any balance sheet date is estimated on a cumulative basis. Therefore, changes in estimates are automatically accounted for in the period in which the change occurs and in future periods, which is in accordance with IAS 8, *Accounting Policies, Changes in Accounting Estimates and Errors*.

According to IAS 11, *Construction Contracts*, there is a requirement to account for attributable profits on construction contracts under the accruals convention. However, there may be a problem with realisation, since it is arguable whether account should be taken of profit which, although attributable to the work done, may not have yet been invoiced to the customer. It is argued that the convention of substance over form is applied to justify ignoring the strict legal position

**Accordingly, the accounting policy adopted by KCL does not meet with these requirements and should be amended.**

#### b) Lease Transactions

A lease is a contract between a lessee and a lessor for the hire of a specific asset. The lessor retains the ownership of an asset but conveys the right of the use of the asset to the lessee for an agreed period of time in return for the payment of specified rentals.

IAS 17, *Leases* require that different accounting treatment should be applied for finance and operating lease. In distinguishing between operating and finance leases, IAS 17 gives the following definitions:

A **finance lease** is a lease that transfers substantially all the risks and rewards incidental to ownership of an asset. Title may or may not eventually be transferred.

An **operating lease** is a lease other than a finance lease

According to IAS 17, the classification as to whether a lease is finance or operating should be made at the inception of the lease. Any revised agreements should be treated as a new agreement over its term. **Based on this, it can be argued that the leases entered into by KCL are in the nature of operating leases and the accounting treatment applied is correct.**

**However, if the intention to renew the leases every year can be established at the inception of the leaser, and is considered probable, then it is possible to use the substance of transaction principle and to treat these leases as finance leases**

#### **c) Investment properties**

IAS 40, *Investment properties* defines an investment property as land or building, or part of a building, or both, held by the owner or the lessee under a finance lease to earn rentals and/or for capital appreciation, rather than for use in production or supply of goods and services or for administrative purposes or for sale in the ordinary course of business.

One of the distinguishing characteristics of investment property (compared to owner-occupied property) is that it generates cash flows that are largely independent from other assets held by an entity. Owner-occupied property is accounted for under IAS 16, *Property, Plant, and Equipment*.

An investment property shall be measured initially at cost, including transaction charges. Again, the principles for determining cost are similar to those contained in IAS 16, in particular for replacement and subsequent expenditure. Subsequently, **an entity shall select either the cost model or the fair value model for** all its investment property.

If the fair value model is selected, after initial recognition, investment property shall be measured at fair value. Fair value is the amount for which an asset could be exchanged between knowledgeable, willing parties in an arm's-length transaction. Any gains or losses arising from changes in fair value shall be recognized in the income statement.

An entity that selects the cost model shall measure all of its investment property in accordance with IAS 16's requirements for that model.

**In KCL, the investment property is accounted for on the basis of the cost model. Accordingly, it is erroneous to state that the fair value model has been adopted. Either the accounting treatment should be revised to cost model, or the accounting applied to investment properties be modified to reflect the fair value model.**

#### QUESTION 4

##### **REPORT OF THE ACCOUNTANTS TO THE MEMBERS OF Kamwala Constructions Limited (KCL)**

We report without carrying out an audit, on the financial statements for the year ended 31 December 2010 set out on pages 2 to 12

##### **Respective Responsibilities of the directors and the reporting accountants**

As described on note 2 the directors are responsible for the preparation of the financial statements. It is our responsibility to carry out procedures designed to enable us report our opinion

##### **Basis of opinion**

Our work was conducted in accordance with the Statement of Standards for Reporting Accountants, and so our procedures consisted of comparing financial statements with the accounting records kept by the company, and making such limited enquiries of the officers of the company as we considered necessary for the purpose of this report. These procedures provide only the limited assurance expressed in our opinion.

##### **Opinion**

In our opinion:

- a) The financial statements for the year ended 31 December 2010 are in all material respects in agreement with the accounting records kept by the company
- b) Having regard only to, and on the basis of, the information contained in those accounting records, the financial statements have been drawn up in a manner consistent with the accounting requirements.

#### QUESTION 5

According to IAS 37, *Provisions, Contingent Liabilities and Contingent Assets*, a liability is an obligation of an enterprise to transfer economic benefits as a result of past transactions or events. A provision is defined as a liability of uncertain timing or amount.

IAS 37 states that a provision should only be recognised as a liability in the financial statements when:

- An enterprise has a present obligation (legal or constructive) as a result of a past event
- It is probable that a transfer of economic benefits will be required to settle the obligation
- A reliable estimate can be made of the obligation.

Applying this to the K150 million provision in KCL,

- a) There appear to be no present legal or constructive obligation resulting from a past event. KCL has not entered into any contractual agreement to carry out the repairs with a third party, nor has KCL created an expectation that KCL will accept and discharge any responsibility relating to repairs.
- b) It is not demonstrated that KCL will transfer economic benefits to a third party. In other words it is possible that the repairs may not take place or may take place. Either way, KCL does not have a present obligation
- c) A reliable estimate of K150 million seems to have been made. However, it is not clear how this amount was arrived at as a legal or constructive obligation

Accordingly, the provision of K150 million has failed to meet the requirements of IAS 37 and should not be included in the financial statements.

