COMPETENCE PRACTICE EXAMINATION (CPE)

FULL AUDIT

QUESTION ONE

Muchinga Associates

Muchinga Associates, a successful audit firm, which commenced operations in 2007, is a firm registered with the Zambia Institute of Chartered Accountants (ZiCA). The firm provides both assurance and non-assurance services.

You are Abraham Chinsali, an Audit Manager in Muchinga Associates and you are currently responsible for the audit of the financial statements for five (5) companies. The audits are at various stages of the audit process.

Mongu Plc

You are now planning the audit of the financial statements for Mongu Plc for the year ended 31 March 2020. Following the initial meeting with the directors of Mongu Plc, you have obtained the following information:

(1) The members of the Audit Committee suspect that the Audit Supervisor is having an intimate relationship with the Finance Manager.

(2) The Engagement Partner wrote a note to the Finance Director assuring him that the audit will be performed properly and thanked him for role he played in ensuring that Muchinga Associates was appointed as auditor for Mongu Plc.

(3) The directors of Mongu Plc want Muchinga Associates to continue handling all tax matters for the company.

(4) The Government holds 52% of the ordinary shares of Mongu Plc. The Chairperson of the Board of Directors is one of the major donors to the ruling party.

(5) Last year's audit opinion was modified and the Finance Director of Mongu Plc has requested Muchinga Associates to review the opinion.

(6) The tax authorities are currently carrying out a tax audit.

(7) Following an audit recently carried out by the Office of the Auditor-General (OAG), Government has instructed Mongu Plc to prepare a strategic plan for the next five (5) years which should address the criticisms identified by the audit. The Board of Directors has requested Muchinga Associates to assist in defining corporate strategies.

(8) The Audit Committee has permitted Muchinga Associates to commence the audit process while negotiations involving the audit fee is still ongoing. No major disputes are expected. The Engagement Partner has confided in you that he is finding it difficult to determine how long this audit will take and does not want to make a loss on this engagement.

<u>Kasama Ltd</u>

You have just received the following email from Luke Hanjamba, the Engagement Partner responsible for the financial statements audit of Kasama Ltd for the year ended 31 December 2019.

To: Abraham Chinsali, Audit Manager

From: Luke Hanjamba, Engagement Partner

Date: 14 January 2020

Subject: Kasama Ltd Audit planning

Abraham

We were appointed to audit Kasama Ltd last month and you have been assigned as Audit Manager to this audit. I recently held a meeting with the Finance Director of Kasama Ltd. I would like you to prepare a memorandum for me setting out the business risks and an explanation of the relationship between business risks and audit risks as they relate to Kasama Ltd.

The details in the memorandum will form the basis of our discussion with the rest of the engagement team members. I have attached notes from the meeting to this email which you should use when preparing the memorandum.

Kindly have this memorandum ready for me as soon as possible.

Regards

Luke Hanjamba

Attachment

Kasama Ltd manufactures a variety of beer and soft drinks which are sold through retailers, mainly in the Zambian market. The economic pressures being experienced in the country have meant that imported raw materials have become expensive. The company does not hedge its foreign exchange rate exposure.

Kasama Ltd has introduced enhanced credit facilities and invested heavily by building its own shops across the country in order to maintain the profit margins. This has been financed by a secured K400 million 13% loan repayable within two (2) years.

The Board of Directors is currently considering the replacement of the entire IT system which was installed eight (8) years ago. The new IT system will significantly contribute to improved quality of the products. The market for beer and soft drinks is very competitive and retailers do not show much loyalty to their suppliers. The main competitor replaced its IT system last year and a number of customers have switched their business.

A preliminary assessment shows that Kasama Ltd has strong internal controls. Muchinga Associates has been providing non audit services to Kasama Ltd for five (5) years. The Managing

Director and Finance Director are satisfied with the level of professionalism and commitment. They have also requested Muchinga Associates to assist them in sourcing additional long term debt which the company urgently needs.

Choma Plc

Muchinga Associates has been auditing Choma Plc for the past two (2) years. Choma Plc is an agricultural company which exports its produce to Europe. Most of the inputs and equipment are imported and the company uses matching as means of hedging its foreign currency exposure. Transactions are on credit, although a number of customers prefer paying in advance.

The Audit Manager previously assigned to the audit of Choma Plc has been moved to another urgent assignment and you have brought in to assist. You have obtained the draft financial statements for the year ended 31 March 2020.

FINANCIAL STATEMENT EXTRACTS FOR THE YEAR ENDED 31 MARCH

	Draft	*Actual*
	2020	*2019*
	Km	Km
Revenue	6,900	5,200
Cost of sales	(4,100)	(3,900)
Gross profit	2,800	1,300
Operating expenses	(1,400)	(1,100)
Profit before interest and taxation	1,400	200
Non-current assets	5,750	4,872
Inventory	1,960	760
Receivables	2,250	990
Cash	3	120
Trade payables	2,850	1,430
Overdraft	1,325	45

Most of the European countries are on lockdown due to the corona virus (COVID 19) pandemic, since the beginning of November 2019. The profits for the months of December 2019 and January 2020 were significantly below budget mainly due to the lockdown. In February 2020, the Board of Directors approved a bonus scheme for management based on profitability. The Engagement Partner wants you to identify and explain the main risks of material misstatement to be taken into account in planning the final audit. He wants you to only focus on the risks which could be attributed to COVID 19 since the other risks were adequately dealt with by the previous Audit Manager.

Kitwe Bank

Kitwe Bank has an effective board which is collectively responsible for promoting the success of the Bank by directing and supervising the Bank's affairs. The Bank has a strict policy on confidentiality which also affects the Bank of Zambia in a few areas. The roles of Chairperson and Chief Executive Officer (CEO) is held by two (2) different people. Board sub-committees are responsible for supervising specific aspects of corporate governance. The Bank has the following Board Committees:

(1) Audit Committee – staffed by non-executive directors, is responsible for liaising with external audit, supervising internal audit and reviewing the annual accounts and internal controls.

(2) Risk Committee – responsible for overseeing the organisation's risk response and management strategies. Management sits on this committee and reports on risks are highly confidential.

(3) Nomination Committee – responsible for recommending the appointments of new directors to the board based on a stringent criteria developed by management.

(4) Remuneration Committee – responsible for advising on non-executive director remuneration policy.

Kitwe Bank has been an audit client for Muchinga Associates for the past twelve (12) years. The Engagement Partner, Francis Mande, has a first class Masters' Degree in Finance and normally advises various companies and individuals on acquisitions and mergers on behalf of Muchinga Associates. On 31 January 2020, immediately after the audit for Kitwe Bank, Francis Mande was asked to speak at a board meeting of Lusaka Bank which was planning a takeover of Kitwe Bank as the latest accounts (for the year ended 31 December 2019) showed very good profits. During the meeting, he said that he "absolutely stood by the results of Kitwe Bank", which he had signed off. In February 2020, the takeover went ahead, but at the beginning of March 2020, Lusaka Bank found that Kitwe Bank was in fact close to insolvency rather than being profitable. It is now considering suing Muchinga Associates for negligence.

Mukushi Plc

The audit of the financial statements for Mukushi Plc for the year ended 31 March 2020 is nearing completion. The remaining audit work only relates to:

(1) Value in use – the auditor responsible for this area has obtained management's calculations and a written representation to confirm the reasonableness of the assumptions used. The value in use was used in the computation of the impairment loss for general machinery. However, he is unable to proceed further and the Audit Senior is out attending a very important two (2) day specialized training organized by ZiCA.

(2) Going-concern – management has provided a forecast for nine (9) months to 31 December 2020. No work has been performed by the audit team.

Management of Mukushi Plc is also considering the publication of an integrated report in the interim report for the six months ended 30 September 2020. They want Muchinga Associates to evaluate the key factors that may affect the successful introduction of Integrated Reporting (IR) so that they get it right first time.

Section A

Required:

(1) Using the information regarding Mongu Plc:
   (a) Identify and evaluate six (6) ethical threats and other professional issues raised in respect of the audit of Mongu Plc. (15 marks)
   (b) Recommend what action, if any, Muchinga Associates should take in respect of the ethical threats and other professional issues in the audit of Mongu Plc. (6 marks)

(2) Using the information provided in respect of Kasama Ltd, prepare a memorandum clearly:
   (a) Explaining seven (7) business risks; and (14 marks)
   (b) Discussing the relationship between business risk and audit risk, giving three (3) examples. (7 marks)

(3) Describe four (4) potential risks of material misstatement in respect of the financial statements for Choma Plc for the year ended 31 March 2020, which could mainly be attributed to the corona virus (COVID 19) pandemic. (8 marks)

(Sub-total: 50 marks)

Section B

Required:

(4) Using the information in respect of Kitwe Bank:
   (a) Identify and explain six (6) corporate governance deficiencies. (9 marks)
   (b) Recommend actions to be taken regarding the deficiencies identified in (a) above. (6 marks)

(5) Advise the Engagement Partner as to whether or not Muchinga Associates would be liable for a claim of professional negligible if Lusaka Bank sued the firm. (11 marks)

(6) Using the information in respect of Mukushi Plc:
   (a) Evaluate the key factors that may affect the successful introduction of Integrated Reporting (IR). (8 marks)
   (b) Explain four (4) further audit procedures to be performed in respect of the value in use. (8 marks)
   (c) Explain three (3) further audit procedures to be performed in respect of the going concern status of Mukushi Plc. (8 marks)

(Sub-total: 50 marks)
[Total: 100 MARKS]

QUESTION TWO

Nawa Chartered Accountants

Nawa Chartered Accountants is a medium-sized audit firm which was established in 2015 by Charles Nawa with his wife, Sophie Mudenda Nawa. Both are qualified accountants and have praticising certificates issued by ZiCA.

Sophie Mudenda Nawa is concerned about the lack of reliable information about the firm's operations and performance. She believes that the success of the firm has been built on a reputation for reliable service and strong brand recognition, although they have no firm evidence to support this opinion. The recent review carried out by the staff from the ZiCA Practice Review department identified a number of deficiencies regarding three (3) audits which were performed during the last quarter of 2019. The findings included the following:

(1) The firm's policies and procedures on quality have been graded as "Poor", which is the lowest possible rating.

(2) Know Your Client (KYC) procedures are non-existent.

(3) Reviews of audit working papers are weak, and in one of the audits there were discrepancies in a number of areas between the actual findings and the conclusions reached.

(4) In another audit, the staff from the ZiCA Practice Review department were surprised to discover that an audit report was issued without any audit evidence.

(5) The firm has an abnormally high level of staff turnover and the staff from the ZiCA Practice Review department discovered that most of the audit staff who performed the three (3) audits had left.

Charles Nawa feels it is no longer fun at Nawa Chartered Accountants anymore. He remembers that when the firm was established there fewer staff and the only Audit Manager could dive in and solve most of the problems. The firm now has three (3) additional Audit Managers and employs more than twelve (12) audit staff at lower levels. He is wondering what they all do.

You were recently employed as a Senior Manager in Nawa Chartered Accountants. Charles Nawa wants you to mainly be responsible for practice management issues and handle only a few audits. You previously worked for a competing firm for over eight (8) years. You are aware of significant differences between Nawa Chartered Accountants and the competing firm where you worked before.

The competing firm's clients are very demanding and are willing to pay a premium fee. However, despite wanting high quality, most of the clients for Nawa Chartered Accountants are often reluctant to pay high fees and negotiate with Audit Managers to obtain the best deal they can get.

Although Charles Nawa is disappointed at the level of the ZiCA Practice Review department's criticism, he has requested you to investigate the various issues raised and suggest possible solutions. Sophie Mudenda Nawa is proceeding on maternity leave and has requested you to handle the assignments for Vinny Ltd, Bupe Givers (a faith based Public Benefit Organisation – PBO), Bibi Ltd (a State Owned Enterprise) and Pinkie Ltd.

Vinny Ltd

The audit of Vinny Ltd for the year ended 31 March 2020 is almost complete. Vinny Ltd manufactures and sells various electrical equipment. The draft financial statements for the year ended 31 March 2020 show profit before taxation of K8 million (2019 – K5 million) and total assets of K49 million (2019 – K45 million). Charles Nawa is expected to meet the Audit Committee next week to discuss any outstanding issues. The Audit Senior has brought the following issues to your attention:

(1) Vinny Ltd had the following three loans in place throughout the year ended 31 March 2020:

	K' million
12% Loan notes	6
15% Bank loan	3
7% Preferential loan	9

On 1 May 2019, K6 million was drawn for the construction of an extension to the factory which was completed on 28 February 2020.

The company has capitalized borrowing costs amounting to K1.5 million but the Audit Senior thinks only K0.5 million should be capitalized.

(2) Vinny Ltd's revenue as shown in its draft statement of profit or loss for the year ended 31 March 2020 is K60 million. This includes K5 million for a consignment of industrial electrical motors sold on 31 March 2020 on which Vinny Ltd will incur ongoing service and support costs for three (3) years after the sale.

The supply of the industrial electrical motors and the provision of service and support are separate performance obligations under the terms of IFRS 15 *Revenue from Contracts with Customers.* The cost of providing service and support is estimated at K0.25 million per annum. Vinny Ltd applies a 25% margin to all service and support costs.

Management wants to reduce the revenue recognized in the draft statement of profit or loss by K0.9375 million to account for the cost of providing service and support. The Audit Senior does not know whether this accounting treatment and the amount is correct.

(3) On 16 March 2020, Vinny Ltd's Internal Audit department discovered a fraud committed by the company's Cashier, who fled to an unknown foreign country. The outcome of the fraud is K0.12 million of the company's trade receivables have been stolen by the Cashier and are not recoverable. The whole amount relates to the year ended 31 March 2019. Vinny Ltd has not insured against this fraud and has therefore included this amount under the administration costs. The Audit Senior believes this treatment is correct.

(4) At 31 March 2020, Vinny Ltd had 900 units of small welding Machines in inventory, included at a cost of K600 per unit. On 20 April 2020, the units were all sold to a government ministry for

K400 per unit, with the staff who got the business receiving a 2% commission on the normal price of the small welding machine. The profit markup on the small welding machines is 20%.

The Audit Senior has advised management to value the inventory using Net Realizable Value (NRV) but they have refused.

Charles Nawa has also requested you to carry out an analytical review. You have requested the Audit Senior to provide you with information but he wants you to clearly specify the information needed.

Bupe Givers (a faith based Public Benefit Organisation – PBO)

Bupe Givers was established in 1990 to offer scholarships to refugees who want to pursue the CA Zambia programme. It receives significant support from the Government of the Republic of Zambia and foreign donors.

Bupe Givers has funds which it is proposing to use to acquire a computerized database system for beneficiaries in order to improve transparency and accountability which the Government and foreign donors are demanding. Prior to a decision to implement the proposal, Management of Bupe Givers has decided that it should carry out a value for money (VFM) audit. You have been given the task of preparing a report to the Management of Bupe Givers that analyses VFM audit for the acquisition of a computerized database system for beneficiaries.

Nawa Chartered Accountants offers both assurance and non-assurance services to Bupe Givers.

Bibi Ltd (a State Owned Enterprise)

Bibi Ltd was formed by an Act of Parliament in the Republic of Zambia, on 6 May 2003. The company commenced operations on 2 September 2003 and offers technical services to the Mining, Health and Agriculture sectors.

After experiencing a number of years of growth and profitability, the company is likely to report a loss this year. An initial investigation into this has revealed that overhead costs have risen greatly and consequently margins have been eroded in recently completed assignments. Many attribute this to a significant decrease of orders from key stakeholders especially government institutions. The parliamentary committee on state owned enterprises (SOEs) has recommended that all loss making SOEs must undergone serious restructuring especially at senior management levels.

The Managing Director has said that senior management is demotivated. Senior managers are all highly qualified in their field but feel not appreciated by the company. One of senior managers told the Managing Director in confidence that the increased overhead costs could be due to fraudulent activities mainly involving inflated claims for overtime. The excess overtime is shared and some senior managers are involved. A recent internal audit report confirmed the existence of various fraudulent activities including the inflated claims for overtime. The external auditors have assessed the control environment as poor.

The Finance Director of Bibi Ltd has recently had to address the Audit Committee about the findings of the internal audit and the assessment of the control environment by external auditors as poor. He confirmed that the findings were true and attributed this to understaffing in the accounts department as a main cause. The company is unable to attract qualified accountants due to uncompetitive conditions of service. However, the Audit Committee still feels the deficiencies can be addressed with the existing staff and has given the Finance Director three (3) months in which to clean up the mess.

Pinkie Ltd

Pinkie Ltd is involved in the supply of computer accessories. The audit field work was completed last week and the Engagement Partner has requested you to review the draft audit report prepared by the newly promoted Audit Supervisor. The draft financial statements for the year ended 31 December 2019 show a profit before tax of K1.5 million and total assets of K21 million.

An extract from the draft audit report is shown below:

Basis of opinion

We conducted our audit in accordance with auditing standards. Our objectives are to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatements, whether due to fraud or error, and to issue an auditor's report that includes our opinion. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our opinion.

Opinion

We have audited the financial statements of Pinkie Ltd for the year ended 31 December 2019. In our opinion, the accompanying financial statements give the true and fair view.

Other Matters paragraph

The general description of the business environment and outlook in the Chairman's Statement to be published with the financial statements is not in line with the official projections given by reputable organistations, including the Central Bank.

You have also read the following notes from the current audit file:

(1) Current liabilities that total K2 million include a suspense account amounting to K50,000. Management has stated that investigations will be conducted in the first quarter of the year 2020.

(2) The depreciation figure of K3 million includes K475,000 which has been valued based on the directors' estimate. This is due to the loss of invoices relating to the assets in question. The audit team has consulted experts and are satisfied that the estimate is reasonable.

(3) The directors have requested Nawa Chartered Accountants not to include a "Key Audit Matters paragraph".

The newly promoted Auditor Supervisor has requested you to explain whether or not the inclusion of the "Other Matters paragraph" is a modification.

Section A

Required:

(1) Evaluate the deficiencies identified by the staff of the ZiCA Practice Review department and recommend possible solutions. (18 marks)

(2) Using the specific information provided in respect of Vinny Ltd:

(a) Explain the information that you would require in order to perform analytical procedures during the review stage of the audit. (6 marks)

(b) Comment on the matters that you should consider; and (22 marks)

(c) State the audit evidence that you should expect to find, in undertaking your review of the audit working papers and financial statements of the company for the year ended 31 March 2020. (4 marks)

(Total: 50 marks)

Section B

Required:

(3) Prepare a report for the Management of Bupe Givers that analyses VFM audit for the acquisition of the computerized database system for the beneficiaries. (10 marks)

(4) Using the information in respect of Bibi Ltd:

(a) Explain five (5) fraud risk factors which exist in Bibi Ltd. (10 marks)

(b) Advise the Management of Bibi Ltd on the actions which can be taken to address the fraud risk factors in (a) above. (5 marks)

(c) Discuss your responsibility as auditors of Bibi Ltd regarding detection of fraud. (5 marks)

(5) Using the specific information provided in respect of Pinkie Ltd:

(a) Explain whether or not the inclusion of the "Other Matters paragraph" is a modification. (5 marks)

(b) Critically appraise the draft audit report for Pinkie Ltd and ensure you take into account the information obtained from the current audit file.

N.B. You are not required to re-draft the extracts from the auditor's report. (15 marks)

(Sub-total: 50 marks)

[Total: 100 MARKS]

END OF PAPER

COMPETENCE PRACTICE EXAMINATION (CPE)

FULL AUDIT

SOLUTION ONE

SECTION A

(1) (a) & (b) Ethical and other professional issues, and recommendations

Ethical and other professional issues	Evaluations	Recommended actions
Familiarity, self-interest and intimidation threats – Audit Supervisor suspected of having an intimate relationship with Finance Manager.	It is possible that the suspicion may not be true. However, the IESBA code requires auditors to be independent in both mind and appearance. The suspicion could adversely affect independence in appearance and audit work performed by the Audit Supervisor may lack the required professional credibility. If it is true, even independent in mind could be affected adversely. The Audit Supervisor would want to protect his interest and avoid upsetting the Finance Manager. The Finance Manager could also use this relationship to demand favourable conclusions.	Whether it is true or false, the Audit Supervisor should be replaced in order to maintain independence in both mind and appearance.
The integrity of the Engagement Partner – note written to assure the Finance Director and thank him.	The contents of the note could be misunderstood especially that a listed company is involved. It is mainly the integrity of the Engagement Partner which gives weight to the audit opinion. His objectivity is likely to be questionable, especially if the note was to become public knowledge.	The Engagement Partner should be replaced and Muchinga Associates must ensure a second partner review is performed before issuing the final audit report.
Self-review, self-interest and intimidation threats – continue handling all tax matters.	It is possible for Muchinga Associates to end up receiving more than 15% of its total fees from Mongu Plc; and therefore could become	Muchinga Associates should not handle tax matters for Mongu Plc.

	more dependent on on Mongu Plc. Muchinga Associates may not want to lose such a client and could want to impress them at all costs. Mongu Plc could also take advantage of this position and demand favourable conclusions and opinions. It is extremely wrong for auditors of listed companies to perform non-audit services for their audit clients. It is possible that they may not exercise the required professional scepticism especially on tax matters since they will be reviewing their own work.	
Intimidation threat – the Government holds 52% of the ordinary shares of Mongu Plc and the Chairperson of the Board of Directors is one of the major donors to the ruling party.	Political interference cannot be ruled out especially if the corporate governance structures are generally weak. This increases the reputational risk for Muchinga Associates as there will be more publicity if something goes wrong.	Muchinga Associates should hold serious discussions with the Audit Committee regarding the potential political interference and review the corporate governance structures. The potential reputational risks are too high and if the findings are not favourable, then it will advisable to decline the appointment.
Second opinion/opinion shopping – intimidation threat and self-interest threat – review of last year's modified audit opinion.	It is Mongu Plc's legitimate right to seek second opinions. However, this could result in an intimidation and self-interest threats for Muchinga Associates. Mongu Plc may be looking for an opinion which supports their position and may not be happy if Muchinga Associates acted otherwise. The directors could threaten Muchinga Associates with removal and the firm may not want to be removed from such a lucrative engagement. Independence and objectivity could be highly compromised.	Muchinga Associates should not give an opinion until the present auditors have been informed. This is not only a matter of courtesy but may also reveal other aspects to the modification which was not forthcoming from Mongu Plc.

Potential non-compliance with tax laws and regulations – integrity and possible money laundering – current tax audit being carried out.	A tax audit does not necessarily mean there is wrongdoing by Mongu Plc. However, it could reveal widespread non-compliance. This may cast significant doubt on the integrity of management and Muchinga Associates since the firm has been handling the tax matters. Both could be accused of practising money laundering, which is a serious criminal offence.	Muchinga Associates must take a keen interest in the tax audit and request management to keep the firm updated on a regularly basis. If significant irregularities are discovered or the tax authorities change the tax audit into a tax investigation, then Muchinga Associates should seek legal advice and seriously consider resigning as auditors.
Self-review threat – assist in defining corporate strategies.	Corporate Strategies are seriously scrutinized by the Board of Directors before being finalized. The self-review threat could therefore be insignificant.	Muchinga Associates may accept this assignment provided safeguards such as using different teams of staff are put in place, and ensuring no management decisions are taken on behalf of Mongu Plc. Mongu Plc should also acknowledge full responsibility for the strategic plan.
Self-interest and intimidation threats – audit fees.	The Engagement Partner is interested in making a profit on this engagement. He may be willing to comprise his objectivity for the sake of achieving this financial objective. Mongu Plc's management and those charged with governance may exploit this to their advantage and demand favourable conclusions and opinions in return for a high audit fee.	The position of the Engagement Partner makes commercial sense but must be handle with care so that ethical behavior is not impaired. The Engagement Partner should quickly estimate an audit fee and possibly arrange with the Audit Committee a margin rise, as it becomes apparent how long the audit will take. Detailed time records should be maintained so that Mongu Plc does not feel cheated.

[Award ½ mark for identifying ethical or professional issue – Maximum 3 marks

Award up to 2 marks for each proper evaluation – Maximum 12 marks

Award up to 1 mark for each recommendation – Maximum 6 marks

Overall maximum – 21 marks]

(2) (a) Business risks

Memorandum

For: Luke Hanjamba, Engagement Partner

By: Abraham Chinsali, Audit Manager

Subject: Kasama Ltd Audit planning

1.0 Introduction

This memorandum sets out the business risks and the relationship between business risks and audit risks as they relate to Kasama Ltd.

2.0 Business risks

The business risks which relate to Kasama Ltd are as follows:

Business risks	Explanations
Economic pressures	These have a direct impact on the disposable income of the populace. It is possible that aggregate demand has reduced and Kasama Ltd is experiencing reduced profitability. This is a serious financial risk.
Expensive imported raw materials	Kasama Ltd may be struggling to import the raw materials and eventually may fail to pay its suppliers. This is a serious operational risk.
Heavy investment in building own shops	This could be misplaced priorities amidst economic pressures, putting unnecessary pressure on cash flow. The investment could prove to be a "white elephant" or simply a waste of limited resources. This is a serious financial risk.
Overtrading	Kasama Ltd could be overtrading. The company may not have the capacity to sustain the enhanced credit facilities and this will have serious financial implications and eventually negatively impact on the going concern of the company.
High Gearing	Kasama Ltd is relying too much on debt finance. High gearing could negatively impact on the going concern status of the company. It presents serious compliance and financial risks. In addition, in the event of default, the pledged assets could be seized and the operations could be adversely affected. The company has requested Muchinga Associates

	to assist in sourcing additional long term debt which the company urgently needs. This may be an indication of the extent of the problem.
Outdated IT systems	Customers are switching business due to poor product quality and possibly sub-standard customer relationship management. This has both serious operational and financial implications.
Quality of products	There could also be other serious causes of poor product quality apart from the outdated IT systems. The company may not have appropriately qualified and creative employees in the production department.
Competition	The market for beer and soft drinks is very competitive and retailers do not show much loyalty to their suppliers. If the company does not develop appropriate strategies to have a competitive advantage it may not survive.
Currency risk	Currency risk is a reality in Kasama Ltd especially that the company does not hedge its foreign exchange rate exposure. Foreign exchange losses have a direct negative impact on cash flows and represents a serious financial risk.

[Award ½ mark for each business risk identified – Maximum 3 ½ marks

Award up to 1 ½ marks for valid explanations – Maximum 10 ½ marks

Overall maximum – 14 marks]

3.0 Relationship between business risk and audit risk

Business risk is the risk inherent to the company in its operations, while audit risk is the risk that the auditor expresses an inappropriate audit opinion when the financial statements are materially misstated.

The strong links between them can be seen in the inherent and control aspects of audit risk. For example, in the case of Kasama Ltd:

- The significant trade receivables may have the business risk that cash is not recovered from receivables, and the audit risk that trade receivables are overstated.
- The strong internal controls put in place by management and those charged with governance is generally in response to business risks identified. This reduces the control risk which is part of audit risk.

- If the business risks materialize, the going concern basis of the financial statements could be affected.

[Award 1 mark for business risk

Award 1 mark for audit risk

Award 1 mark for each valid example on relationship/link – Maximum 3 marks

Overall maximum – 5 marks]

4.0 Conclusion

Kasama Ltd has a number of business risks which could impact on the going concern status of the company if they were to crystallize. The engagement team members should be alert to indicators of possible going concern problems.

Signed

Abraham Chinsali

[Award up to 2 marks for presentation]

(3) Potential risks of material misstatement

The potential risks of material misstatement mainly attributed to the corona virus (COVID 19) pandemic include the following:

- Revenue recognition – the COVID 19 pandemic has negatively affected revenues of businesses. There is a risk of material misstatement that the advance payments is recognized immediately leading to an overstatement of revenue and an understatement of liabilities. There is an impressive increase in the revenue for Choma Plc of 33% which seems illogical given the circumstances. It is possible that the recognition criteria recommended under IFRS15 *Revenue from Contracts with Customers* have been ignored in order to boost profitability and earn the promised bonuses.
- Cost of sales – there is a risk of material misstatement that the cost of sales may be grossly understatement. The increase of only 5% does not appear correct especially if the increase in revenue of 33% is correct. This could have also been used to boost profitability.
- Non-current assets – there is a risk of material misstatement that both non-current assets and profits are overstated. The impact of COVID 19 could be an indicator of impairment of non-current assets which Choma Plc seems not to have taken into account given the

18% increase in the value of non-current assets. The provisions of IAS 36 *Impairment of Assets* could have been ignored.

- Inventory – there is a risk of misstatement that both inventory and profits are overstated. Agricultural products are generally perishables. There is a possibility that the inventory figure also includes items which cannot be sold or can only be sold below cost. IAS 2 *Inventories* guidelines to value inventories at the lower of cost and net realizable value (NRV) could have been ignored given an increase of 158%.
- Receivables – it is possible that COVID 19 could result in significant irrecoverable debts. There is a risk of material misstatement that the allowance for receivables is understated given the increase in the value of receivables by 127%.
- Going concern – the increased overdraft could be an indication that Choma Plc is experiencing cash flow problems due to the negative impact of COVID 19. There is a risk that the financial statements could be incorrectly prepared on a going concern basis.

[Award up to 2 marks for each valid risk of material misstatement – Maximum 8 marks]

SECTION B

(4) (a) & (b) Deficiencies in corporate governance in Kitwe Bank

Deficiencies	**Explanations**	**Recommendations based on Bank of Zambia Corporate Governance Directives**
Directors appointment	Appointments of new directors to the board is based on a stringent criteria developed by management. The criteria developed by management may not be in line with recommended best practice since this is a potential source of conflict of interest.	Directors should be appointed through a formal, rigorous and transparent process. This criteria should be developed by the board of directors and approved by the shareholders.
Management sitting on board committees	Management sits on the risk committee. This may compromise the independence of the committee and limit the extent of the deliberations.	Kitwe Bank must have an effective and independent risk management function, which shall have sufficient stature, independence, resources and access to the board of directors or the risk committee of the board. Committees should be made up of non-executive directors. Management shall not be included on those

		committees but may be invited to provide input on any matter that is of interest to the board.
Compensation for directors	The remuneration committee advises on non-executive director remuneration policy. There is a major weakness in that the executive directors who are generally accused of obtaining unjustified compensation are not covered.	The main focus should be on executive directors not non-executive directors. Kitwe Bank's compensation of directors, executives and staff should be transparent, fair and reasonable and should not encourage risky behavior.
Relationship with the Bank of Zambia	Kitwe Bank has a strict policy on confidentiality which also affects the Bank of Zambia in a few areas. It is possible that the Bank could be hiding important information from an important regulatory institution which generally acts in public interest.	The Board shall maintain an open and transparent relationship with the Bank of Zambia which promotes mutual trust and confidence. The policy should be revised as a matter of urgency.
Risk management	Reports on risks are highly confidential. This makes implementation of the recommendations problematic.	An effective risk governance framework requires robust communication within the bank about risk, both across the organisation and through reporting to the board and senior management. Kitwe Bank must make the reports available to all relevant staff to facilitate implementation.
External audit	Kitwe Bank has been an audit client for Muchinga Associates for the past twelve (12) years. This long association may have an adverse effect on independence and objectivity. Muchinga Associates may fail to exercise the required professional scepticism.	According to the Bank of Zambia Corporate Governance Directives the board shall ensure the quality and independence of the external audit process. The maximum recommended period is 10 years. Kitwe Bank must start the process of replacing Muchinga Associates.

[Award ½ mark for identification of corporate governance deficiency – Maximum 3 marks

Award 1 mark for each valid explanation – Maximum 6 marks

Award 1 mark for each recommendation – Maximum 6 marks

Overall marks – 15 marks]

(5) Professional negligence

To succeed in an action for negligence, Lusaka Bank must prove three (3) things:

- Muchinga Associates owed them a **duty of care**
- It **breached** that duty of care
- As a natural consequence of the breach, Lusaka Bank **suffered loss**.

Duty of care

In the case of Caparo Industries Plc V Dickman and others (1990), it was decided that auditors owe a duty of care to the shareholders of a company in respect of their audit work. This duty does not extend to the world at large or to shareholders increasing their stakes in the company.

This strictly means that Lusaka Bank is not owed any duty in respect of its reliance on the accounts for making its investment decision. However, Lusaka Bank could argue that a 'special relationship' had been established. Firstly, since Muchinga Associates provided information in the knowledge that Lusaka Bank was contemplating an investment and secondly, that Lusaka Bank would rely on the information provided by the senior partner when deciding whether or not to proceed.

Similar facts occurred in ADT Ltd V BDO Binder Hamlyn (1995). In this case, similar comments were made by an Audit Partner in respect of a proposed takeover. The court decided that the auditors assumed responsibility for comments made and held that a duty was owed.

It is therefore likely that Lusaka Bank is owed a duty of care by Muchinga Associates.

Breach of duty

Where auditors provide information that is to be used in important business transactions, a higher standard of care is required, NRG V Bacon and Woodrow and Ernst and Young (1996). On the facts of the case it is likely that Muchinga Associates will be found to have breached this duty as they did not carry out any extra work to support the advice given by the firm's person.

Suffered loss

It is clear that the negligent advice caused the loss to Lusaka Bank – had they been advised that the figures were inaccurate then it is unlikely that the takeover would have gone ahead.

Conclusion

On the facts of the case and that of ADT Ltd V BDO Binder Hamlyn (1995), it is likely that Lusaka Bank could recover damages from Muchinga Associates for the loss they suffered.

[Award 1 mark for each valid point on duty of care – Maximum 4 marks

Award 1 mark for each valid point on breach of duty – Maximum 3 marks

Award 1 mark for each valid point on loss – Maximum 2 marks

Award 2 marks for valid conclusion

Overall maximum – 11 marks]

(6) (a) Key factors

The key factors that may affect the successful introduction of integrated Reporting (IR) include:

- IT costs – the introduction of IR will most likely require significant upgrades to be made to Mukushi Plc's IT and information system infrastructure. Such developments will be needed to capture Key Performance Indicators (KPIs) data. Due to the broad range of business activities reported on using IR (customer, supplier relations, finance and human resources), it is highly likely that the costs of improving the infrastructure will be significant.
- Time/staff costs – the process of gathering and collating the data for inclusion in the report is likely to require a significant amount of staff time. This may affect staff morale if they are expected to undertake this work in addition to existing duties. Additional staff may need to be employed.
- Consultancy costs – organisations producing their first integrated report may seek external guidance from an organisation which provides specialist consultancy on IR. Consultancy fees are likely to be significant.
- Disclosure – there is a danger that Mukushi Plc may volunteer more information about their operational performance than intended. Disclosure of planned strategies and key performance measures are likely to be picked up by competitors.

[Award 2 marks for each valid point on implications – Maximum 8 marks]

(6) (b) Further audit procedures on value in use

- Reperform calculation to ensure that it is mathematically correct.
- Compare the cash flow projections to recent budgets and projections approved by the board to ensure that they are realistic.
- Compare to previous calculations of value in use to ensure that all relevant costs of maintaining the asset have been included.
- Compare discount rate used to published market rates to ensure that it correctly reflects the return expected by the market.

[Award 2 marks for each valid procedure – Maximum 8 marks]

(6) (c) Further audit procedures on going concern

- Request management to extend its assessment period to at least 12 months.
- If management extends the assessment period to at least 12 months, consider whether management's assessment includes all relevant information of which the auditor is aware as a result of the audit.
- Inquire of management as to its knowledge of events or conditions beyond the period of management's assessment that may cast significant doubt on the entity's ability to continue as a going concern.
- Ensure disclosures are adequate.
- If management refuses to extend its assessment period to at least 12 months, the auditors may modify the opinion either by issuing a qualified opinion or a disclaimer of opinion.

[Award 2 marks for each valid procedure – Maximum 8 marks]

SOLUTION TWO

SECTION A

(1) Evaluation of deficiencies and recommendations

Deficiencies	**Evaluations**	**Recommendations**
The firm's policies and procedures on quality have been graded as "Poor", which is the lowest possible rating.	The grading should be a major concern to the partners and senior management. ISQC 1 *Quality Control for Firms that perform audits and reviews of financial statements, and other assurance and related services engagements* requires firms to take quality issues seriously and implement policies and procedures such that the internal culture of the firm is one where quality is considered essential. This absent in Nawa Chartered Accountants. If this continues, disciplinary action could be taken by ZiCA against the firm.	Nawa Chartered Accountants must immediately appoint an individual who has: • Sufficient and appropriate experience • The ability to carry out the job • The necessary authority to carry out the job. The employment of a Senior Manager may not satisfy this requirement.
Know Your Client (KYC) procedures are non-existent.	KYC is an important part of being in a position to comply with the law on money laundering, because knowledge of the client is at the bottom of "suspicion" in the context of making reports about money laundering. It is important from the outset of a relationship with a new	Nawa Chartered Accountants must immediately engage an expert to assist them develop, train and implement KYC procedures. ZiCA can assist the firm in this regard. In the long term, Nawa Chartered Accountants should appoint a "Money Laundering Reporting Officer (MLRO)".

	client to obtain KYC information, such as: • Expected patterns of business • The business model of the client • The source of the client's funds It is important that Nawa Chartered Accountants observes all laws and regulations as required by the ethical guidelines.	
Reviews of audit working papers are weak, and in one of the audits there were discrepancies in a number of areas between the actual findings and the conclusions reached.	ISA 220 *Quality Control for an audit of financial statements* emphasizes the aspect or reviews on specific audit engagements. The Audit Manager normally carries out more details reviews while the Engagement Partner reviews critical areas of judgement, significant risks and other important matters. The finding may border on incompetence or negligence on the people responsible in Nawa Chartered Accountants. Reviews include: • The work has been performed in accordance with professional standards and regulatory and legal requirements • The work performed supports the conclusions reached and is appropriately documented • The objectives of the engagement procedures have been achieved. Weak review greatly contributes to poor quality and Nawa Chartered Accountants could be sued for	Nawa Chartered Accountants should reassess the competence of its staff. An independent person who is appropriately qualified should be used. Appropriate corrective action should be taken thereafter and this could include: • Recruitment of qualified and experienced personnel • Assignment of tasks to properly qualified and experienced staff • Communication of findings to all staff • Organising appropriate training • Disciplinary action, if necessary.

	negligence and/or disciplined by ZiCA.	
In another audit, the staff of the ZiCA Practice Review department were surprised to discover that an audit report was issued without any audit evidence.	This is unacceptable and is against the guidelines issued by ISA 500 *Audit Evidence,* which requires that auditors obtain sufficient appropriate audit evidence on which to base the auditor's opinion. Nawa Chartered accountants risk losing its certification with ZiCA. This can also be taken to mean that Nawa Chartered Accountants may be "selling" audit opinions which is a serious criminal offence. It is also possible that Nawa Chartered Accountants may not have the time to conduct all the engagements they accept.	Nawa Chartered Accountants must investigate this finding and ensure this does not happen again. ZiCA must urgently be informed of the results of the investigation so that they carry out appropriate action. The audit report must be withdrawn. Nawa Chartered accountants must only accept engagements which they can competently undertake and cutting corners must be avoided at all costs.
The firm has an abnormally high level of staff turnover and the staff of the ZiCA Practice Review department discovered that most of the audit staff who performed the three (3) audits had left.	It is likely that the conditions of service in Nawa Chartered Accountants are generally poor. It is even stated that despite wanting high quality, most of the clients for Nawa Chartered Accountants are often reluctant to pay high fees and negotiate with Audit Managers to obtain the best deal they can get. Staff may not be devoting sufficient time on the engagements so that they create time for their private jobs. This is highly unprofessional conduct and should not be encouraged.	Nawa Chartered Accountants must perform detailed reviews of the firms' fees policy and conditions of service so that any shortcomings can be addressed. Staff must be appropriately remunerated to promote excellence in the staff. This will also assist in attracting and retaining people with appropriate skill and experience.
Charles Nawa is disappointed at the level of the ZiCA Practice Review department's criticism.	It is unfortunate that Charles Nawa is demeaning the findings. The findings have serious consequences for partners and the firm as a whole if not handled properly.	It is crucial that Charles Nawa changes his attitude towards the ZICA Practice Review findings. This will significantly benefit the firm and staff.

[Award up to 3 marks for each valid evaluation – Maximum 18 marks]

(2) (a) Information required

The information required in order to perform analytical procedures during the review stage of the audit of the financial statements for Vinny Ltd include:

- Separate detailed information for each product (e.g. industrial electrical motors, welding machines etc.) – This will be necessary because each product will probably have different levels of revenue, profit margins and structures of assets and liabilities, so that analytical procedures performed on the company as a whole would be meaningless.
- Budget information – this will be used in the computation of variances. Unexpected material variances may require further investigation.
- Prior year(s) information – this will be used in trend analysis. This may reveal unusual trends which need further investigation.
- Industry information – this will be used to check whether Vinny Ltd's information is reasonable and can be relied upon.
- Important accounting ratios for prior year(s) – these will be compared with the ratios for the current year. Material inconsistencies will require further investigation.
- Detailed information on one-off transactions (e.g. consignment of industrial electrical motors sold on 31 March 2020 on which Vinny Ltd will incur ongoing service and support costs for three (3) years after the sale) – these will distort the current picture and will therefore be ignored in trend analysis.
- Details of any changes in the accounting policies used, or in estimation techniques – previous year(s)' information will require adjustment if there are changes, otherwise, the comparisons will be meaningless.
- Variations caused by industry or economic factors – consideration of these will contribute to credible comparisons, analysis and conclusions.

[Award 1 mark for each well-explained information – Maximum 6 marks]

(2) (b) & (c) Matters to consider and evidence

Capitalization of borrowing costs

Matters to consider:

- Materiality – the correct figure for borrowing costs to be capitalized is the K0.5 million (Working) computed by the Audit Senior. Hence there is an overstatement of K1 million (K1.5 million – K0.5 million). The misstatement of K1 million is 12.5% of profit before tax (1/8 x 100%) and 2% of total assets (1/49 x 100%). It is therefore material to both the statement of profit or loss and the statement of financial position.

- Risk of misstatement – the profits and the assets are overstated.
- Accounting treatment – According to IAS 23 *Borrowing costs* only borrowing costs which are directly attributable to acquisition/construction/production of a qualifying asset should be capitalized. The K1 million excess capitalized cannot be attributed to the construction of the factory extension and should therefore be expensed.
- Impact on audit report – if an adjustment is not made for this misstatement, the audit opinion will be modified. A qualified audit opinion will be given since the misstatement is material but unlikely to be pervasive.

Evidence

- Loan agreement documents
- A copy of all the calculations made in relation to the interest capitalized
- A schedule showing the breakdown of the value of the factory extension

Workings:

Weighted average capitalization rate:

	%
6/18 x 12%	4
3/18 x 15%	2.5
9/18 x 7%	3.5
Weighted average capitalization rate	10

Interest to be capitalized = K6 million x 10% x 10/12 = K0.5 million.

[Award 1 for each valid matter – Maximum 4 marks

Award ½ mark for each valid evidence – Maximum 1 marks

Award 3 marks for working

Overall maximum – 8 marks]

Adjustment for cost of providing service and support

Matters to consider:

- Materiality – the correct figure for the adjustment for cost of providing service and support is K1 million (Working). Hence there is an understatement of K0.0625 million (K1 million – K0.9375 million). The misstatement of K0.0625 million is 0.1% of revenue (.0625/60 x 100%), 0.8% of profit before tax (0.0625/8 x 100%) and 0.13% of total assets (0.0625/49 x 100%). It is therefore immaterial to both the statement of profit or loss and the statement of financial position.
- Risk of misstatement – the profits are overstated while liabilities are understated.
- Accounting treatment – the accounting treatment is in line with the guidance given in IFRS 15 *Revenue from Contracts with Customers* but the amount is not correct. Management has taken the profit as a markup instead of margin. This contradicts the information given regarding the costs of providing service and support.
- Impact on audit report – if the adjustment is not made for this misstatement, the audit opinion will be unmodified, since it is immaterial.

Evidence

- The agreement regarding ongoing service and support costs for three (3) years after the sale
- Workings for the adjustment
- Invoice for the sale

Workings:

Adjustment for service and support costs = K0.25 million x 3 x 100/75 = K1 million.

[Award 1 for each valid matter – Maximum 4 marks

Award ½ mark for each valid evidence – Maximum 1 marks

Award 1 mark for working

Overall maximum – 6 marks]

Fraud committed by the company's Cashier

Matters to consider:

- Materiality – the fraud involving K0.12 million is 1.5% of profit before tax (0.12/8 x 100%) and 0.2% of total assets. It is immaterial to both the statement of profit or loss and the statement of financial position.
- Risk of misstatement – if the accounting treatment is wrong, then administration costs are overstated and profits understated.
- Accounting treatment – the correct accounting treatment is to adjust the retained earnings brought forward. This in line with recommended accounting treatment under IAS 8 *Accounting policies, changes in accounting estimates and errors.* The whole amount relates to the year ended 31 March 2019.
- Impact on audit report – if the adjustment is not made for this misstatement, the audit opinion will be unmodified, since it is immaterial.

Evidence

- Internal audit report
- Supporting documents e.g. Invoices
- Schedule giving a breakdown of administration costs

[Award 1 for each valid matter – Maximum 4 marks

Award ½ mark for each valid evidence – Maximum 1 marks

Overall maximum – 5 marks]

Inventory

Matters to consider:

- Materiality – there is a misstatement of K0.19296 million (Workings) which is 2.4% of profit before tax (0.19296/8 x 100%) and 0.39% of total assets (0.19296/49 x 100%). This is immaterial to both the statement of profit or loss and statement of financial position.
- Risk of misstatement – the inventories, profits and assets are all overstated.
- Accounting treatment – IAS 2 *Inventories* states that inventories should be valued at lower of cost and net realizable value (NRV). The accounting treatment used by management is wrong.
- Impact on audit report – if the adjustment is not made for this misstatement, the audit opinion will be unmodified, since it is immaterial.

Evidence

- Inventory valuation sheets
- Price lists

- Invoice for the sale
- Workings for the commission

Workings

	K' million
Cost of inventory 900 x 600	0.54
NRV of inventory 900 x 400 – (900 x 600 x 120% x 2%)	0.34704
Overstatement	0.19296

[Award 1 for each valid matter – Maximum 4 marks

Award ½ mark for each valid evidence – Maximum 1 marks

Award 2 marks for workings

Overall maximum – 7 marks]

SECTION B

(3) Report

To: Management – Bupe Givers

From: Senior Manager – Nawa Chartered Accountants

Date: 24 March 2020

Subject: VFM audit for the acquisition of a computerized database system for the beneficiaries

Introduction

The aim of the report is to set out an analysis of a value for money (VFM) audit for the acquisition of a computerized system of the database system for the beneficiaries. This report is solely for the use of the Management of Bupe Givers and should not be relied upon by any third party.

VFM audit

VFM audit examines the 3Es (economy, efficiency and effectiveness) associated with a particular decision. Armed with this information, it will be much easier for the Management of Bupe Givers to make an informed decision on whether to go ahead with the acquisition of a computerized database system. Any potential problems are likely to be uncovered before the acquisition, and the risk of unpleasant surprises afterwards will be minimized.

This is particularly important in public benefit organisations (PBOs) where any misuse of funds immediately brings distrust.

Economy

Examining for economy will involve minimizing the cost of the automation through the lifecycle of the database system, from the point when the database system is acquired all the way through its operation and maintenance. However, this must not be at the expense of quality.

If Bupe Givers lacks appropriate computer technical knowledge and skills to specify the requirements of the computerized database accurately, it may pay for database system functions that it does not actually need.

The information from the VFM audit will also offer a useful tool for negotiating the price.

Efficiency

Examining for efficiency will involve maximizing the utilization of the database system for the given level of beneficiaries. It will be important to ensure that there are no unnecessary processes in the computerized database system. Proper training will be required to ensure the computerized database system is fully utilized by users.

Effectiveness

Examining for effectiveness will involve establishing whether Bupe Givers will met its objective of improving transparency and accountability which the Government and foreign donors are demanding. It will be important to appropriately involve representatives from the Government and foreign donors in the evaluation process before the final decision is made. This will also assist in verifying representations from potential vendors.

Conclusion

Acquisition of a computerized database system can be complex and therefore a VFM audit will provide Management of Bupe Givers with the confidence to make the acquisition decision based on all available facts. The involvement of the representatives from the Government and foreign donors will add to the credibility of the evaluation process and provide the required comfort over transparency and accountability.

[Award 1 mark for introduction

Award 1 mark for each valid point on VFM audit – Maximum 2 marks

Award 1 mark for each valid point on Economy – Maximum 2 marks

Award 1 mark for each valid point on Efficiency – Maximum 2 marks

Award 1 mark for each valid point on Effectiveness – Maximum 2 marks

Award 1 mark for conclusion

Overall maximum – 10 marks]

(4) (a) & (b) Fraud risk factors and corrective actions

Fraud risk factors	**Explanations**	**Corrective actions**
Political pressure	Bibi Ltd is definitely faced with enormous political pressure to directly or indirectly support government activities. This unnecessarily increases costs and put pressure on cash flows. This normally involves overriding any controls and recording fictitious journals.	The board should formally approve a budget for such support and open an account code in the ledgers. A committee should be responsible for any disbursement and a report should be produced on a regular basis.
The parliamentary committee on state owned enterprises (SOEs) has recommended that all loss making SOEs must undergone serious restructuring especially at senior management levels.	Significant decrease of orders and increased costs are threatening the profitability of Bibi Ltd and a loss is expected this year. This could put pressure on management to engage in fraudulent financial reporting to protect their jobs.	The recommended restructuring must be explained clearly in as much detail as possible to senior management. Management must be told that these recommendations are still subject to other approvals.
Senior management is demotivated and they feel not appreciated by the company.	This is not healthy because senior managers may use this to justify their engagement in fraudulent activities, like the reported overtime claims. They will also condone fraudulent behaviour by lower levels which could eventually create an environment not conducive for business. The going concern of Bibi Ltd will become highly questionable.	The board should immediately engage an independent experienced consultant to investigate the causes of the demotivation and give recommendations. Senior managers must be given the freedom to speak to the consultant freely without fear of any reprisals.
Poor control environment.	This encourages and tolerates fraud. It provides opportunities for misappropriation of assets to thrive. In such a poor control environment, the assets for	It may be advised to change the entire senior management and give the company a new lease of life. If this continues, Bibi Ltd may not survive. The internal audit and audit

	Bibi Ltd will be stolen, used for personal purposes and embezzling receipts may be the order of the day.	committee must be strengthened.
Understaffing in the accounts department	This means there is no effective segregation of duties. Hence, providing opportunities for fraudulent activities like paying fictitious suppliers, colluding with suppliers to overpay for goods received or paying for goods that are not delivered.	In the short term, experienced staff should be employed on special conditions while in the long term, all vacant positions in the accounts department must be filled.
Uncompetitive conditions of service.	This creates unnecessary pressures as most of the employees are unable to meet financial obligations. Hence, resorting to fraudulent activities in order to meet their personal financial obligations.	An independent reputable firm or individual should be engaged to review the conditions of service and consider benchmarking against some of the reputable organisations.
The Audit Committee has given the Finance Director three (3) months in which to clean up the mess.	Excessive pressure on the Financial Director may encourage fraudulent financial reporting. This will not be in the interest of business.	A more workable plan must be developed with the participation of all key stakeholders. Unrealistic deadlines or threats must be avoided.

[Award 2 marks for each well explained fraud risk factor – 10 marks

Award 1 mark for each corrective action – Maximum 5 marks

Overall maximum 15 marks]

(4) (c) Auditor's responsibilities

Nawa Chartered Accountants must conduct an audit in accordance with ISA 240 *The Auditor's responsibilities relating to fraud in an audit of financial statements* and are responsible for obtaining reasonable assurance that financial statements taken as a whole are free from material misstatement whether caused by fraud or error.

In order to fulfil this responsibility, Nawa Chartered Accountants is required to identify and assess the risks of material misstatement of the financial statements due to fraud.

They need to obtain sufficient appropriate audit evidence regarding the assessed risks of material misstatement due to fraud, through designing and implementing appropriate responses. In addition, Nawa Chartered Accountants must respond appropriately to fraud or suspected fraud identified during the audit.

When obtaining reasonable assurance, Nawa Chartered Accountants is responsible for maintaining professional scepticism throughout the audit, considering the potential for management override of controls and recognizing the fact that audit procedures which are effective in detecting error may not be effective in detecting fraud.

To ensure that the whole engagement team is aware of the risks and responsibilities for fraud and error, ISAs require that a discussion is held within the team. For members not present at the meeting, the audit engagement partner should determine which matters are to be communicated to them.

[Award 1 mark for each valid point – 5 marks]

(5) (a) Use of "Other Matters paragraph"

The "Other Matters paragraph" is a paragraph included in the auditor's report that refers to a matter other than those presented or disclosed in the financial statements that, in the auditor's judgement, is relevant to users' understanding of the audit, the auditor's responsibilities or the auditor's report.

The "Other Matters paragraph" is a modification of the audit report and not a modification of the audit opinion.

It is a modification of the audit report because the "Other Matters paragraph" is not part of the standard unmodified report given in ISA 700 *Forming an opinion and reporting on Financial Statements.*

ISA 706 *Emphasis of Matter paragraphs and Other Matter paragraphs in the independent auditor's report* addresses additional communication in the auditor's report where the audit opinion remains unaffected.

[Award marks as follows:

1 mark definition of Other Matter paragraph

1 mark modification of audit report

1 mark for not modification of audit opinion

1 mark for reference to ISA 700

1 mark for reference to ISA 706

Maximum – 5 marks]

5 (b) Critical appraisal of the draft audit report for Pinkie Ltd

The format of the report

The format of the report drafted by the newly promoted Audit Supervisor is not in line with ISA 700 (Revised) *Forming an opinion and reporting on Financial Statements.* The "Opinion paragraph" should be placed before the "Basis of opinion paragraph". Readers should find it easy to compare auditors' reports.

Opinion paragraph

The contents of the "Opinion paragraph" are not in line with the recommended contents by ISA 700 (Revised). The paragraph does not mention the components of the financial statements and compliance with International Financial Reporting Standards (IFRS). In addition, the opinion paragraph states "**the** true and fair view" instead of "**a** true and fair view". Any potential misunderstandings must be avoided at all costs by included all details recommended by the standard.

Basis of opinion

The contents of the "Basis of opinion" are also not in line with the recommended contents by ISA 700 (Revised). The paragraph does not make it clear that International Standards on Auditing (ISAs) were used when conducting the audit. Readers must know exactly which auditing standards have been used. The second sentence should be placed in the paragraph on "Auditor's Responsibilities for the Audit of the Financial Statements".

Details on independence have been omitted. These are important since they add credibility to the report.

Other Matters paragraph

This "Other Matters paragraph" is no longer used in line with ISA 720 (Revised) *The Auditor's responsibility relating to other information* where other information is materially misstated. Instead of using an "other Matters paragraph", the auditor describes the misstatement in the "Other Information" section of the auditor's report.

Notes from the current audit file:

(1) Suspense account

The amount in the suspense account represents 3.3% of the profit before tax (50,000/1,500,000 x 100%) and 0.24% of total assets (50,000/21,000,000 x 100%). Hence, the amount in the suspense account is immaterial to both the statement of profit or loss and statement of financial position. This means the audit opinion will remain unmodified.

(2) Depreciation figure

The depreciation figure of K475,000 represents 31.7% of profit before tax (475,000/1,500,000 x 100%) and 2.3% of total assets (475,000/21,000,000 x 100%). This is material to both the statement of profit or loss and the statement of financial position. The audit team has consulted experts and are satisfied that the estimate is reasonable. Hence, the audit opinion remains unmodified.

(3) Non-inclusion of "Key Audit Matters paragraph"

Listed company auditor's reports must include a "Key Audit Matters paragraph". Pinkie Ltd is not a listed company. It is therefore acceptable not to include a "Key Matters paragraph".

[Award marks as follows:

1 mark for each relevant point on format – Maximum 2 marks

1 mark for each relevant point on "Opinion paragraph" – Maximum 3 marks

1 mark for each relevant point on "Basis of opinion paragraph" – Maximum 3 marks

1 mark for each relevant point on "Other Matters paragraph" – Maximum 2 marks

1 mark for each relevant point on "Suspense account" – Maximum 2 marks

1 mark for each relevant point on "Depreciation figure" – Maximum 2 marks

1 mark for "Key Audit Matters paragraph"

Overall maximum – 15 marks]

END OF SOLUTIONS