AUDIT JUNE 2017

QUESTION ONE

You are a manager in the audit department of Mundia & Co, a firm of Chartered Certified Accountants registered with the Zambia Institute of Certified Accountants (ZiCA). You are responsible for the audit of Mpundu Holdings Co, a listed company specialising in the design and manufacture of equipment and machinery used in the quarrying industry. You are planning the audit of the financial statements for the year ending 31 March 2017. The projected financial statements for the 2017 year-end recognise revenue of K138 million (2016 – K135 million), profit before tax of K9·8 million (2016 – K9·2 million) and total assets of K90 million (2016 – K85 million).

Mpundu Holdings Co obtained listing on the Lusaka Stock Exchange (LUSE) on 1 March 2017.

Company background

Mpundu Holdings Co was established 20 years ago and has become known as a leading supplier of machinery used in the quarrying industry, with its customers operating quarries which extract stone used mainly for construction. Its customer base is located solely in Zambia but most of the components used in Mpundu Holdings Co's manufacturing process are imported from foreign suppliers. The company executes hedging arrangements as a way to reduce exposure to foreign exchange fluctuations.

The machines and equipment made by Mpundu Holdings Co are mostly made to order in the company's three manufacturing sites located on the Copperbelt, Lusaka and Livingstone. As a means of social responsibility, Mpundu Holdings has deliberately extended its operations to selected deprived areas – Sesheke and Sinazongwe. This has attracted government grants to support with payment of salaries and wages and investments in these areas

Revenue Contracts with Customers

Customers approach Mpundu Holdings Co to design and develop a machine or piece of equipment specific to their needs. Where management considers that the design work will be significant, the customer is required to pay a 30% payment in advance, which is used to fund the design work. The remaining 70% is paid on delivery of the machine to the customer. Typically, a machine takes three months to build, and a smaller piece of equipment takes on average six weeks. The design and manufacture of bespoke machinery involving payments in advance has increased during the year. Mpundu Holdings Co also manufactures a range of generic products which are offered for sale to all customers, including drills, conveyors and crushing equipment. Revenue is recognized on the basis of total costs incurred to-date in relation to the total cost of the contract.

Corporate Governance - Notes from meeting with Mpundu Holdings Co audit committee

This year has been successful from a strategic point of view in that Mpundu Holdings Co achieved its listing on the Lusaka Stock Exchange (LUSE) in March 2017, and in doing so raised a significant amount of equity finance. The company's corporate governance was reviewed as part of the flotation process, resulting in the recruitment of three new non-executive directors and a new finance director. In addition to the audit committee, the rest of the corporate governance is now constituted as below

- Mr. Emmanuel Mpundu is Chairman and Chief Executive Officer
- The Board comprises 3 executive directors and 3 non-executive directors
- Board members are eligible to offer themselves for re-election every year
- The Chairman is responsible for recommendation compensation and remuneration for the directors, based on prevailing rates recommended by the Institute of Directors of Zambia

Accountability and the Reporting framework

Following the listing in March 2017, the new finance director has undertaken a review of the reporting framework of Mpundu Holdings to ensure that the company now fully complies with applicable International Financial Reporting Standards. As this process is ongoing, Mundia & Co are expected provide advice, especially with regard to the implications of adopting new accounting standards and any prior year adjustments arising.

In March 2017, a cash-settled share-based payment plan was introduced for senior executives, who will receive a bonus on 31 March 2019. The amount of the bonus will be based on the increase in Mpundu Holdings Co's share price from that at the date of the flotation, when it was K2·90, to the share price at 31 March 2019.

On the advice of the newly appointed finance director, no accounting entries have been made in respect of the plan, but the details relating to the cash-settled share-based payment plan will be disclosed in the notes to the financial statements. The finance director recommended that the company's manufacturing sites should be revalued. An external valuation was performed in October 2016, resulting in a revaluation surplus of K3·5 million being recognised in equity. The finance director has informed the audit committee that no deferred tax needs to be provided in respect of the valuation because the property is part of continuing operations and there is no plan for disposal.

Government grants

In November 2016, a government grant of K10 million was received as part of a government scheme to subsidise companies which operate in deprived areas. Specifically K2 million of the grant compensates the company for wages and salaries incurred in the year to 31 March 2017. The remaining grant relates to the continued operations in the deprived area, with a condition of the grant being that the manufacturing site in that area will remain operational until July 2020.

Inventory counts

All of the company's manufacturing sites will be closed at the year end to allow the inventory counts to take place. According to the most recent management accounts which are available, at 30 February 2017 work in progress is valued at K12 million (2016 – K9·5 million) and the majority of these orders will not be complete until after the year end. In recent weeks several customers have returned equipment due to faults, and Mpundu Holdings Co offers a warranty to guarantee that defective items will be replaced free of charge.

Preliminary review of results

Preliminary analytical review (extract) and other financial information

	Based on projected figures to 31 March 2017	Based on audited figures to 31 March 2016
Revenue	K138 million	K135 million
Operating gross margin	15%	13%
Inventory days	175 days	150 days
Receivables collection period	90 days	70 days
Trade payables payment period	60 days	55 days
Earnings per share	75 cents per share	–
Share price	K3·50	–

REQUIREMENTS

1) **In relation to the acceptance and the audit of Mpundu Holdings**
   a) Specific to quality control
      i) Identify and comment on quality control issues arising (2 marks)
      ii) Recommend the action that your firm should take (4 marks)

b) Specific to other ethical, corporate governance and other professional issues arising
   i) Identify and comment on the matters arising (8 marks)
   ii) Recommend the action that your firm should take (4 marks)

c) Evaluate whether pre-conditions for the audit are satisfactory (6 marks)

2) In relation to the planning of Mpundu Holdings for the year ended 31st March 2017,

a) Using the information provided identify and justify EIGHT sources of evidence or information required to assist in the planning of the audit of Mpundu Holdings for the year ended 31st March 2017 (8 marks)

b) Comment on the reliability of such information for audit purposes (4 marks)

3) In relation to the planning of Mpundu Holdings.

a) Using the information provided on Mpundu Holdings, other than the preliminary review of results, identify and evaluate TEN audit risks arising (25 marks)

b) Using the information relating to the preliminary review of results, identify and evaluate FIVE audit risks arising (10 marks)

c) Using information in (a) and (b) above, determine and justify an appropriate level of materiality (6 marks)

d) Based on your answer to © explain the difference between planning materiality and performance materiality and justify the use of performance materiality in performance of your audit (3 marks)

4) In relation to the audit of Mpundu Holdings

a) Discuss the relevance of the concept of professional skepticism and suggest how this should be applied to the audit for the year ended 31st March 2017 (5 marks)

b) As a response to the audit risks identified, determine suitable substantive procedures that should be performed in respect of:
   i) Revenue recognition related to bespoke machinery (5 marks)
   ii) The valuation of work in progress (5 marks)
   iii) The recognition and measurement of the government grant (5 marks)

QUESTION TWO

Your name is Bwalya Bwalya and you're an audit manager in Trump associates, a firm registered with the Zambia Institute of Chartered Accountants (ZiCA). Trump Associates is a relatively small size firm with 2 partners, 4 managers and 6 other auditors. The firm is specialised in the auditing of medium size companies within the trading sector – mainly involved with importing and selling of finished products.

Your firm has received notification from ZICA that quality reviews on selected clients would be undertaken in the next six months. Just in case your firm is selected, the managing partner of Trump Associates – Mr. Trump Dambe has requested you to undertake the following activities:

a) Review of existing quality control policies and procedures
b) Review whether adequate procedures relating to acceptance of new clients are being followed – Bwino Millers
c) Review whether extent of reliance on internal auditor is properly evaluated – Bwino Millers
d) Review whether adequate procedures are implemented to ensure that the objectivity of the firm is not impaired for long- standing clients – Kadson Insurance
e) Review whether the new auditing reporting requirements have been properly implemented:
    - Kadson Insurance
    - Industrial Equipment Ltd (IEL)

a) Review of existing Quality Control policies and procedures

You are aware that the Zambia Institute of Chartered Accountants (ZiCA) has reported that a number of firms, particularly smaller firms, have not carried out a review of their current policies and procedures to ensure that these comply with the requirements of ISQC 1. In order to comply with the requirements of ISQC 1, firms need to ensure that their quality control policies and procedures cover key controls on leadership responsibilities for quality, compliance with ethical requirements, engagement acceptance and continuance, human resources, engagement performance and monitoring. Firms should document these policies and procedures and ensure that all its audit personnel have read and understood them.

You have been provided with a summary of quality control policies and procedures for Trump Associates as per below;

Leadership responsibilities
Each manager on the audit is expected to ensure that suitable quality control procedures are adopted on each audit. As part of engagement performance, each audit manager is required to brief the audit team on the overall audit strategy and implementation of that strategy.

Human Resources
In order to promote diversity, recruitment is focused on promoting balance between male and female as well as ensuring that opportunities are extended to the differently abled. Members of staff are encouraged to plan for their training and development consistent with their particular career objectives. The firm supports all training that is considered relevant to accounting and auditing.

The firm considers that its remuneration package offers suitable compensation and is comparable to other similar size firms in Zambia.

The allocation of staff to engagement teams depends on the staff available and clients are expected to accept the members of staff included on a particular audit team.

Engagement performance
The standard of performance is determined by the partner and manager on each audit. Members of the audit team are expected to strictly adhere to the original audit plan to perform their work with little or no supervision. No deviation from the audit plan is acceptable and any unforeseen circumstances should be documented for follow up in the audit for the following year.

Monitoring
Given the size of the firm, there is no separate quality control unit. However, each partner on the audit is required to evaluate the quality control procedures implemented on the audit as part of the process of reporting on the audit. This is considered adequate to ensure good quality work

b) Review whether adequate procedures relating to acceptance of new clients are being followed

During the year, Trump Associates were invited to become auditors of Bwino Millers Ltd (BM). BM is a chain of milling plants with satellite plants in Lusaka, Copperbelt and Livingstone. Past press reports suggest several senior management members of BM had been implicated in some corruption cases.

The Chairman and Chief Executive Officer of BM, Mr. Fashion Bwino has now indicated that the senior members implicated in the corruption cases have since been dismissed and is adamant that BM has now changed its cultural outlook and is keen to adopt a more rigorous code of ethical values.

A signed letter of engagement confirm that Trump Associates accepted to be external auditors of BM. There appears to be no formal documentation of acceptance procedures undertaken.

c) Review whether extent of reliance on internal auditor is properly evaluated

BM has an established internal audit team. Mr. Bwino has suggested that Trump Associates should use the internal audit team as much as possible when performing the audits of BM as this will reduce the audit fee.

The internal audit team was established several years ago and is headed up by a qualified accountant, Jo Malaiti, who has a lot of experience in designing systems and controls. Jo and her team monitor the effectiveness of operating and financial reporting controls, and report to the Chairman of the Board. Apart from being involved in appraisal of internal controls, the internal audit team is involved in pre-audits and periodically performs value for money exercises such as reviewing the terms negotiated with suppliers.

d) Review whether adequate procedures are implemented to ensure that the objectivity of the firm is not impaired for long- standing clients

Trump Associates has maintained long-standing relationships with several clients. One of these clients is Kadson Insurance Company which has been an audit client since 2006. Kadson Insurance is the third largest provider of insurance services in Zambia

Kadson Insurance has recently reconstituted its board and has now appointed a new audit committee headed by Ms. Chileshe Mataka. In her first address as chairperson, Miss Mataka has raised concerns on the objectivity of Trump Associates to continue to act as auditors of Kadson Insurance. She has suggested that Trump should no longer be automatically re-appointed as auditors and should be subjected to rotation; failure to which they should be invited to bid for audit services along with other audit firms. In future, Kadson Insurance should consider compulsory rotation for firms after ten years. In her view, this would not only comply with good corporate governance but should lead to a reduction in audit fees. She has also intimated that the fees being charged by Trump Associates are on the high side.

e) Review whether the new auditing reporting requirements have been properly implemented

i) Kadson Insurance

In January 2015, the International Auditing and Assurance Standards Board (IAASB) issued the final package of new and revised auditor reporting standards whose overall objective is to enhance the value and relevance of the auditor's report. The most significant innovation in the new standards is the introduction of Key Audit Matters (KAM).

The application of ISA 701 is mandatory for the audit of general purpose financial statements of listed entities and may also be applied on a voluntary basis for other audits. The rationale for only requiring the reporting of KAM for listed entities is derived from the material impact that such entities have on markets and economies as a whole.

Accordingly, ZICA has issued a pronouncement that makes it MANDATORY for all auditors of specified entities to report on KAM in the auditor's report on financial statements as required under ISA 701.

The following report was issued and signed on the financial statements of Kadson Insurance for the year ended 31March 2017. Apart from holding assets in a fiduciary capacity, Kadson Insurance is also classified as a public interest entity.

The financial statements of Kadson Insurance for the year ended 31st March 2017 recognise profit before tax of K46 million (2015: K490 million) and total assets of K475 million (2015: K461 million). An extract from the audit report is shown below. The financial statements also include a provision of K3 million representing general risks facing the company. Additionally, Kadson Insurance adopted IFRS 15, *Revenue from contracts with customers* for the first time this year

Basis for qualified opinion
As more fully explained in the note to the financial statements, an amount of K3 million has been included in "Provisions" in respect of general risks facing the company. The directors consider that such a provision is prudent in the light of the changing economic and social factors in Zambia and globally. We believe that this provision does not meet the requirement of

International Reporting Standards. Accordingly, the profit for the year is understated by K3 million and the provisions are overstated by the same amount.

Key Audit Matters
We do not consider that there are any key audit matters that need to be communicated in our report.

Opinion
In our opinion, because of the effects of the matters discussed above, the financial statements do not give a true and fair view of the financial position of the Group as at 31st March 2017, and its financial performance and its cash flows for the year then ended.

Trump Associates

Signed
Hsgiwuwt **------ 15 April 2017**

ii) Industrial Equipment Ltd (IEL)

During the year, one of your other clients Industrial Equipment Ltd (IEL) suffered severe strain in its operations due to the emergence of cheaper equipment from China. Examination of correspondence with clients after the year end suggest that 75% of the customers would not renew their contracts with IEL in 2018. It is estimated that these contracts contribute more than 60% of the IEL's revenue.

IEL's Finance Director – Moses Mumba maintains that the company will still continue in operational existence for the foreseeable future.

REQUIREMENTS

1) **Comment on the policies and procedures adopted by Trump Associates AND recommend appropriate changes that should be made to fully comply with ISQC 1.**
   a) Leadership responsibilities for quality control (4 marks)
   b) Human resources (6 marks)
   c) Engagement performance (4 marks)
   d) Monitoring (4 marks)

2) With regard to the acceptance to become external auditors of Bwino Millers (BM)

a) Evaluate the ethical and other professional issues that should have been considered.

(6 marks)

b) Recommend safeguards that should have been applied in accepting to become external auditors of BM.

(12 marks)

3) With regard to the internal audit at BM

a) Comment on the acceptability of internal auditors at BM being involved in pre-audit work .

(4 marks)

b) Evaluate to what extent Trump Associates can rely on the work of internal audit at BM.

(8 marks)

4) With regard to maintaining objectivity on long-standing clients

a) Explain the ethical threats created by a long association with clients such as Kadson insurance and state the ZICA position on compulsory rotation of auditors. (6 marks)

b) Evaluate the advantages of compulsory rotation. (4 marks)

c) Evaluate the disadvantages of compulsory rotation. (5 marks)

5) With regard to reporting on Kadson Insurance

a) Explain why ZICA considers that the concept of Key Audit Mattes (KAM) is important. (4 marks)

b) The concept of KAM is mandatory to Public Interest Entities (PIE). Provide THREE examples of entities that may be included in this category. (6 marks)

c) Critically appraise the report issued on Kadson Insurance for the year ended 31st March 2017.

(15 marks)

6) Based on the information relating to IEL LTD

a) State the procedures you should carry out and the action you should take to conclude whether IEL LTD will continue in operational existence for the foreseeable future.

(8 marks)

b) Assuming that IEL LTD is a going concern but a significant doubt exists, comment on the reporting implications.

(4 marks)