SOLUTIONS TO QUESTON TWO - nonaudit

QUESTION TWO

SECTION A

1) Fundamental principles – Application of fundamental principles to the assignment

a) **Members should strive for objectivity and integrity:** The independence and impartiality of Tepwe is equally expected on assignment such as these. Tepwe & Co should not be seen to be making any preconceived conclusions about the state of management accounts and should approach the assignment with integrity, objectivity and impartiality.

b) **Members should not accept or perform work which they are not competent to undertake:** Before accepting this assignment Tepwe & Co should assess their ability to undertake this investigation taking it account requisite qualifications and experience, as well as the resources in terms of time and personnel

c) **Members should carry out their professional work with due, skill, care diligence and expedition:** Where as accountants are supposed to have requisite skills relating to accounting and auditing matters, this assignment obviously demands specific investigative skills. It is likely that Pola Lime is very anxious to get this issue resolved as soon as possible, requiring due care, diligence and expedition on the part of Tepwe & Co.

d) Members should behave with courtesy and consideration towards all with whom they come into contact: An investigation is particularly a very sensitive assignment therefore the need for courtesy and consideration cannot be emphasised. This is crucial in extracting relevant information from various people, especially the suspects.

2) Matters and procedures in planning an investigation

	Matter to consider (a)	**Procedures to carry out (b)**
1	Purpose, nature and scope of the investigation and extent to which fraud is suspected	Discuss the assignment with Pola management to determine the purpose, nature and scope of the investigation. In particular, discuss whether any irregularity (theft/fraud) is suspected and, if so, whether evidence gathered will be used: • in criminal proceedings; • in support of an insurance claim.
2	Terms of reference (TOR) and right of access.	Obtain clarification of terms of reference (TOR) in writing from Pola management. The TOR should give the investigating team full access to any aspect of Chipata's Branch's operations relevant to their investigation.
3	Focus of the investigation.	Discuss with management focus of the investigation. Investigation will involve consideration of:

		• possible understatement of inventory value at 30 June 2010; • high material consumption for the quarter ended 30 June 2010.
4	Staffing requirements and timing of the investigation, including impact on other assignments.	Assess whether the availability of suitable staff may affect the proposed start of the investigation. Alternatively, the timing of other assignments may have to be rescheduled to allow this investigation to be started immediately.
5	Engagement economics in terms of fee expectations	Produce a budget of expected hours, grades of staff and costs. Agree the anticipated investigative fee with Pola management.
6	Expectations regarding completion of the assignment and impact on the next inventory count scheduled for 30th September 2010.	Pola Lime management will presumably want the investigation completed before the next inventory count (at 30 September 2010) to know if the findings have any implications for the conduct of the count and the determination of year-end inventory. Plans and strategies should be developed to meet this expectation
7	The depth of the investigation and the use of the report.	Discuss and assess the required depth of the investigation and determine to what extent it will depend on matters such as: • the extent of reliance expected to be placed on the investigation report; • whether the report is for Pola Lime's internal use only or is it likely to be circulated to bankers and/or shareholders.
8	The type of assurance expected.	Discuss and determine the type of assurance (e.g. 'negative', reasonable) is likely to have a bearing on: • any caveats in the report; • the level of risk/potential liability for any errors in conclusions given in the final report;
9	Terms of engagement	An engagement letter must be drafted and Pola Lime management must agree to its terms in writing before any investigative work can begin. The letter of engagement should include: • details of work to be carried out; • likely timescale; • basis of determining fee; • the reliance that can be placed on the final report and results of the investigation; • the extent of responsibilities agreed; • any indemnity agreed; • the information to be supplied as a basis for the

		investigation; and • any areas specifically excluded.
10	Need for a caveat in the report.	Assess the appropriateness of an exclusion clause; for example: 'CONFIDENTIAL – this report has been prepared for the private use of Pola Lime only and on condition that it must not be disclosed to any other person without the written consent of the preparing accountant'.

3) Undervaluation of inventories

a) Matters to consider – inventory undervaluation

i) Physical inventory count

(1) Inventory will be undervalued at 30 June 2010 if all inventory is not counted. The investigation should consider the adequacy of quarterly physical count procedures. For example, whether or not:

- all items are marked when counted;
- management carries out test checks;
- stock sheets are pre-numbered and prepared in ink;
- a complete set of stock sheets is available covering all categories of inventory;
- Pola Lime management and the branch management uses the stock sheets to produce the inventory value.

ii) Cutoff

(1) Inventory will be undervalued at 30 June 2010 if:

- any goods set aside for sale in July were excluded from the count;
- a liability was recognised at 30 June 2010 for goods that were excluded from inventory (e.g. in transit from the supplier);

(2) production did not cease during the physical count and raw materials being transferred between warehouse and production were omitted from inventory.

iii) Scrap materials

(1) Inventory will be undervalued if any scrap from materials used in production that has a value (e.g. because it can be

- recycled) is excluded. Inventory may be undervalued compared with the previous quarter if there is any change in
- Rank's scrap/wastage policy (e.g. if previously it was valued in inventory but now it is excluded).

(2) If production problems increased wastage in the last period this would account for the lower value of inventory and

b) Accounting procedures that may be carried out to quantify amount of under-valuation

i) Physical count

1) Inspect the warehouse/factory areas to identify high value inventory items and confirm their inclusion on the stock sheets at 30 June 2010 (or otherwise vouch to a delivery note raised after that date).

2) Recast all additions and recalculate all extensions on the stock sheets to confirm that there have been no omissions, transposition errors or other computational discrepancies that would account for an undervaluation.

ii) Cut off

1) Ascertain the last delivery notes and dispatch notes recorded prior to counting and trace to purchase/sales invoices to confirm that an accurate cutoff has been applied in determining the results for the quarter to 30 June 2010 and the inventory balance at that date.
2) Trace any large value purchases in June to the 30 June stock sheets. If not on the stock sheets inquire of management whether they are included in production (or sold). Verify by tracing to production records, goods dispatch notes, etc.

iii) Analytical procedures

1) Compare large volume/high value items on stock sheets at 31 March with those at 30 June to identify any that might have been omitted (or substantially decreased). Inquire of management if any items so identified have been completely used in production (but not replaced), scrapped or excluded from the count (e.g. if obsolete). Any inventory excluded should be counted and quantified.
2) Compare inventory categories for 30 June against previous quarters. Inventory value at 30 June is 10% less than at 31 March, though revenue is 28% higher. An increase in inventory might have been expected to support increased revenue if there is a general increase in trading activity. (Alternatively, a decrease in inventory may reflect difficulties in obtaining supplies/maintaining inventory levels if demand has increased).

iv) Scrap materials/wastage

1) Make inquiries of Chipata branch's warehouse and production officials regarding the company's scrap/wastage policy and any records that are kept.

a) Review production records on a month-on-month basis and discuss with the factory manager whether any production problems have increased wastage in the quarter to 30 June 2010.

v) Pricing test

(1) Raw materials – select a sample of high value items from the 31 March 2006 inventory valuation and confirm that any unit price reductions as shown by the 30 June 2010 valuation are appropriate (e.g. vouch lower unit price to recent purchase invoices or write down to net realisable value).

(2) WIP and finished goods – agree a sample of unit prices to costing records (e.g. batch costings). Recalculate unit prices on a sample basis and vouch make-up to invoices/payroll records, etc.

4) Higher level of material consumption

a) Possible reasons for high material consumption

Materials consumption has increased from 70% of revenue to 78%. There could be valid business reasons for this (e.g. there could be an abnormally high level of wastage) or accounting errors that result in overstatement of materials. Other possible reasons include:

i) Cutoff

(1) Raw material purchases: Materials consumption will be overstated if goods delivered after the quarter-end have been included (incorrectly) in purchases to 30 June 2010 although excluded (correctly) from the June count.
(2) Revenue: Materials consumption will be overstated as a percentage of revenue if revenue is understated (e.g. if goods sold before 30 June 2010 are recorded in the next quarter).

ii) Losses

(1) Materials consumption will be higher than normal if there is an abnormally high level of raw materials scrapped or wasted during the production process. This could be due to inferior quality raw materials or technical problems with the manufacturing process.
(2) Materials consumption will also be overstated if raw materials recorded as being used in production are stolen.

iii) Obsolete or redundant inventory

(1) Materials consumption will appear higher if inventory at 30 June 2010 is lower. For example, if slow-moving, damaged or obsolete inventory identified at the count was excluded or written-down (although included in the previous quarter's inventory valuation).

iv) Individual contracts

(1) Materials consumption will be higher if the increase in revenue is attributable to a small number of large contracts for which substantial discounts have been negotiated.
(2) Materials consumption will be higher if the cost of materials on customers' specifications has been underestimated in the determination of selling prices.

v) Purchasing

(1) Materials consumed will increase if the Chipata Branch has changed to a more expensive supplier in the quarter to 30 June 2010.

b) Accounting procedures to detect high material consumption

i) Cutoff

1) Purchases: Select a sample of invoices included in purchases to 30 June 2010 and match to goods received notes to confirm receipt at 30 June 2010 and hence inclusion in inventory at that date.
2) Revenue: Inspect dispatch notes raised on or shortly before 30 June 2010 and trace goods sold to invoices raised on or before 30 June 2010.

ii) Scrap

1) Inquire of production/factory and warehouse officials the reasons for scrap and wastage and how normal levels are determined.
2) Inspect records of materials wastage and confirm the authorisation for scrapping materials and/or reissuing replacement materials to the production process.
3) Physically inspect scrap, if any, to confirm that its condition renders it unsuitable for manufacture (and hence confirm its exclusion from inventory at 30 June 2010).
4) Review credit notes received after 30 June 2010 to identify materials returned (e.g. of inferior quality).

iii) Obsolete or redundant inventory

1) Inspect the stock sheets at 30 June 2010 for goods identified as obsolete, damaged, etc and compare with the level (and value) of the same items identified at the previous quarter's count.

iv) Individual contracts

(1) Compare discounts given on new contracts with normal discount levels and confirm the authority of the person approving discounts.
(2) Calculate actual material cost as a percentage of revenue on individual major contracts and compare with the 70% benchmark.

v) Accounting procedures

1) Purchases: Inspect goods received notes to confirm that raw materials are being checked for quality and quantity upon receipt. Inspect invoices recorded to confirm that goods have been received (as evidenced by a goods received note).
2) Review goods returns recorded on pre-numbered goods return notes and confirm matched to subsequent credit notes received.
3) Observe gate controls and other physical security over inventory and review the segregation of duties that seek to prevent or detect theft of inventory.
4) Sales: Review goods dispatch notes and confirm matching to sales invoices that have been raised promptly and recorded on a timely basis.
5) Sales returns: Review credit notes for authorisation and matching to goods returns notes.

5) Conditions for revenue recognition

IAS 18 Revenue Recognition states that the following conditions must be satisfied before revenue from the sale of goods can be recognized.

i) The enterprise has transferred to the buyer the significant risks and reward of ownership of the goods. In most cases, transfer of the risks and rewards of ownership coincides with the transfer or legal title or the passing of possession to the buyer, but this is not the always the case. If the enterprise retains significant risk of ownership, the transaction is not a sale and revenue cannot be recognized. For example, the enterprise might retain an obligation for unsatisfactory performance not covered by normal warranty provisions. However, if the risk retained is insignificant, the transaction is a sale and revenue is recognized. For example, a retail sale is recognized where a refund if offered if the customer is not satisfied, provided the seller can reliably estimate future returns and recognises a liability based on previous experience and other relevant factors

ii) The enterprise retains neither continuing managerial involvement to the degree usually associated with ownership nor effective control over the goods sold

iii) The amount of revenue can be measured reliably

iv) It is probable that the economic benefits associated with the transaction will flow to the enterprise. For example, it may be uncertain that a foreign government will grant permission to remit consideration from a sale in foreign country. Revenue cannot be recognized until the uncertainty is removed

v) The costs incurred or to be incurred in respect of the transaction can be measured reliably.

6) **Accounting for transaction 1- Sale of property**

The key issue here is whether Pola Lime has retained the risks inherent in owning the property. This depends on whether Pola Lime is likely to exercise its option to repurchase the property in practice:

i) Pola Lime can repurchase the property any time until February 2015, but the bank cannot require repurchase. This means that Pola Lime is protected against any fall in the value of the property below K5 billion. This suggests that some risk has been transferred to the bank

ii) In practice, the value of the property is expected to rise by 25% each year for the foreseeable future. Therefore it is extremely unlikely that the value of the property will fall below K5 billion.

iii) Pola Lime can benefit from the expected rise in the value of the property by buying it back at a price that is well below its anticipated market value.

In conclusion, Pola Lime is likely to exercise the option and therefore has retained the risk of changes in the property's market value. Other important aspects of the transaction are:

- The sale price of the property was only 50% of its market value
- Pola Lime occupies the property rent-free (a reward of ownership)
- The repurchase price depends on the length of time that elapses between the date of the agreement and the date of repurchase, rather than on the market value of the property.
  Therefore the transaction is essentially a loan secured on the property, rather than the outright sale. The K50 million payable for each month that the bank holds the property is the interest on the loan.
  The property remains in the financial statements of Pola Lime at its cost or market value (depending on the accounting policy adopted by Pola Lime). The loan of K5 billion and accrued interest of K350 million (7 *50 million) are reported under non-current liabilities, interest of K 350 million is recognized in the statement of income.

7) **Accounting for transaction 2- Sale of branch**

The key issue here is whether Pola Lime retains the risk associated with the ownership of the branch. Pola Lime continues to control the operations of the branch and the amount that it receives from Shawa Finance is the operating profit of the branch less the interest payable on the loan. Pola Lime also suffers the effect of any operating losses made by the branch. Therefore the position is essentially the same as before the "sale"

Although Shawa Finance is not a subsidiary of Pola Lime as defined by IAS 27 *Consolidated and Separate Financial Statements,* it is a special purpose entity (quasi-subsidiary). It gives rise to benefits for Pola Lime that are in substance no different from those that would arise if it were a subsidiary. Its assets, liabilities, income and expense must be included in the consolidated financial statements.

The assets and liabilities of Pola Lime are included in the consolidated statement of financial position at K7 billion (their original value to the group). The loan of K 8 billion is recognized as non-current liability. The profit on disposal of K 1 billion and the operating fee of K1.2 billion are cancelled as intra-group transactions. The operating profit of K2 billion is included in the consolidated statement of income as is the loan interest of K 800 million