



COMPETENCE PRACTICE EXAMINATION

FULL AUDIT

DECEMBER 2010

TIME ALLOWED: 5 HOURS

INSTRUCTIONS TO CANDIDATES

1. This paper has Two Questions.
2. You are required to attempt ALL the two questions
3. Each question has Sections:

Question one has two sections: A and B
Question two has two sections: A and B
4. All the two questions carry equal marks.
5. The Examination is divided into sessions of 2¹/₂ hours each. There will be a 30 Minutes break in between the sessions.
6. Please use your Membership number and your National Registration Card number on the front of the answer booklet. Your name must NOT appear anywhere on your answer booklet.
7. This is an open book examination.

QUESTION ONE

Background

Chartered Accountants wishing to go into public practice need to demonstrate that they are able to handle various types of assurance engagements and other audit and assurance issues with higher levels of professional approach. Auditors should be able to meet the needs and requirements of a diverse clientele by creating sufficient confidence that is not disputable.

The issue that normally arises is the expectation gap, i.e. what the public believes auditors do and what the auditors actually do. The expectation gap has been broken down into three:

The **standard gap** where auditing standards are looked at to be different from what they actually are. The **performance gap** is where auditors are believed to be operating below current standards and finally the **liability gap** where it is not very clear whether auditors are legally responsible despite the popular ruling in Kaparo Industries plc Vs Dickman and others case of 1990.

Going by many corporate failures and numerous scandals world-wide such as Enron scandal – USA, Agri-flora scandal – Zambia, WorldCom scandal – USA, Arthur Andersen, MOH scandal – Zambia, MOHA – Zambia, ZamTrop Scandal – Zambia, Parmalat – Italy, Hollinger and many more, it has been very difficult for Accountants in general to justify their existence.

Generally, a Chartered Accountant wishing to go into public practice must demonstrate that the following aspects applicable to the audit environment namely, the **regulatory environment**, the **professional and ethical considerations**, **practice management**, **various procedures involved in a range of audit and assurance engagements** and familiarity with reporting both from the **financial reporting** and **audit reporting perspectives** are appreciated and understood. It is also a fact that evidence gathering is a key process in ensuring the integrity of the reports issued thereafter. Finally, a practicing accounting (auditor) must be up to date with current issues and developments that may impact on the auditors reporting environment. In this way, the expectation gap is likely to reduce hence create sufficient confidence to the public.

In order for ZICA to determine as to whether you as a **prospective practicing accountant** is ready to practice and assume responsibility of the assurance engagements and related assignment carried out, the following working papers have been brought to you for review in order to gauge your competence.

Working paper	No.
Financial Statements	FS/1
Warehousing Services	WHS/1

Introduction:

ISA 570 Going concern states that when preparing accounts, management should make an explicit assessment of the entity's ability to continue as a going concern. In making the assessment, management should consider the degree of uncertainty about the events or conditions being assessed increases significantly the further into the future the assessment is made, judgements are made on the basis of the information available at the time, judgements are affected by the size and complexity of the entity, the nature and condition of the business and the degree to which it is affected by external factors.

The standard clearly states the auditors' responsibilities and various audit procedures and give a number of examples of possible indicators of going concern problems.

With the current economic down turn, there is a likely would that some significant delay in approving accounts may be experienced thus delays in inviting auditors to carry out the audit. In such circumstances, the auditor should consider whether the delay was due to doubts about the going concern status of the business. This may prompt the auditors to perform additional procedures on going concern.

Client: AGRI-EQUIP	Prepared by: POP	FS/1- 1/1
Year end: 31/12/10	Date: 30/11/10	
Subject: Financial statements		

As part of the planning process to audit AGRI-EQUIP whose principal activities are agriculture equipment and warehousing services and repair of Agric-equipment and machinery, the draft summary accounts for the year ended 31 December 2010 have been provided below.

	Draft 2010 K'000,000	Actual 2009 K'000,000
<i>Summary income statement</i>		
Revenue	9,873.0	10,404.0
Cost of sales	<u>(9,182.7)</u>	<u>(9,426.6)</u>
Gross profit	690.3	977.4
Administrative expenses	(703.8)	(701.1)
Interest payable and similar charges	<u>(211.5)</u>	<u>(166.5)</u>
Net (loss) profit	(225.0)	109.8
 <i>Summary statement of financial position</i>		
Non-current assets	<u>4,660.2</u>	<u>4,203.0</u>
Current assets		
Inventory (parts and consumables)	85.5	54.9
Receivables	<u>2,677.5</u>	<u>2,132.1</u>
	<u>2,763.0</u>	<u>2,132.1</u>

Current liabilities		
Bank loan	225.0	-
Overdraft	1,120.5	821.7
Trade payables	1,361.7	1,120.5
Lease obligations	186.3	-
Other payables	<u>182.7</u>	<u>134.1</u>
	<u>3,076.2</u>	<u>2,076.3</u>
Long-term liabilities		
Bank loan	675.0	900.0
Lease obligation	<u>425.7</u>	-
	<u>1,100.7</u>	<u>900.0</u>
Net assets	<u>3,246.3</u>	<u>3,413.7</u>

Notes:

1. The managing director has indicated that the fall in revenue is due to a loss of a dependable commercial customer in Mkushi who has since decided to be dealing with a competing company in the same industry. The fall may also be attributed to the warehouse services business especially the closure of the Nakonde Warehouse (**working paper WHS/1**)
2. There has been a decline in trade in the repair of Agric – equipment and machinery.
3. Due to the declined business in the repairs of Agric – equipment and machinery, AGRIC –EQUIP has decided to close the repair workshop and sell the equipment and spares inventory. No entries resulting from this section are reflected in the draft accounts.
4. During the year under review, the company made arrangements to purchased modern Agric – equipment and machinery through a combination of leasing and increased overdraft arrangements. This facility is to be reviewed in March 2011 after the audited accounts are available.
5. Though the draft accounts show a loss for 2010, a forecast indicates that a return to profitability is likely to be attained in 2011 as the managing director is optimistic about generating additional revenue from new and modern equipment and machinery the company has decided to be stocking and perceived interest shown by some commercial farmers.

Client: AGRIC - EQUIP	Prepared by: POP	WHS/1 1/1
Year end: 31/12/10	Date: 30/12/10	
Subject: Warehousing services		

Additional information:

Government of the republic of Zambia identified the agricultural industry as one of beacon of hope for the Zambian economy to grow in addition to the mining industry. An enabling environment was therefore created for companies willing to invest in the agriculture sector. A number of incentives were provided such as tax rebates. AGRIC – EQUIP had to seize the opportunity considering its activities in warehousing. In 2008, the company was given a three (3) year renewable licence and contract in warehousing and allowed to operate in the following geographical locations; Lusaka being the head office; Kabwe, Kapiri Mposhi, Mkushi, Serenje, Chitambo, Mpika, Chinsali, Isoka and Nakonde where already established locations were available. However, AGRIC – EQUIP was expected to register with each of the Councils in the locations to which they are expected to pay land rates and licence renewal is depended on meeting council requirements. Whilst Head office is headed by the Managing Director, each warehouse location is headed by Warehouse Manager who is expected to operate in accordance with the company policies. AGRIC –EQUIP also sales seed maize in all branches as a way of bringing farming inputs to as closer to the customers as possible. So far indications are that some seed maize sold to some farmers cannot germinate properly in line with farmers’ expectations. Warehouse managers are expected to ensure that monthly accounting and inventory returns are sent to head office.

Monthly accounting and inventory returns are normally delayed for a few days and it has been noticed that revenue trends are going down despite improved sales. The selling of seed is done on a cash basis and those buying more than K50 kg are given a discount of 5 percent. Because of AGRIC-EQUIP warehouses proximity to the local farmers, most farmers groups have registered with it and normally make some advance payments towards the cost of inputs of 10 % on cost and 15% for those wishing to pay the full amount in advance to encourage farmers invest in inputs and not misuse funds before the next season. These fees are not refundable but could be traded – off with other similar products required in farming.

The Nakonde warehouse was closed in July 2010 for five months to facilitate renovations, whereas the Mkushi warehouse was partially closed on similar lines. As a result, the managing director recommended for suspension of activities in Nakonde and put the members of staff on unpaid leave until the warehouse is renovated. However, the Warehouse manager was transferred to head office.

Staff on unpaid leave are not happy with the development and has complained to their union to intervene and have threatened taking serious action against AGRIC - EQUIP.

Some nearby farmers who were using the closed warehouse are not happy of the development as they cannot access farming inputs faster and have to buy from other dealers whose products may not be suitable. It has also been noticed of late that the inputs normally

come late. Some Warehouse Managers are also not very satisfied due to AGRIC –EQUIP policy on training and as such managers are not given the opportunity to enhance their skills. This has seen some skilled staff leaving the company and in some cases AGRIC – EQUIP has opted for part-time employees. However, new employees are attracted to the company especially those wanting to benefit from free inputs for one hectare to be ploughed.

Due to the above developments, AGRIC – EQUIP has projected a huge loss for the year ending December 2010 considering that sales have reduced not only from the Nakonde warehouse but also from other warehouses due to competition.

AGRIC – EQUIP has decided to put in place a deliberate policy to embark on training of its managers and have also decide to refurbish its warehouses and other storage facilities in all its locations in operation. However, these programmes may be hampered by the reduced cash flow. Management has also decided to provide reduced prices to groups of farmers other than individual as a way of establishing niches and ultimately improving its revenue base. Because of the incentive being provide by the government in the agricultural industry, a lot more companies dealing in warehousing have applied to be given contracts to put up alternative warehouses in order to increase accessibility of inputs by farmers. For AGRIC – EQUIP, the tax rebate is expiring at the end of December 2010.

SECTION A

1. As part of your review and in line with the background information provided and in particular the many corporate failures and scandals highlighted, what is it that you expect to see or put in place in order to redress future occurrences in each of the following areas.
 - (a) Regulatory environment (5 marks)
 - (b) Professional and ethical considerations (5 marks)
 - (c) Practice management (5 marks)
 - (d) Procedures involved in a range of audit and assurance engagements. (5 marks)

2. As part of the review, and based on working paper **FS/1** – 1/1
 - (a) State the circumstances particular to AGRIC – EQUIP that may indicate that the company is not a going concern. (10 marks)
 - (b) Explain why these circumstances given cause for concern? (20 marks)
 - (c) Outline the audit procedures to be performed in respect of going concern of AGRIC-EQUIP. (10 marks)

(Sub-total: 60 marks)

SECTION B

1. In relation to working paper **WHS/1** – 1/1
 - a)
 - (i) Identify and explain the business risks that should be assessed by AGRIC – EQUIP management of warehouses. (15 marks)
(One or two risk in FS/1 -1/1 may be applicable to this)
 - (ii) How do the identified risks in (i) above link to the financial statements risk. (15 marks)
 - (b) Arising from AGRIC – EQUIP activities and expected performance, list and justify **suitable internal controls** to be put in place to assist in remedying the situation. (10 marks)

(Sub-total: 40 marks)

(Total: 100 marks)

QUESTION TWO

Introduction

BOLTs Metal Fabricators Ltd is a company specialized in the production and fabrication of heavy duty bolts used in most mining equipment and machinery. The company was created in 2002 in order to seize an opportunity in the mining industry where heavy duty bolts proved to be on high demand due to the massive equipment and machinery in use. Its major customers are mainly KCM and Mopani copper mines. While its headquarters is in Kitwe, it has other branches in Chingola, Chililabombwe and Mufurila where service bolts are delivered for easy access by its clientele. In its seven years of existence, business opportunities have been forthcoming and the demand for heavy duty bolts has been overwhelming. However, in 2009, BOLTs Metals Fabricators Ltd started experiencing low demand as most mining companies decided to engage themselves in service contracts with the suppliers of heavy duty equipment and machinery as a way of cutting costs. This was a strategy muted by the Chief of Operations of KCM upon noticing that the Global Credit Crunch had heavily affected their operations. This was also a similar development with other major customers who also decided to put in place cost reduction strategies following the economic crisis. BOLTs Metals Fabricators Ltd would only receive few orders when some mining companies experience some delay in receiving service parts on time. This has made Bolts Company's cash flow to be a source of concern.

At the beginning of 2010, the CEO – Mr. Tembo held a management briefing and presented a report on what he called “the survival plan”.

The Finance Director has just finished preparing the financial statements for the year ended 2010 and has invited CHOP a medium sized auditing firm to act as its auditors and conduct the year - end audit for the company. CHOP has decided to accept this particular engagement.

As part of the inception meeting with the audit team, the CEO has briefed the team on the nature of its business and the strategies that the company has put in place to ensure that the company remains a going concern. This has been provided to the audit team as Working paper (SP/1). The CEO is worried that in the event that the audit opinion is qualified, some of the arrangements that form part of the strategies will not be fulfilled.

One of the biggest challenges faced by auditors is that of giving an opinion on the financial statements as to whether they give a “true and fair view” or “presents fairly in all material respects” and have been prepared in accordance with the regulatory framework and relevant accounting standards. Auditing standards ISA 700 and ISA 701 provide sufficient leverage in as far as the types of opinions to be given depending on the evidence available and evaluated. In giving an audit opinion, an auditor is expected to evaluate and review matters relating to specific accounting issues. Among the most important issues to consider is materiality, risk, relevant accounting standards and audit evidence.

The audit partner has appointed you as audit manager to lead a team of three auditors. Based on the financial statements submitted for audit, the audit manager has produced the following working papers for review.

Working paper	Reference
Summary financial statements and notes	FS/1 – 1/1
The survival plan strategy	SP/1 – 1/1
Deferred tax treatment	FS/2 -1/3
Provisions and contingencies	FS/2 – 2/3
Borrowing costs	FS/2 – 3/3

Client: BOLTs Metal	Prepared by: Joe	FS/1 1/1
Year end: 31/12/10	Date: 15/12/10	
Subject: Summary financial statements and notes		

BOLTs Metal Fabricators Ltd draft consolidated financial statements for the year ended 31 December 2010 show revenue of K42.2 billion (2009 – K41.8 billion). The profit before taxation stands at K1.8 billion (2009 – K2.2 billion) and total assets of K30.7 billion (2009 – K23.4 billion).

Notes:

1. In addition to the survival plan in working paper SP/1 below, in December 2010, the management board announced plans to cease its operations in the Mufurila branch from the end of the month. These sales amounted to K600 million for the year to 31 December 2010 (2009 – K800 million). A provision of K200 million has been made as at 31 December 2010 for the compensation of redundant employees (mainly marketers). Delivery vehicles used in delivering parts and marketing have been classified as non-current assets held for sale as at 31 December 2010 and measured at fair value less costs to sell, K800 million (carrying amount, K500 million).
2. Historically, all owned premises have been measured at cost depreciated over 10 to 50 years. The management board has decided to value these premises for the year ended 31 December 2010. At the balance sheet date, two properties had been revalued by a total of K1.7 billion. Another 15 properties have since been revalued by K5.4 billion and the remaining three properties which are expected to be revalued during 2011. A revaluation surplus of K7.1 billion has been credited to equity.
3. During the year, BOLTs Metal paid K100 million (2009 – K300 million) in fines and properties relating to breaches of polluting the nearby river. These amounts have not been separately disclosed but included in the cost of sales.
4. The deferred tax has not been adjusted for the current period. More details for this has been reflected in working paper **FS/2 – 1/3**

5. The issue of provisions and contingencies need to be addressed thoroughly both as per **Note 3 above** and working paper **FS/2 – 2/3**
6. According to IAS 23 borrowing costs, guidance is given on how borrowing costs are supposed to be capitalized. Working paper **FS/2 – 3/3** gives details on the requirements

Client: BOLTs Metal	Prepared by: Joe	SP/1 1/1
Year end: 31/12/10	Date: 15/12/10	
Subject: Survival plan strategies		

Ladies and gentlemen, you may all be aware that the company has not been doing very well in terms of making sufficient sales to cover both the direct and indirect costs. You may recall that in one of the management meetings, I did indicate to you that our major customers, mainly the big mines, had gone into service contracts with the suppliers of heavy duty equipment and machinery to also be supplying them with repair accessories such as bolts. This has been termed as a cost reduction strategy on their part.

You are also aware that our product is mainly for use in heavy duty equipment and machinery and are used by the same mines. Our market intelligence indicates that most of these mining companies have been affected by the Credit Crunch or economic crunch and as such are not able to service most of suppliers of goods and services due to their poor cash flows. The prices of copper and similar metals have gone down drastically to a level whereby mining costs cannot be recovered.

I see this as a total threat to our existence. However, information on the ground indicates that we can modify the same product by producing bolts also suitable for other users other than the mines and metal plates that can be sold for other metal works. For this strategy to work, we need additional equipment and machinery that can produce both heavy and light duty bolts.

The following strategic measures have been put in place as part of the survival plan.

1. Agreed with the bank to provide extended overdrafts on our main revenue account to allow us improve the working capital. However, it is the bank's requirement that all payments to this account have to be sanctioned by the bank until further notice.
2. The company has negotiating for a loan from another bank and used as a fixed charge on the equipment and machinery used to make heavy duty bolts. The loan has not yet been provided pending verification of the soundness of the company and considering that the mining sector in Zambia and world over was not performing well. The lender has therefore attached some conditions based on high turnover and improved asset based for BOLTs Metal Fabricators Ltd.
3. Review and increase the credit terms to our customers as a way of promoting more sales.

4. Work on the efficiency of the available equipment as a way of increasing revenue by constructing another plant using part of the funds to be borrowed.

Client: BOLTs Metal	Prepared by: Joe	FS/2 1/3
Year end: 31/12/10	Date: 15/12/10	
Subject: Deferred Tax		

In accordance with IAS 12, the method of providing for deferred tax is based on full provision. This recognizes that each timing difference at the period end has an effect on future tax payments. Deferred tax assets and liabilities are measured at the tax rates expected to apply to the end period when the asset is realized or liability settled, based on the tax rates that have been enacted (or subsequently enacted) by the end of the reporting period. It is also a requirement that deferred assets and liabilities cannot be discounted. In terms of recognition, deferred tax assets are only recognized to the extent that it is probable that taxable profit will be available against which the deductible temporary difference can be utilized.

BOLTs Metal Fabricators Ltd draft accounts for the year ended 31 December 2010 as per summary financial statement in **FS/1**, i.e. Revenue of K42.2 billion (2009 – K41.8 billion). Profit before tax of K1.8 billion (2009 – K2.2 billion) and the total assets stand at K30.7 billion (2009 – 23.4 billion). The following additional information has been provided.

1. The deferred tax balance of K1.7 billion in the in the financial statements is the brought forward balance from previous years. No deferred tax adjustment has been made for the current period.
2. At the period end, BOLTs Metal have plant and equipment with a carrying amount of K10.4 billion and a tax base at that date of K4.4 billion.
3. The tax rate to be applied is 30%

Client: BOLTs Metal	Prepared by: Joe	FS/2 2/3
Year end: 31/12/10	Date: 15/12/10	
Subject: Provisions and Contingencies		

In October 2010, the managing director suspended the director in-charge of production. At a disciplinary hearing held by the company on 10 December 2010, the director was dismissed for gross misconduct and it was decided the director’s salary should stop from that date and no redundancy or compensation payments should be made.

The director has claimed unfair dismissal and is taking legal action against the company to obtain compensation for loss of his employment. The director says he has a service contract with the company which would entitle him to two year’s salary at the date of dismissal.

The financial statements for the year ended 31 December 2010 record the resignation of the director. However, they do not mention his dismissal and no provision for any damages has been included in the financial statements.

Client: BOLTs Metal	Prepared by: James	FS/2 3/3
Year end: 31/12/10	Date: 15/12/10	
Subject: Borrowing costs		

As part of BOLTs strategies, the company is expected to borrow funds from the bank. Part of these funds will be used to construct another plant in order to improve on the operational efficiency. This is part of the survival plan strategy in **working paper SP/1**.

BOLTs Metal borrowed K15 billion to finance the construction of an additional plant whose construction is scheduled to take place from January 2010. Construction started in January 2010 at the time the loan facility was drawn. K9 billion was utilized up to June 2010 and another K6 billion utilized up to December 2010 and the remaining funds invested temporary.

The loan rate was at 15% and BOLTs Metal can invest surplus funds at 10%.

SECTION A

1. Based on the **working paper FS/1 – 1/1, and has it relate to NOTES 1, 2 and 3.**
 - (a) Comment on the matters that you should consider in undertaking your review of the working papers and financial statements of BOLTs Metal for the year ended 31 December 2010.

(25 marks)
 - (b) State the audit evidence that you should expect to find in undertaking your review of the working papers and financial statements of BOLTs Metal for the year ended 31 December 2010 for matters considered in (a) above.

(20 marks)

 2. Based on the **working papers FS/2 - 1/3, 2/3, and 3/3 and has they relate to NOTES 4, 5 and 6.**
 - (a) State the matters you would consider for audit purposes in BOLTs Metal.

(20 marks)

 - (b) Various tests or procedures that should be carried out in respect of the matters considered in 2 (a) above.

(15 marks)
- (Sub-total: 80 marks)**

SECTION B

1. In line with the introductory information provided above and based on **working paper SP/1 - 1/1,**
 - (a) As Audit Manager to be in-charge of the audit of BOLTs Metal Fabricators Ltd, and taking into account the impact of the economic credit crunch during the year under review, outline the **audit risk alerts** that should be considered as part of the credit crunch when planning the audit?

(10 marks)

 - (b) In relation to the audit risk alert pertaining to the **going concern issue**, what are the risk factors that you should consider to determine whether BOLTs Metal Fabricators Ltd is exposed to going concern issues?

(10 marks)
- (Sub-total: 20 marks)**

(Total: 100 marks)

END OF EXAMINATION