



CHARTERED ACCOUNTANTS EXAMINATIONS

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PROFESSIONAL LEVEL

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P4: AUDIT AND ASSURANCE SERVICES

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THURSDAY 18<sup>TH</sup> DECEMBER 2014

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TOTAL MARKS: 100; TIME ALLOWED: THREE (3) HOURS

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**INSTRUCTIONS TO CANDIDATES**

1. You have fifteen (15) minutes reading time. Use it to study the examination paper carefully so that you understand what to do in each question. You will be told when to start writing.
2. This paper is divided into TWO sections:  
Section A: One (1) compulsory question.  
Section B: Four (4) Optional Questions. Attempt any three (3) questions.
3. Enter your student number and your National Registration Card number on the front of the answer booklet. Your name must **NOT** appear anywhere on your answer booklet.
4. Do **NOT** write in pencil (except for graphs and diagrams).
5. The marks shown against the requirement(s) for each question should be taken as an indication of the expected length and depth of the answer.
6. All workings must be done in the answer booklet.
7. Present legible and tidy work.
8. Graph paper (if required) is provided at the end of the answer booklet.

## **SECTION A**

### **QUESTION ONE**

**This question is compulsory and must be attempted.**

Your firm, Banda & Mwemba Chartered Accountants, recently responded to a tender for the provision of audit services to Lukanga Ltd a large car assembly company. Your partner has written informing you that your firm has been appointed auditors of Lukanga Ltd after evaluation by Lukanga Ltd.

He wants you to prepare detailed notes which will be used by your firm in deciding whether or not to accept the appointment. The following information has been provided to you to help you prepare the notes requested.

#### **Management of Lukanga plc.:**

Lukanga Ltd is a privately owned company with five major shareholders. Two of the shareholders are based abroad and they come to Zambia four times a year to attend quarterly board meetings. The other three shareholders are the Chief Executive, the Production Director and the Finance Director.

#### **Matters arising in a meeting your partner had with the CEO of Lukanga PLC:**

Chintu the Chief Executive has been at the helm of the company since its inception ten years ago. He makes all the major decisions and he has indicated to your partner that all serious audit finding should be referred to him. He indicated that the company terminated the services of the previous auditors on grounds of not consulting him on matters of concern they had.

In response to a request for authority from your firm to communicate with Manda & Co Chartered Accountants, the outgoing auditors, the Chief Executive Officer indicated that this will delay your appointment as auditors and he is reluctant to let your firm communicate with them.

Other issues noted by your partner:

- Tembo, the only one who can be the audit manager on this audit, is a nephew of the Finance Director of Lukanga Ltd. He feels that because of this relationship your firm will not face any problems with this engagement.
- There is a very tight timetable for the audit and the CEO emphasized that the audit should be complete within one month of the year. The overseas shareholders can only come to Zambia at this time for the AGM.

- The CEO has recommended that if your firm will need to engage an expert to value work in progress at the year end it should be a company that Lukanga Ltd has used in the past. This is a company in which the Production Director of Lukanga Ltd has a controlling interest.

**Nature of company:**

The company imports more than 60% of its components from the Far East. The balance of 40% of components is imported from a subsidiary company that was established in a neighboring country. The justification for setting up a manufacturing company in the neighboring country is the low labor costs compared to those in Zambia.

The subsidiary in the neighboring company imports most of its raw materials from the west. A new law has just been passed in this country restricting the amount of foreign exchange that can be externalized per month. This has resulted in operational problems for the subsidiary resulting in lower production.

The company sells its vehicles through car dealers spread in the country on a consignment basis. A significant drop in sales has been experienced in the last two years and this is attributed to a high increase in cheap imported second hand vehicles.

Lukanga Ltd exports some of its vehicles to car dealers abroad based in the country the subsidiary is located. The car dealers are given one month in which to pay for the vehicles. There has been a noted increase in old outstanding debts from export sales.

**Matters raised in an informal meeting with the outgoing auditors:**

Manda & Co have been auditors of Lukanga Ltd for the last three years. There were disagreements between the auditors and Lukanga Ltd in the treatment of research and development expenditure. This led to Lukanga Ltd terminating the services of Manda & Co Chartered Accountants.

Manda & Co Chartered Accountants are aware that Lukanga Ltd will not allow them to communicate with the incoming auditors. The engagement partner who was assigned this audit is a friend of the Chief Internal Auditor of Lukanga Ltd who informally told him who the incoming auditors are. Phiri the partner in charge of Manda & Co called your partner for an informal meeting at which a number of issues were discussed.

Phiri told your partner that this meeting should be regarded as informal and the CEO of Lukanga Ltd should not come to learn about it. He stated that the integrity of the management of Lukanga Ltd is questionable and the internal controls in place are weak.

Over a period of time the same control weaknesses have been highlighted to management through letters of weakness. When the CEO was handing the letter terminating the services of Manda & Co Chartered Accountants he indicated that he does not expect them to communicate anything bad about the company in the event that the incoming auditors insist on communicating with them.

The outgoing auditors have informed your partner that Lukanga Ltd has been sued by a number of vehicle buyers because of brake failure. This has arisen because of a component imported from the Far East and which is substandard. The company has underplayed this and is trying to settle these claims outside court for fear of bad publicity.

### **An understanding of the entity from press reports:**

It has been established from press reports that Lukanga Ltd runs a garage at which it conducts repairs and servicing of vehicles. The garage accumulates large quantities of used oil which it disposes of into the council drainage which flows into a stream. There are people who live down stream and they use this water for domestic use.

You read in one of the daily newspaper that a number of companies emitting effluent in the council drains are being prosecuted by the Environmental Management Agency. The report states that there are heavy penalties against those found to be in breach of the legislation regarding disposal of hazardous material. Your own investigations have revealed that one of these companies being sued is Lukanga Ltd.

The draft financial statements of Lukanga Ltd have a figure of K225 000 charged to income being the expense for the year arising from share options granted to employees. The scheme commenced on 1 January 2011 whereby Lukanga Ltd granted 100 share options to each of its 500 employees. Each grant is conditional upon the employee working for the entity until 31 December 2013. At the grant date the fair value of each share option is K15.

During 2011, 20 employees left and the entity estimates that a total of 20% of the 500 employees will leave during the three year period.

During the current year, a further 20 employees leave and the entity now estimates that only a total of 15% of its 500 employees will leave during the three year period.

### **Required:**

- (a) Describe the professional and ethical matters that your firm should consider in making the decision whether or not to accept appointment as auditors of Lukanga plc.

(12 marks)

- (b) Identify and explain the risk of material misstatement that may occur as a result of Lukanga Ltd not complying with the environmental regulations. (6 marks)
- (c) Identify and explain the business risks that Lukanga Ltd faces. (14 marks)
- (d) Describe the principal audit procedures to be carried out in respect of the measurement of the share based payment expense of K225 000.00. (8 marks)

**[Total: 40 marks]**

## **SECTION B**

**There are four (4) questions in this section. Attempt any three (3).**

### **QUESTION TWO**

Kalungwishi Plc is a fast growing listed company on the Lusaka Stock Exchange. The company recently expanded its operations by setting up subsidiaries in three neighboring countries. All the subsidiary companies are listed on the stock exchanges of the host countries.

The parent company and each of the subsidiary companies have different audit firms auditing their financial statements. At a recent board meeting held in Zambia the following resolutions were passed:

1. For ease of preparing the consolidated financial statements, all the subsidiaries should change their year-end to December which will be in line with the parent company.
2. Subsidiaries should not reappoint their current auditors for another term at the expiry of the current year. All subsidiaries should appoint the parent company auditors as their new auditors so that all companies in the group are audited by the same firm.
3. Each subsidiary should set up a risk committee of the board.

The realignment of ensuring same year end and having one firm of auditors will make the conduct of a transnational audit efficient for the Kalungwishi Group of companies.

#### **Required:**

- (a) Discuss the reasons for a group of companies to prepare consolidated financial statements which are audited by the group auditor. (6 marks)
- (b) Distinguish between the group auditor and the component auditor clearly stating their respective duties for the group audit. (8 marks)
- (c) Define 'transnational audit', and explain the relevance of the term to the audit of Kalungwishi Group. (4 marks)
- (d) Discuss the arguments for setting up a risk committee on the board of Kalungwishi PLC. (2 marks)

**[Total: 20 marks]**

### **QUESTION THREE**

You are the audit manager in your firm of Chartered Accountants. You have recently been appointed auditors of Kafue plc a company in the Manufacture of high tech audio equipment. This will be the first client in this industry for your firm.

Kafue plc has been incurring operating losses in the past three years. The losses are attributed to high research and development expenditure incurred and charged to income. The company requires large investments in equipment and has borrowed heavily in the recent past to achieve this. The bankers are reluctant to give additional financing as they are concerned about the going concern aspects of the company.

As audit manager of this client you are now planning for the audit of the financial statements for Kafue plc for the year ended 30 September 2014.

As part of your risk assessment you have established the following:

1. There is an increase in competition in this industry. This has come about because of a relaxation in import regulations resulting in an increase in cheap audio equipment from the Far East.
2. The company has been experiencing labor disputes in the past few months resulting in the company not being able to pay salaries on due dates.
3. You have also read in the press that the CEO of Kafue plc is being prosecuted for money laundering offences committed by a company in which he is Chairman which company is connected to Kafue plc.

The engagement partner has requested you to provide him with information on a number of issues.

#### **Required:**

- (a) Describe the meaning of money laundering and comment on the adherence of professional ethics and reporting money laundering activities to competent authorities. (6 marks)
- (b) Discuss any going concern issues you may have clearly stating the responsibilities of management and auditors on going concern. (4 marks)
- (c) Contrast business risk and risk of material misstatement of Kafue plc. (4 marks)
- (d) Describe how your firm may use analytical reviews in assessing the risk in Kafue plc and suggest the information you may require to enable you use analytical reviews. (6 marks)

**[Total: 20 marks]**

#### **QUESTION FOUR**

- (a) Auditors are required to carry out substantive audit procedures whose results will form the basis of arriving at an appropriate audit opinion. Generally, audit procedures carried out are as specified in the relevant International Standards on Auditing as well as responses to audit risks identified by the auditor.

The following risks have been identified during the audit of one of your audit clients:

**Risk one:**

Revenue for the year under review has significantly risen by 45% from K965 000 in the previous year to K1 399 250.00 in the current year. Arising from audit procedures conducted on sales proceeds, it has been established that cash discounts have significantly increased during the same period by 35%. The client has substantial inventory at the period end in the statement of financial position. There has been a noted increase in the receivables balance this year compared to the previous year.

**Risk two:**

The company sells the bulk of its products giving a three month warranty for any goods that are defective because of factory faults. There is a noted decrease in the provision for warranty in the draft financial statements.

**Risk three:**

The company has been investing large sums of money in research and development in the last five years. Most of this expenditure has been written off to income in the past resulting in low reported profits in the last three years. The Chief Executive Officer is concerned that because of low profitability he and the Finance Director will not get their annual bonus because the company is failing to meet its profit targets.

**Risk four:**

At the year-end there is a court case that has been going for five years. This case involves former employees who have sued the company for terminal benefits that they claim were underpaid. The employees have got judgment in the High Court of Zambia. The management has appealed against the judgment to the Supreme Court and has argued that there is no need to make a provision in the financial statements as they are confident that the appeal will succeed.

**Required:**

Suggest audit procedures your firm will carry out in responses to the above risks.

(8 marks)

- (b) You are the audit manager in your firm of Chartered Accountants. You receive the following e mail from James the engagement partner of Magnum Ltd one of your firm's audit clients.

To: John - Audit Manager  
From: James -Engagement Partner  
Subject: Review of working papers

Dear John

I have just finished reviewing the working papers for Magnum Ltd. I am generally pleased that sufficient and appropriate audit evidence has been gathered based upon which an appropriate audit opinion may be given.

I attach for your reference the draft audit report for Magnum. I have not been able to finalize and conclude this work because I have to take urgent leave to attend to pressing family matters abroad. I have asked Chris the Senior Partner to conduct a review of the working papers for this client so that any matters of concern are resolved before I return in a week's time.

Could you please go through my review points and pass on the file to Chris for review before I return and your review should include the following:

- (i) A critical review and comment for appropriateness of my draft report for Magnum Ltd.
- (ii) A distinction between unmodified and modified audit reports giving suitable circumstances when they would be used.

I will appreciate you attend to my request.

Kind regards

James

***Attachment:***

Draft audit report:

*Opinion*

In our opinion the financial statements present fairly, in all material respects the financial position of Magnum Ltd as at 31 March 2014, its financial performance and its cash flows for the year then ended in accordance with International Financial Reporting Standards.

*Basis for unmodified opinion:*

The basis for us issuing an unmodified audit opinion is that we have been able to obtain sufficient appropriate audit evidence during the course of the audit.

*Auditor responsibility:*

Our responsibility is to express an opinion on these financial statements based on our audit. We have conducted our audit in accordance with International Standards on Auditing.

*Management's responsibility to the financial statements:*

Management is responsible for the preparation and fair presentation of these financial statements in accordance with International Financial Reporting Standards, and for such internal controls as management determines as necessary.

*Use of an expert.*

We wish to bring it to the attention of the members that we used a firm of experts to assist us to verify the value of work in progress of Magnum Ltd.

**Required:**

Respond to James's e mail.

(12 marks)

**[Total: 20 marks]**

## **QUESTION FIVE**

- (a) Assurance engagements can be compared with other engagements that the auditors may be engaged in such as review engagements, agreed upon procedures and compilation engagements. The amount of work and the type of report for each will depend on the type of engagement entered into.

### **Required:**

Distinguish and write brief notes on each of the following:

- |       |                          |           |
|-------|--------------------------|-----------|
| (i)   | Assurance engagements.   | (3 marks) |
| (ii)  | Review engagements.      | (3 marks) |
| (iii) | Agreed upon procedures.  | (3 marks) |
| (iv)  | Compilation engagements. | (3 marks) |
- (b) The following figures are extracted from the draft financial statements of Rufunsa Ltd one of your audit clients for the year ended 31 December 2013.

|                                 |      |
|---------------------------------|------|
|                                 | K000 |
| <b>Current assets:</b>          |      |
| Inventory                       | 140  |
| Accounts receivables            | 160  |
| <b>Non-current liabilities:</b> |      |
| Loan                            | 130  |
| Provision for warranty          | 15   |

In obtaining sufficient appropriate audit evidence, the following information relating to the above figures is obtained:

### **Inventory:**

The client deals in high tech equipment such that technological advances move very fast resulting in a high rate of obsolescence for outdated equipment. Included in the inventory figure is a cost of K45 000 for equipment which was sold in February 2014 at less than cost for K28 000.00.

### **Accounts receivable:**

Shortly after the year end in the first quarter of 2014 and before finalization of the audit, a major credit customer of the company has gone into liquidation because of heavy trading losses. It is estimated that this customer will not be able to pay more than K0.35 per kwacha it owes its creditors. The amount included in receivables relating to this customer is K54 000 and no allowance for receivables has been made at the period end.

**Loan:**

Two weeks after the issue of the audit report and before the financial statements are issued it is discovered that the loan figure in the financial statements is materially misstated. Had this fact been known before the issue of the audit report your firm would have modified the opinion.

The figure of K130 000 is understated by K64 000.

**Provision for warranty:**

The figure in the draft financial statements relates to warranty provision for the period to the end of December 2012. The policy of the company is that goods are sold with warranties enabling customers to return their goods within one year of purchase if the goods are found to be faulty.

After the period end before finalization of the report you establish that repairs costing K46 000 have been incurred relating to goods sold in the year under audit.

**Required:**

Discuss the audit issues relating to the above matters and in line with IAS 10 *Events after the period end* and recommend action that management of Rufunsa Ltd should take.

(8 marks)

**[Total: 20 marks]**

**END OF PAPER**

## **P4 SUGGESTED SOLUTIONS**

### **SOLUTION ONE**

#### **a) Ethical & professional matters to consider:**

- It would appear that the CEO intimidates the auditors and wants them to do what he wishes. He wants to be consulted on what he considers serious matters and non consultation resulted in the previous auditors being removed. Auditors should be independent and any intimidation limits their independence and ultimately objectivity.
- It is unethical for the CEO to suggest that the incoming auditors should not communicate with the outgoing auditors. If the CEO insists that there should be no communication with the outgoing auditors then appointment should be declined.
- The integrity of management is brought into question. The reason of disagreement with the accounting treatment of R & D expenditure is not sufficient to terminate the services of the auditors. This is compounded by the fact the CEO suggested to the outgoing auditors that they should not say anything bad about Lukanga if asked by the incoming auditors.
- The fact that Tembo, the audit manager, who is the only one who can be assigned to this client is a nephew to the Finance Director would give rise to self interest and familiarity threats. This relationship would impair the independence of the auditors. This is enough grounds to decline appointment unless a suitable safeguard such as assigning another manager who has no relationship is made.
- The firm should consider the issue of having sufficient resources to audit this client.
- The insistence by the CEO that our firm should use a company of their choice to value work in progress at the period end is not acceptable. Lukanga Ltd may use this company as management experts and the auditors should appoint their own auditor expert to carry out the work in progress valuation at the year end. The expert engaged by the auditor should be independent of the client which will not be the case if the suggestion by the CEO is followed.
- Phiri the partner in Lukanga Ltd should not have agreed to have an informal meeting with the outgoing auditors. Phiri should have simply asked for authority to communicate with Manda & Co if permission is denied this is sufficient grounds to decline the appointment.

## **b) Risk of not complying with environmental regulations:**

Non compliance with environmental regulations by Lukanga Ltd could result in the company being sued for contaminating water by disposing of waste material in an acceptable manner.

If convicted the company may be slapped with heavy penalties and reading from press reports the company is among those that have been sued.

Non compliance could result in misstatements of the provisions in the financial statements at the period end. Non compliance of regulations by Lukanga meets the requirements of IAS 37 *Provisions, contingent liabilities and contingent assets* and if this is the conclusion of the auditor then a provision should be made in the financial statements.

- The company has a legal obligation as a result of a past event i.e. contaminating water source.
- It is probable that there will be an outflow of resources if the company loses the case in court.
- A reliable estimate of the amount involved can be made.

There is also the risk that the company could have its operating licence withdrawn in the extreme case. This has implications on the going concern aspect of the company.

## **c) Business risks of Lukanga Ltd**

- Lukanga Ltd is dealing with a related company in the neighboring country. There is a risk that dealings with related parties may not be transparent and may result in breach of laws and regulations in other countries with increased risk of legal action.
- The forex restrictions that have been imposed in the related company will result in that company failing to meet the requirements of Lukanga Ltd which will ultimately affect production.
- Poor internal controls reported by auditors over a number of years suggest a poor internal control environment. Management is inclined to override the controls that are in place. The auditor is unlikely to rely on

internal controls and will end up carrying out and relying on substantive audit procedures which are more costly.

- Lukanga Ltd is in a highly regulated industry whereby it is expected to adhere to environmental regulations that are in place. There is a risk of non compliance with laws and regulations.
- The increase in cheap imported second hand vehicles can have a significant impact on the demand for new cars and this may see a reduction in revenue of Lukanga Ltd. This may pose going concern issues as this is a capital intensive industry.
- There is a risk that the foreign debt may be irrecoverable with a significant number of these car dealers failing to pay their dues to Lukanga Ltd.
- The integrity of management is brought into question. They are trying to hide the fact that Lukanga has been sued because of brake failure.
- Lukanga Ltd runs the risk of being sued and liable to heavy penalties by buyers of vehicles whose brakes fail due to malfunctioning brakes.

#### **d) Principle audit procedures for share based payment expense:**

Audit procedures on the figure of share based payment expense are aimed at ensuring that the provisions of IFRS 2 Share based payment have been complied with and the amount is not materially misstated.

The following audit procedures will be undertaken:

- Review the contractual documentation available for the share based payment scheme and agree the following to the calculation of the K225 000 expense.
  - The number of employees in the scheme
  - The number of options per employee.
  - The length of vesting period.
  - The grant date of the share options
  - Any performance conditions that may be attached to the options.
- Re perform the calculation done by management in the calculation of the expense of K225 000 ensuring that the value is spread correctly over the vesting period.
- Agree the fair value of K15 to any specialist report that may be available.
- Check and confirm that the fair value is calculated at the grant date.

- Enquire from management on the assumptions used to determine the forecast staff turnover.
- Obtain written representation from management confirming the assumptions used in measuring the expense are reasonable and that there are no share based payment schemes in existence that have not been disclosed to the auditors.
- Confirm the number of employees who have left during the year by examining personnel files and correspondence to that effect.

## **SOLUTION TWO**

### **a) Group financial statements and audit:**

A group of companies comprises a parent company and one or more subsidiary companies. The parent company controls the majority of the shares in the subsidiary companies. The rest of the shares are controlled by non controlling interest.

Since the parent company has invested in shares of subsidiary companies, in its financial statements it is carrying figures of investments in subsidiaries. Effectively the shareholders of the parent company are the owners of the subsidiary companies. From the point of view of the parent company shareholders the parent and the subsidiary companies are one investment. As such the parent company shareholders wish to see the performance of the parent and the subsidiaries as one entity. It is therefore, necessary that consolidated financial statements are prepared for the benefit of the shareholders of the parent. The interest of the non controlling interests is shown in the statement of financial position of the consolidated financial statements.

Since the shareholders of the parent company are interested in the performance of the group as one, it is necessary that the group financial statements are audited and an audited independently. Usually the parent company is responsible for the preparation and audit of the group financial statements.

### **b) Group auditor and component auditor:**

A group of companies such as the Zambezi group will not necessarily have the same firm of auditors auditing the financial statements of the parent and the subsidiary companies as is the case here.

**The group auditor:**

This is the auditor who audits the consolidated financial statements. The parent is responsible for the preparation of the consolidated financial statements. It is these consolidated financial statements which include figures of the parent and the subsidiaries that the group auditor audits.

*Responsibility on the consolidated financial statements:*

The group auditor is responsible for ensuring that the consolidation process has been carried out in accordance with relevant accounting standards. The group auditor is responsible for gathering sufficient appropriate audit evidence to enable him form an appropriate audit opinion on the group financial statements. He is responsible for the opinion that he will arrive at and cannot apportion any blame to the component auditors.

**The component auditor:**

These are the auditors of the subsidiaries of the group. They conduct the audit of the subsidiary financial statements and are responsible for the opinion on the subsidiary financial statements. The subsidiary financial statements form a part of the consolidated financial statements. The component auditors are expected to cooperate with the group auditor and provide any information the group auditor may require in the audit of the consolidated financial statement.

*Responsibility on the consolidated financial statements:*

The component auditor has no direct responsibility on the opinion on the consolidated financial statements.

**c) Transnational audit:****Definition:**

A transnational audit is an audit of financial statements which are or may be relied upon outside the audited entity's home jurisdiction for various purposes including lending, investment decisions or regulatory decisions.

**Relevance:**

Kalungwishi plc is listed on the stock exchanges of the countries that it is operating in. The group plans to raise additional capital through the listings it has and it is subject to the regulations of the stock exchanges where the shares are listed and so is subject to rules outside its home country. The group has foreign subsidiaries meaning that it operates in a global business and financial environment.

**d) Arguments for setting up risk committee:**

A risk committee is one of the committees of the board of directors. The following are some of the arguments for setting up a risk committee:

- The committee will advise the rest of the board of directors on matters relating to risk of the company.
- Will monitor management on matters relating to risk management and ensure that management responds appropriately to ensure that the company meets its objectives.
- Will aid the statutory auditors to gain a good understanding of the risks facing the company and enable them respond appropriately.

**SOLUTION THREE****a) Money laundering:**

Money laundering is a process by which criminals attempt to hide the true origin of the proceeds of criminal activities. It is a way in which money earned from criminal activities is transferred and transformed so that it appears to have come from a legitimate source. Money laundering includes a wide range of potential crimes including possessing, dealing with, or concealing the proceeds of crime. The objective of money laundering is to break the connection between the money, and the crime that it resulted from

The ethical matter that the auditor will be concerned with in relation to money laundering is that of confidentiality. Generally, the auditor should not disclose to

third parties any information that comes to his attention by virtue of the position that he holds without the permission of the client.

In this case where the client is or is suspected to be involved in money laundering activities, the auditor may disclose to competent authorities the client's activities. This will be covered under the exceptions to the general rule whereby the auditor has an obligatory responsibility to disclose any criminal activities their client may be involved in.

As long as the auditor has sufficient grounds to believe that the client is involved in money laundering activities, he will not be in breach of the professional ethics of confidentiality. If in doubt the auditor may seek independent legal advice.

#### **b) Going concern:**

Kafue Limited appears to be faced with going concern issues. It is in the manufacture of high tech equipment whose technological advances move very fast. For a firm to succeed in such an industry it should be able to move at the same pace as the competition otherwise it will face the problem of obsolescence such that its products will be out of date and not be able to meet the production costs.

With the need for large amounts of money to be spent in R & D and the bank's refusal to extend further credit, Kafue Ltd may be faced in serious cash flow problems which will prevent it from investing in research. The fact that the current loan is secured on the assets of Kafue plc, means that the company does not have any assets it can use as collateral to borrow from other financiers.

The relaxation of importation regulations means that there will be an influx of cheap equipment and this may result in Kafue plc not being competitive. This may put additional pressure on the company being able to meet its financial obligations resulting in going concerns worries.

#### **Responsibilities of management regarding concern:**

It is the responsibility of the management of Kafue plc to assess the going concern matters of the company at the period end. The management should make an assessment that in their opinion the company is a going concern for a period of at least twelve months from the end of the accounting period. The

assessment of management that the company is or is not a going concern should cover a period of not less than 12 months from the period end.

The assessment of the going concern aspects of the company will determine the basis upon which the financial statements will be prepared whether on the historical cost basis or a break up basis if the company is assessed as not a going concern.

### **Responsibilities of the auditors regarding going concern of a client company:**

The responsibility of the auditors with regard to going concern of a client company is to evaluate management's assessment and assess its reasonableness. The auditors will review the basis upon which management will assess the going concern assumption of the entity. They will review the assumptions made for reasonableness. Auditors will obtain necessary representations from management as part of the evidence obtained.

The auditors should confirm that management's assessment should cover a period of not less than 12 months from the end of the accounting date. If it is less the auditor should ask the client to extend the period.

### **c) Business risk and risk of material misstatement:**

#### *Business risk:*

Can be defined as a threat which could result in the business to fail to meet its business objectives. That is the risk that the business may fail. Business risks represent problems which are faced by the management of a business, and these problems should be identified and assessed for their possible impact on the business. For example the relaxation of import regulations for imported products poses a business risk for Kafue Plc.

#### *Risk of material misstatements:*

This is the risk that components of the financial statements could be misstated, through inaccurate or incomplete recording of transactions or disclosure. Risks of material misstatement represent potential errors or deliberate misstatements in the published financial statements of a business.

### *Relationship between business risk and risk of material misstatements:*

There is in most cases a relationship between business risk and the risk of material misstatement. In most cases if management do not address a business risk it will have an impact on specific components of the financial statements. For example in the case of Kafue Ltd the business risk of obsolescence if not addressed could result in the misstatement of inventory in the financial statements. Further, business risks are usually linked to going concern issues because if a business is failing to meet its objectives then it may struggle to continue in operational existence.

### **d) Reasons for using analytical procedures at planning stage:**

#### *Identify risks:*

Performing analytical procedures at the planning stage of an audit can help the auditors to identify key audit risks. For example by comparing the increase in revenue over the year and relating this to the increase in discount given to customers may reveal a risk that any inventory at the period end may be misstated due to the fact that net realizable value is lower than cost.

After identifying the risks, the auditor can work out a strategy of the audit that is specifically tailored to the risks that have been identified in this client. This way detection risk will be reduced and by directing work to risky areas the risk of carrying out unnecessary work will be reduced.

#### *Understanding the business:*

Performing analytical procedures at the planning stage of the audit can help the auditor to develop an understanding of the client's business. An auditor can get a lot of information from an analysis of the prior period and the draft accounts. For example the auditor can find out the main revenue streams. This is more important when the client is new as in this case. The auditor will have a particular need to find out the basic facts about the client's business. For example by calculating the gross margin of the client the auditor can compare it

with others in the same industry and therefore gauge the performance of the client more reasonably.

### **Information required for analytical reviews:**

To be able to use analytical reviews at the planning stage and risk assessment, the firm will need information including:

- Previous year financial statements which will be used for comparison purposes and trends.
- Current year draft financial statements. The reliability of these is questionable because the information is subject to change.
- Industry information such as average performance in this industry.

## **SOLUTION FOUR**

### **a) AUDIT PROCEDURES TO RESPOND TO IDENTIFIED RISKS:**

#### **Risk one:**

The increase in the turnover of 45% does not appear to have arisen because of aggressive sales force. The fact that discounts allowed has significantly increased suggests that this is the main cause of the increase in revenue.

The significant reduction in the sales price in view of the discount may suggest that the net realizable value for any stocks held may be lower than the cost. It will be necessary to review the inventory valuation working and compare with the sales price in order to ensure that inventory is valued at the lower of cost and NRV as per IAS 2. Further, it will be appropriate to confirm the realizable value by examining a sample of after year-end sales prices.

#### **Risk two:**

There is a risk that provisions at the period end may be misstated because of the subjectivity in determining the likely cost of repairs.

The audit procedure that should be undertaken includes a review of the previous year end estimates compared to the actual cost of repairs in the following year. This will confirm the management's capacity to make these estimates. It will be

necessary to obtain details of returns by customers due to defects over the year and also review the basis of the computation for the estimate at the period end.

### **Risk three:**

The audit risk in this case is that with a view to improve the performance of the entity and hence enable the CEO and the Finance Director get their bonuses they may capitalize R & D expenditure instead of writing it off against revenue.

The audit work that should be done includes a review of the R & D expenditure in the year and ensure it has been treated correctly in accordance with IAS 38 *Intangible assets*. Only expenditure which meets the conditions set up in the standard may be capitalized and any other R & D expenditure should be written off to revenue.

It may also be appropriate to obtain management representations that R & D expenditure has been accounted for correctly per relevant accounting standards.

### **Risk four:**

This risk could result in the wrong provision figure in the financial statements. In this case no provision has been made in the financial statements notwithstanding that the employees have a high court judgment in their favor.

The audit work that will be taken includes:

- Discuss the matter with management and obtain their reasons for not making a provision in the financial statements. It may be necessary to obtain management representations on this matter.
- Review any correspondence concerning this matter including the arguments for the employees which form the basis of them taking the matter to court.
- Discuss the matter with the legal experts of the client and obtain their view and thinking on the outcome of the case.
- Seek independent legal opinion from lawyers.
- Possibly obtain a copy of the judgment and make an independent evaluation.

## **b) Audit reports**

### **i. Comments on draft report:**

- The draft report does not have an introductory paragraph. This should be the first paragraph which among other information will state the addressees of the report and identify the financial statements that have been audited and being reported on.
- The opinion paragraph is placed in the wrong position, it is supposed to come after the paragraph which specifies the responsibilities of the auditors.
- The paragraph entitled 'Basis for unmodified opinion' is misplaced and is not one of the paragraphs that should be included in an unmodified report. This paragraph is introduced in the case where the audit report is modified and is meant to state the basis of the modification adopted by the auditor.
- The paragraph specifying the responsibilities of management should come above the one which gives the responsibilities of the auditors.
- The draft report is not dated.
- The draft report is not signed as required.

### **ii. Distinction between unmodified and modified reports:**

#### **Unmodified audit report:**

*ISA 700 (Redrafted) Forming an opinion and reporting on financial statements* gives guidance on the unmodified audit opinion.

This is the form of opinion that is issued by the auditor where in the opinion of the auditor the financial statements show a true and fair view. In this case the auditor concludes that the financial statements are free from material misstatements.

#### **Modified audit reports:**

ISA 705 *Modifications to the opinion in the independent auditor's report* gives guidance on modifications of audit reports.

There are generally three forms of modifications of audit report that the auditor may use as follows:

### **Qualified audit opinion:**

This form of modification is used in two instances as follows:

- Where there is an issue of concern that is material to the financial statements but this is not pervasive to the financial statements. In this case a qualified audit opinion may be issued.
- Where the auditor is unable to obtain sufficient appropriate audit evidence and this is not pervasive to the financial statements.

The wording of the modification for a qualified audit opinion is 'except for' ..... the financial statements show a true and fair view.

### **Adverse opinion:**

This is the worst form of opinion and indicates that the financial statements do not show a true and fair view. In this case the auditor has obtained sufficient appropriate evidence and there is a matter of concern which is both material and pervasive to the financial statements. The auditor concludes that the financial statements do not show a true and fair view.

The form of wording is 'The financial statements do not show a true and fair view'.

### **Disclaimer of opinion:**

This form of modification is issued when there is a material and pervasive inability for the auditor to obtain sufficient appropriate audit evidence.

The form of wording that is used is 'we have not been able to obtain sufficient appropriate audit evidence to provide a basis for an audit opinion'.

### **Use of an expert:**

Auditors are free to use the services of an expert in gathering sufficient appropriate audit evidence. This does not mean that they are absolved of their responsibility to obtain sufficient appropriate evidence. It is their duty to gather this evidence and they are fully responsible for their opinion.

In the audit report the auditors are not required to mention the use of experts. The paragraph in the draft report is not required and it is not one of the elements of a standard audit report.

## **SOLUTION FIVE**

### **a) Auditor engagements:**

#### **i. Assurance engagement:**

This is an engagement that is entered into between the auditor and a client whereby the auditor gives a high level of assurance on the financial statements.

In order for the auditor to give this high level of assurance he has to perform work sufficiently enough that he is able to arrive at an appropriate opinion. In this form of engagement the amount of work that the auditor carries out is high compared to the other forms of engagements.

Arising from an assurance engagement the auditor gives a positive form of report such as 'the financial statements show a true and fair view'.

#### **ii. Review engagement:**

In a review engagement, enables the auditor to state whether on the basis of procedures which do not provide all the evidence that would be required in an audit or assurance engagement, anything has come to his attention that would cause him the auditor to believe that the financial statements are not prepared, in all material respects, in accordance with an identified financial reporting framework.

Review engagements are used mostly in the case where the client needs an independent party to provide assurance such as in the case of a due diligence assignment.

There are two types of review engagements namely attestation engagements and direct reporting engagements.

**iii. Agreed upon procedures:**

This is an engagement to perform agreed-upon procedures. The work that the auditor will carry out will be as agreed by the auditor and the entity and any appropriate third party for the auditor to report on factual findings.

The recipients of the report will then make their own conclusions from the report that will be issued by the auditor. The report is restricted for use to the persons that it is intended for as it may be misinterpreted if used by other people.

**iv. Compilation engagement:**

In the case of a compilation engagement, the practitioner who is the accountant, is engaged by a client to use his accounting expertise to collect, classify and summarize financial information. In this case no assurance is given by the practitioner.

## **b) Lukanga Limited:**

### **Inventory – K140 000.00**

According to IAS 2 *Inventory*, inventory held at the period end and included in the financial statements should be valued at the lower of cost and net realizable value.

The sale of the equipment at K28 000 is an event after the period end which gives evidence of conditions that existed at the period end. The inventory was valued at a figure of K45 000.00 and at the time it was not clear what the realizable value was. In accordance with IAS 10 *Events after the reporting period* any events after the period end and which give additional information of the conditions that existed at the period end should result in the adjustment of the related figures.

The fact that the inventory has been sold for a lower than cost is indicative of the fact that the realizable value is lower than the cost. Since the audit has not yet been finalized and the report issued, the value of inventory at the period end should be reduced by K17 000 so that the new inventory figure is K123 000

### **Accounts receivables – K54 000.00**

In accordance with IAS 10 *Events after the reporting period*, this event can be classified as an adjusting event. This is because it gives additional evidence of conditions that existed at the period end. With hindsight, it is clear that most of this debt is irrecoverable and as such the figure of K54 000 at the period end is misstated.

The audit procedures will include:

- A discussion with management on the irrecoverability of the debt so that an allowance for receivables is made.
- Ensure that a provision of K35 100.00 is made since the maximum the client will get is K18 900.00
- In the event management refuses to make a provision, consider the effect of this on the audit report. This will depend on the materiality and pervasiveness of the amount to the financial statements.

**Loan:**

The auditors do not have any obligations to perform procedures or make enquiries regarding the financial statements after the date of their report. They have a passive duty.

If they come across a matter that would have caused them conclude otherwise their duty then becomes active and they need to:

- Discuss the matter of the understated loan amount with management and where appropriate with those charged with governance.
- The auditor should determine whether the financial statements need to be amended and if this is the case
- Find out with management how they hope to deal with this matter.

If the financial statements are changed the auditors will need to perform further audit procedures on the amendments. They will also need to extend the period of reviewing events after the period date to the date of the new report that will be issued. If management declines to amend the financial statements, the auditors will consider the effect of this on their opinion.

**Provision for warranty:**

The risk in this situation is that provisions may be misstated at the end of 2013. The risk is high because it is a matter of accounting estimate requiring judgment.

The question states that no provision relating to sales made during 2013 has been made in the financial statements. The fact that repairs totaling K14 000 have been made in the subsequent period indicates that a provision should have been made.

The following audit procedures will be undertaken:

- Discuss with management and establish their policy regarding warranty provisions.
- Examine the prior year provision and compare with the actual repair costs in order to determine the accuracy of the management estimates.
- Require management to increase the provision for warranty based on a realistic estimated repair cost but to not less than the actual cost incurred of K14 000 made in the subsequent period.

**END OF SUGGESTED SOLUTIONS**