**QUESTION ONE**

**PUTA AND ASSOCIATES**

Your name is Niles Sampa and you are a manager in Puta and Associates, a firm of Chartered Certified Accountants responsible for the audit of the Salapo Group, a listed entity. The Group operates in the textile industry, buying cotton, silk and other raw materials to manufacture a range of goods including clothing, linen and soft furnishings. Goods are sold under the Salapo brand name, which was acquired by the Group many years ago.

Your firm was appointed as auditor in January 2019.

You have been provided with the following exhibits:

1) Information about the Group's general background and activities.
2) Extracts from the draft Group financial statements for the year ending 31 May 2019.
3) Notes from a meeting held between Max Puta, the engagement partner, and the Group's finance director and representatives from its audit committee.
4) Quality control issues arising from the finalisation of the audit of Lusaka Furnitures Co
5) Schedule of uncorrected misstatements – Lusaka Furnitures Co

**Exhibit 1 – Background and structure of the Salapo Group**

Information about each of the components of the Group is shown below:

Kafue Silk Co, Blantyre Recycling Co and Lusaka Furnitures Co are all wholly owned, acquired subsidiaries which manufacture different textiles. Salapo Co also owns 25% of Zambia Clothing Co, a company which is classified as an associate in the Group statement of financial position at a value of K12 million at 31 May 2019. The shares in Zambia Clothing Co were acquired in January 2019 for a consideration of K11·5 million. Other than this recent investment in Zambia Clothing Co, the Group structure has remained unchanged for many years. Information relevant to each of the group companies

**Salapo Co**
Salapo Co is the parent company in the group and its main activities relate to holding the investments in its subsidiaries and also the brand name which was purchased many years ago. Salapo Co imposes an annual management charge of K800,000 on each of its subsidiaries, with the charge for each financial year payable in the subsequent August.

**Kafue Silk**
Kafue Silk Co manufactures luxury silk clothing, with almost all of its output sold through approximately 200 department stores. Kafue Silk Co's draft statement of financial position recognises assets of K21·5 million at 31 May 2019. Any silk clothing which has not been sold within 12 months is transferred to Blantyre Recycling Co, where the silk material is recycled in its manufacturing process.

**Blantyre Recycling**
Blantyre Recycling Co is located in Malawi, where it can benefit from low cost labour in its factories. It produces low price fashion clothing for the mass market. A new inventory system was introduced in December 2018 in order to introduce stronger controls over the movement of inventory between factories and stores. Blantyre Recycling Co is audited by Kamuzu & Co, and its auditor's reports in all previous years have been unmodified. Kamuzu & Co is a small accounting and audit firm, but is a member of an international network of firms. Blantyre Recycling Co's draft statement of financial position recognises assets of K24 million at 31 May 2019.

**Lusaka Furnitures**
Lusaka Furnitures Co manufactures soft furnishings which it sells through an extensive network of retailers. The company is cash-rich, and surplus cash is invested in a large portfolio of investment

properties, which generate rental income. The Group's accounting policy is to measure investment properties at fair value. Lusaka Furnitures Co's draft statement of financial position recognises assets of K28 million at 31 May 2019, of which investment properties represent K10 million.

**Exhibit 2 – Extracts from draft Group consolidated financial statements**

**Draft consolidated statement of profit or loss and other comprehensive income**

| | Year ended 31 May 2019 K'000 Draft | Year ended 31 May 2018 K'000 Actual |
|---|---|---|
| Revenue | 725,000 | 650,000 |
| Cost of sales | (463,000) | (417,500) |
| Gross profit | 262,000 | 232,500 |
| Other income – rental income | 200 | 150 |
| Operating expenses | (250,000) | (225,000) |
| Operating profit | 12,200 | 7,650 |
| Net finance cost | (1,000) | (1,000) |
| Profit before tax | 11,200 | 6,650 |
| Income tax expense | (1,500) | (1,000) |
| **Profit for the year** | **9,700** | **5,650** |
| **Other comprehensive income:** | | |
| Gain on investment property revaluation | 1,000 | 3,000 |
| Total comprehensive income | 10,700 | 8,650 |

Draft consolidated statement of financial position

| | 31 May 2019 K'000 Draft | 31 May 2018 K'000 Actual 31 |
|---|---|---|
| **Non-current assets** | | |
| Property, plant and equipment | 45,000 | 45,000 |
| Investment property (recognised at fair value) | 10,000 | 7,500 |
| Intangible asset – brand name (recognised at cost) | 8,000 | 8,000 |
| Investment in associate | 12,000 | – |
| | 75,000 | 60,500 |
| **Current assets** | | |
| Inventory | 12,000 | 6,000 |
| Receivables | 10,500 | 6,600 |
| Cash | 10,000 | 22,000 |
| | 32,500 | 34,600 |
| **Total assets** | **107,500** | **95,100** |

| | | |
|---|---|---|
| **Equity and liabilities** | | |
| Share capital | 35,000 | 35,000 |
| Retained earnings | 34,000 | 24,600 |
| | 69,000 | 59,600 |
| **Non-current liabilities** | | |
| Bank loan | 20,000 | 20,000 |
| **Current liabilities** | | |
| Trade payables | 16,000 | 13,500 |
| Tax payable | 2,500 | 2,000 |
| | 18,500 | 15,500 |
| **Total equity and liabilities** | **107,500** | **95,100** |
| | ======= | ====== |

**Exhibit 3 – Notes from discussion with Group audit committee and finance director**

**Recent publicity**

During the year, the Group attracted negative publicity when an investigation by a well-known journalist alleged that child-labour was being used by several suppliers of raw materials to Blantyre Recycling Co. The Group refuted the allegations, claiming that the suppliers in question had no contract to supply Blantyre Recycling Co, and that the Group always uses raw materials from ethically responsible suppliers. The media coverage of the issue has now ended. The Group finance director is confident that the negative publicity has not affected sales of the Group's products, saying that in fact sales are buoyant, as indicated by the increase in Group revenue in the year.

**Systems and accounting policies**

The Group has a policy of non-amortisation of the Salapo brand name. The brand name was acquired many years ago and is recognised at its original cost. The previous audit firm accepted the policy due to the strength of the brand name and the fact that the Group spends a significant amount each year on product development and marketing aimed at supporting the brand. The Group has maintained a good market share in the last few years and management is confident that this will continue to be the case.

As part of management's strategy to increase market share, a bonus scheme has been put in place at Kafue Silk the Group under which senior managers will receive a bonus based on an increase in revenue.

The Group's accounting and management information systems are out of date, and the Group would like to develop and implement new systems next year. The audit committee would like to obtain advice from Puta and Associates on the new systems as they have little specialist in-house knowledge in this area.

**Financing**

In addition, the audit committee requests that the Group audit engagement partner attends a meeting with the Group's bank, which is planned to be held the week after the auditor's report is issued. The purpose of the meeting is for the Group to renegotiate its existing lending facility and to extend its loan, and will be attended by the Group finance director, a representative of the audit committee, as well as the bank manager. The Group is hoping that the audit partner will be able to confirm the Group's strong financial position at the meeting, and also confirm that the audit included procedures on going concern, specifically the audit of the Group's cash flow forecast for the next two years, which the bank has requested as part of their lending decision.

**Exhibit 4 – Quality control issues arising from the finalisation of the audit of the Lusaka Furnitures Co**

One of the audit assistants who has been working on the audit of Lusaka Furnitures Co made the following comments when discussing the completion of the audit with you:

*'I was assigned to the audit of provisions. One of the provisions, amounting to K214,300 relates to a legal claim made against the company after an employee was injured in an accident at one of the steel processing plants. I read all of the correspondence relating to this, and tried to speak to Lusaka Furnitures Co's legal advisers, but was told by the finance director that I must not approach them and should only speak to him about the matter. He said that he is confident that only K10,000 needs to be recognised and that the legal advisers had confirmed this amount to him in a discussion of the matter. I noted in the audit working papers that I could not perform all of the planned audit procedures because I could not speak to the legal advisers. The audit supervisor told me to conclude that provisions are correctly recognised in the financial statements based on the evidence obtained, and to move on to my next piece of work. He said it didn't matter that I hadn't spoken to the legal advisers because the matter is immaterial to the financial statements. 'We received the final version of the financial statements and the chairman's statement to be published with the financial statements yesterday. I have quickly looked at the financial statements but the audit supervisor said we need not perform a final detailed analytical review on the financial statements as the audit was relatively low risk. The manager also said that he had discussed the chairman's statement with the finance director, so no further work on it is needed. The audit has been quite time-pressured and I know that the client wants the auditor's report to be issued as soon as possible.'*

**Exhibit 5 - Schedule of uncorrected misstatements arising from the audit of Lusaka Furnitures Co**

The schedule of uncorrected misstatements included in Lusaka Furnitures Co's audit working papers is shown below, including notes to explain each matter included in the schedule. The audit engagement partner is holding a meeting with management tomorrow, at which the uncorrected misstatements will be discussed.

| | Statement of profit or loss | | Statement of financial position | |
|---|---|---|---|---|
| | Debit | Credit | Debit | Credit |
| | K | K | K | K |
| 1) Share-based payment scheme | 6,428,570 | | | 6,428,570 |
| 2) Restructuring provision | | 1.071,400 | 1.071,400 | |
| 3) Estimate of additional allowance required for slow-moving inventory | 10,000 | | | 10,000 |
| Totals | 6,438,570 | 1.071,400 | 1.071,400 | 6,438,570 |

**Notes:**

1) A share-based payment scheme was established in January 2019. Management has not recognised any amount in the financial statements in relation to the scheme, arguing that due to the decline in Lusaka Furnitures Co's share price, the share options granted are unlikely to be exercised. The audit conclusion is that an expense and related equity figure should be included in the financial statements.

2) A provision has been recognised in respect of a restructuring involving the closure of one of the steel processing plants. Management approved the closure at a board meeting in May 2019, but

only announced the closure to employees in April 2019. The audit conclusion is that the provision should not be recognised.

3) The allowance relates to slow-moving inventory in respect of a particular type of steel alloy for which demand has fallen. Management has already recognised an allowance of K750,000, which is considered insufficient by the audit team.

**REQUIREMENTS**

**Your firm has been appointed to audit the Group financial statements, and also have been appointed to audit the financial statements of the parent company and of all subsidiaries of the Group except for a foreign subsidiary, Blantyre Recycling Co, which is audited by a local firm, Kamuzu & Co. All components of the Group have the same year end of 31 May, report under IFRS® Standards and in the same currency.**

**1) Using the information provided in exhibits 1 and 2**

**a) Evaluate the audit risks to be considered in planning the audit of the Group. Your evaluation should utilise analytical procedures for identifying relevant audit risks. (30 marks)**

**b) Explain the matters to be considered, and the procedures to be performed, in respect of planning to use the work of Kamuzu & Co. (10 marks)**

**c) Design the principal audit procedures to be performed in respect of the following balances recognised as non-current assets in the Group statement of financial position:**

**(i) K12 million recognised as investment in associate, and (8 marks)**

**(ii) K8 million recognised as a brand name. (8 marks)**

**2) The principle of professional competence and due care demands the exercise of appropriate levels professional scepticism**

**(i) In the contest of Salapo Group, define and explain the relevance of the concept of professional scepticism (4 marks)**

**(ii) Recommend the steps your firm should take to demonstrate the requisite level of professional scepticism for the audit of the Salapo Group (6 marks)**

**3) Using the information provided in Exhibit 3,**

**(i) identify and evaluate any ethical threats and other professional issues which arise from the requests made by the Group audit committee. (8 marks)**

**(ii) For each threat and issues, recommend the action that your firm should take (4 marks)**

**4) Using the information in in exhibit 4, identify and evaluate quality control and other professional issues raised by the assistant's comments, discussing any implications for the completion of the audit (10 marks)**

**5) Using the information in exhibit 5,**

**(i) Explain the matters which should be discussed with management in relation to each of the uncorrected misstatements; and (9 marks)**

**(ii) Assuming that management does not adjust the misstatements, justify an appropriate audit opinion and explain the impact on the auditor's report. (3 marks)**

**Total (100 marks)**

**QUESTION TWO**

**THOLE ASSOCIATES**

You are an audit manager in Thole & Asscociates, a firm of Chartered Certified Accountants. You have recently been appointed as senior manager in charge of quality control in the firm. The senior partner, Mr. Thole, is particularly interested in ensuring that the adoption of new accounting standards has been properly addressed during various audits performed in the past year, including related ethical and other professional issues arising. Accordingly you have selected the following sample of clients for your review:

1) Busaka Co
2) Tarclays Bank
3) Lin Construction
4) Zambisa Company plc

**BUSAKA CO**

Busaka Co is an unlisted company and has been an audit client of your firm for a number of years. Busaka Co is a national distributor of cleaning products. The company buys the cleaning products from wholesalers and employs a team of approximately 750 sales staff around the country who sell the company's products to both domestic households and small to medium-sized businesses. Around 75% of Busaka Co's sales transactions are cash-based and each of the company's sales staff prepares a cash sales report on a monthly basis. According to Busaka Co's chief executive, Shuula Banda, and in order to foster 'an entrepreneurial spirit' amongst his staff, each staff member (including the senior management team) is encouraged to make cash sales and is paid on a commission basis to sell the company's products to friends and family. Mr Banda leads the way with this scheme and recently sold Busaka products with a value of K33,000 to a business associate of his. He has transferred these funds directly into an off-shore bank account in the company's name on which he is the sole signatory.

**Review of audit working papers**

Your review of the audit working papers and an initial meeting with Mr Banda have identified the following potential issues:

Following your review of the audit engagement letter and the working papers of the taxation section of the audit file, you have established that Thole & Asscociates performed the taxation computation for Busaka Co and completed the tax returns for both the company and Mr Banda personally. All of the taxation services have been invoiced to Busaka Co as part of the total fee for the audit and professional services. Mr Banda' personal tax return includes a significant number of transactions involving the purchase and sale of properties in various international locations. The taxation working papers include a detailed review of a number of off-shore bank accounts in Mr Banda' name which identified the property transactions.

During your initial meeting with Mr Banda, he informed you that Busaka Co is planning to develop a new website in order to offer online sales to its customers. He has asked Thole & Asscociates to provide assistance with the design and implementation of the website and online sales system.

As a result of your audit review visit at the client's premises, you have learned that the audit team was invited to and subsequently attended Busaka Co's annual office party. The client provided each member of the audit team with a free voucher worth K30 which could be redeemed at the venue during the party. The audit senior, Paul Mata, who has worked on the audit for the last three years has informed you that the audit team has always been encouraged to attend the party in order to develop good client relations.

## TARCLAYS BANK

Tarclays Bank operates in the Central Province of Zambia, a region in which clothing manufacture is a significant industry. The bank provides personal loans and mortgages in the region. The average loan to value ratio for all its mortgage loans is 75%

All loan applications are required to provide information regarding the industry in which they are employed. If the application is for a mortgage, the customer must provide the post code of the property which is to serve as collateral for the mortgage loanl

After applying the provision of IAS 39 in previous years , Tarclays Bank has recently adopted the expected credit loss impairment model in IFRS 9 *Financial Instruments*, as required by the Bank of Zambia. The bank tracks the probability of customer default by reference to overdue status records. In addition, it is required to consider forward-looking information as far as that is available

Tarclays Bank has become aware that a number of clothing manufacturers are losing revenue and profits as a result of competition from abroad, and that several are expected to close

## LIN CONSTRUCTION

Background The following is an extract from the statement of financial position of Lin Construction, a limited entity as at 31 December 2018.

| | **K'000** |
|---|---|
| Revenue – **See below** | 538,000 |
| Non-current assets – **See below** | 160,901 |
| Current assets | 110,318 |
| Equity share capital (K1 each) | 10,000 |
| Other components of equity | 20,151 |
| Retained earnings | 70,253 |
| Non-current liabilities (bank loan) | 50,000 |
| Current liabilities | 120,815 |

The bank loan has a covenant attached whereby it will become immediately repayable should the gearing ratio (long-term debt to equity) of Lin Construction exceed 50%. Lin Construction has a negative cash balance as at 31 December 2018.

### Non-current assets - Livingstone Property

Livingstone property Included within the non-current assets of Lin Construction is a property in Livingstone which has been leased to Sun Hotels under a 40-year lease. The property was acquired for K20 million on 1 October 20X7 and was immediately leased to Sun Hotels. The asset was expected to have a useful life of 40 years at the date of acquisition and have a minimal residual value. Lin Construction has classified the building as an investment property and has adopted the fair value model.

The property was initially revalued to K22 million on 31 March 2018. Interim financial statements had indicated that gearing was 51% prior to this revaluation. The managing director was made aware of this breach of covenant and so instructed that the property should be revalued. The property is now carried at a value of K28 million which was determined by the sale of a similar sized property on 31 December 2018. This property was located in a much more prosperous area and built with a higher grade of material. An independent professional valuer has estimated the value to be no more than K22 million.

The managing director has argued that fair values should be referenced to an active market and is refusing to adjust the financial statements, even though he knows it is contrary to international accounting standards.

**Revenue - Sales contract**

Lin Construction has entered into a sales contract for the construction of an asset with a customer whereby the customer pays an initial deposit. The deposit is refundable only if Lin Construction fails to complete the construction of the asset. The remainder is payable on delivery of the asset. If the customer defaults on the contract prior to completion, Lin Construction has the right to retain the deposit. The managing director believes that, as completion of the asset is performed over time, revenue should be recognised accordingly. He has persuaded the accountant to include the deposit and a percentage of the remaining balance for construction work in revenue to date.

**ZAMBISA COMPANY plc**

Zambisa Company plc (the Company), a listed manufacturer of high quality musical instruments, for the year ended 31 March 2019. The draft financial statements of the Company recognise a loss before tax of K2·2 million (2018 – loss of K1·5 million) and total assets of K14·1 million (2018 – K18·3 million). The audit is nearing completion and the audit senior has drafted the auditor's report which contains the following extract:

**Key audit matters**

**1. Valuation of financial instruments**

The Company enters into structured forward contracts to purchase materials used in its manufacturing process. The valuation of these unquoted instruments involves guesswork and is based on internal models developed by the Company's finance director, Thomas Bwalya. Mr Bwalya joined the Company in January 2019 and there is significant measurement uncertainty involved in his valuations as a result of his inexperience. As a result, the valuation of these contracts was significant to our audit.

**2. Customer liquidation**

Included in receivables shown on the statement of financial position is an amount of K287,253 from a customer which has ceased trading. On the basis that the Company has no security for this debt, we believe that the Company should make a full provision for impairment of K287,253 thereby reducing profit before taxation for the year and total assets as at 31 March 2019 by that amount.

**Qualified opinion arising from disagreement about accounting treatment**

In our opinion, except for the effect on the financial statements of the matter described above, the financial statements have been properly prepared in all material respects in accordance with IFRS Standards.

**Emphasis of matter**

We draw attention to the loss before tax of K2·2 million for the year ended 31 March 2019 and that the Company is in breach of loan covenants with its key finance providers. A material uncertainty therefore exists which may cast doubt on the Company's ability to continue as a going concern. Our opinion is not modified in respect of this matter.

**REQUIREMENTS**

1) **Using the information relating to BUSAKA Co**
   a) **Discuss the policies and procedures which Busaka Co should have in place in relation to an anti-money laundering programme; and (4 marks)**
   b) **Evaluate whether there are any indicators of money laundering activities by either Busaka Co or its staff. (6 marks)**
   c) **Comment on the ethical and professional issues arising from your review of the audit working papers and recommend any actions which should have been taken by Thole & Associates. (15 marks)**

2) **Using the information relating to TARCLAYS BANK**
   a) **How should Credit Bank apply IFRS 9 to its portfolio of mortgages in the light of the changing situation in the clothing industry (5 marks)**
   b) **Later in the year, more information emerged, and Tarclays Bank was able to identify the particular loans that defaulted or were about to default. How should Tarclays bank treat these loans (5 marks)**
   c) **Recommend principal audit procedures relating to:**
      i) **The correct treatment to the provisions brought down under IAS 39 as guided by the Zambia Institute of Chartered Accountants (ZiCA) (6 marks)**
      ii) **The treatment of particular loans that defaulted (5 marks)**
      iii) **The disclosures (4 marks)**

3) **Using the information relating to LIN CONSTRUCTION**
   a) **Comment on the matters to consider and the evidence you should find in your review of working papers relating to:**
      i) **Valuation of the Livingston property (10 marks)**
      ii) **Revenue of recognition (4 marks)**
   b) **Explain any ethical issues which may arise for the managing director and the accountant from each of the scenarios. (10 marks)**

4) **Using the information relating to ZAMBISA COMPANY plc**
   a) **ISA 701 Communicating Key Audit Matters in the Independent Auditor's Report states 'The purpose of communicating key audit matters is to enhance the communicative value of the auditor's report by providing greater transparency about the audit that was performed.'**

      **Required:**
      **Discuss this statement in relation to the benefits and difficulties of communicating key audit matters to users of the auditor's report and the contribution of ISA 701 in addressing the audit expectation gap. (8 marks)**

   b) **Critically appraise the extract from the auditor's report on the financial statements of the Zambisa Company for the year ended 31 March 2019. Note: You are NOT required to re-draft the extract from the auditor's report. (18 marks)**