SUGGESTED SOLUTIONS FOR AUDIT COMPETENCE EXAMS
QUESTION ONE – JUNE 2017 - AUDIT

1) **Acceptance of the audit of Mpundu Holdings**
   a) **Quality Control**

      i) **Issues arising**

      Mpundu Holdings obtaining listing on the Lusaka Stock Exchange during the year. This increases the risk profile of the client for which specific quality control policies and procedures are required, including performance of hot reviews

      According to ISQC 1 (International Standard on Quality Control), hot reviews are compulsory for clients who are listed and in the public interest
      .

      ii) **Action to take – hot reviews**

      Specific procedures to apply include
      - Conduct hot reviews before the audit report is signed
      - The review should be conducted by a Partner who is independent of the main audit team
      - The objective of the review will be to assesses whether:
        - The firm's independence and objectivity is impaired in any way
        - The planning appears to have been carried out properly
        - The file appears to have been reviewed satisfactorily

   b) **Other ethical, corporate governance and professional issues.**

	i) Other Ethical, Corporate Governance and other professional issue	ii) Action to take
1	**Errors – Potential misstatements** Following the listing in March 2017, the new finance director has undertaken a review of the reporting framework of Mpundu Holdings to ensure that the company now fully complies with applicable International Financial Reporting Standards. This generates increased scope for errors. This is in addition to the fact that accounting entries relating to the share based payments have not been made	Mundia & Co are required to provide reasonable assurance that the financial statements are free from material misstatement, whether caused by fraud or error. In order to meet this responsibility, Mundia & Co must plan, perform and review the audit in light of the risks of misstatement due to fraud or error. This should include heightened professional skepticism

2	**Bookkeeping advice – self review** Mundia & Co are expected provide advice on the implementation of new accounting standards. Apart from creating a self-review threat and possible advocacy threat, this is not allowed for listed companies unless in an emergency and safeguards are adequate.	In such an emergency: ✓ Not to be performed by members of the audit team ✓ Managerial decisions not to be made by the firm ✓ Information, assumptions etc to be generated by the client. There is no evidence that there is any emergency, therefore the service should not be provided and Mpundu Holdings should be advised accordingly
4	**Dominant Chairman and Chief Executive** Mr. Mpundu is Chairman and Chief Executive Officer. Effective corporate governance requires distinction between the functions of executive and non-executive members of the board	Mpundu Holdings should be advised that for the board to be effective, there should be segregation of duties between the chairperson of the board and the chief executive
5	**Composition of the board** The Board comprises 3 executive directors and 3 non-executive directors. With Mr. Mpundu being the chairman of the board is dominated by executive directors and is not considered an effective arrangement	Mpundu Holdings should be advised that corporate governance require that the board is dominated by non-executive directors to allow for more independent oversight
6	**Re-election of board members** Board members are eligible to offer themselves for re-election every year. There is no evidence of performance assessment and this implies that there are no term limits. This does not comply with effective corporate governance requirements	Mpundu Holdings should be advised that there should not be automatic re-election of board members. Members should only be re-elected if the performance is assessed to be satisfactory and the re-election is within the term limits imposed
7	**Director Compensation** The Chairman is responsible for recommendation compensation and remuneration for the directors, based on prevailing rates recommended by the Institute of Directors of Zambia. Corporate governance require that no director should be involved in setting his or her own remuneration	Director compensation is a very sensitive issue. Mpundu Holdings should be advised that director compensation should be the responsibility of a suitably constituted remuneration committee comprising independent members

c) **Pre-condition for the audit**

According to ISA 210 *Agreeing terms pf Audit Engagements and the Code of Ethics,* auditors should only accept/continue engagements if the pre-conditions for an audit required are present. The auditor should

- Determine whether the financial reporting framework to be applied in the preparation of the financial statements is appropriate
- Obtain the agreement of management that it acknowledges and understands its responsibilities for
  - Preparation of financial statements
  - Systems and internal controls
  - Provision of access to evidence required

If the pre-conditions for an audit are not present, the auditor should discuss the matter with management and should not accept the engagement unless required to do so by law or regulation

In the context of Mpundu Holdings, an assessment is underway to ensure that the company fully complies with applicable International Financial Reporting Standards. Once this is done, it will be necessary to determine whether the financial reporting framework to be applied is appropriate,

Additionally, as Mundia & Co are expected to provide advice with regard to the adoption of new accounting standards, Mundia & Co should obtain confirmation from management that it acknowledges and understands its responsibility for the preparation of financial statements

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

a) **Evidence / information required for planning include:**

- Details of the stock exchange listing during the year including the terms of the flotation, number of equity shares issued and amount of equity capital raised.
- Any information available in relation to the flotation, for example, investor prospectus, pre- and post-flotation press releases, communications with the stock exchange registrar.
- Information on the specific listing rules relevant to the Lusaka Stock Exchange, for example, the corporate governance code and disclosures necessary in company annual reports and financial statements.
- Details relating to any changes in the accounting and internal control systems, policies and procedures
- Information on the background and experience of the new non-executive directors and the new finance director, for example, their professional qualifications and previous employment or directorships held.
- A full set of forecast financial statements including a statement of cash flows to assess the working capital issues faced by the company.

- Details on the valuation of properties including the date of the revaluation and information on the valuer such as their professional qualification and relationship with the company and a copy of the valuation report.
- Documentation on the cash-settled share-based payment scheme to gauge the number of members of the scheme and its potential materiality to the financial statements.
- Details relating to the new International Financial Reporting Standards to be adopted

b) Reliability of such information

The merit of reliability of audit evidence is influenced by its source: internal or external, and by its nature, visual, documented or oral. The following generalisations will help in assessing the reliability of audit evidence:

- Audit evidence from external sources (for example, confirmation received from a third party) is more reliable than that generated internally. For the forecast information share based agreements are internally generated whereas the valuation report is externally generated
- Audit evidence obtained directly by the auditor is more reliable than that obtained from the entity. For example; may re-perform the calculations relating to the gains and losses arising on revaluation
- Audit evidence in the form of documents and written representations is more reliable than oral representations- For example, information from flotations documents is more reliable than assumptions relating to the forecasts
- Corroborative and consistent evidence would also be considered be more reliable compared to conflicting evidence

3) Planning of Mpundu Holdings.

a) Audit risk evaluation - Information other than review of results

1) Disclosure for listed companies

This is the first set of financial statements produced since Mpundu Holdings became listed. There is a risk that the new finance director will not be familiar with the requirements specific to listed companies, for example, the company now falls under the scope of IAS 33 Earnings per Share and IFRS 8 Operating Segments for the first time. There is a risk of incomplete or inaccurate disclosures in respect of these standards and also in respect of any listing rules in the jurisdiction in which the company is listed.

2) Foreign exchange transactions

Foreign exchange transactions Mpundu Holdings purchases many components from foreign suppliers and is therefore likely to be transacting and making payments in foreign currencies. According to IAS 21 The Effects of Changes in Foreign Exchange Rates, transactions should be initially recorded using the spot rate, and monetary items such as trade payables should be retranslated at the year end using the closing rate. Exchange gains and losses should be recognised within profit for the year. The risk is that the incorrect exchange rate is used for the translation and retranslation, or that the retranslation does not happen at the year end, in which case trade payables and profit could be over or understated, depending on the movement in the exchange rate.

3) Hedging

The company enters into hedging arrangements as a way to reduce exposure to foreign exchange fluctuations. There is a risk that hedging arrangements are not identified and accounted for as derivatives according to IFRS 9 Financial Instruments which could mean incomplete recognition of derivative financial assets or liabilities and associated gains or losses.

4) Revenue Recognition – Payment in advance

Payment in advance and revenue recognition under contract with customers For items where significant design work is needed, Mpundu Holdings receives a payment in advance. This gives rise to risk in terms of when that part of the revenue generated from a sale of goods is recognised. There is a risk that revenue is recognised too early, especially given the risk of management bias and the incentive to overstate revenue and profit as discussed above. According to IFRS 15 Revenue from Contracts with Customers, revenue should only be recognised as control is passed, either over time or at a point in time.

5) Revenue Recognition – Timing of revenue recognition

The timing of revenue recognition will depend on the contractual terms with the customer, with factors which may indicate the point in time at which control passes including the transference of the physical asset, transference of legal title, and the customer accepting the significant risks and rewards related to the ownership of the asset. It is likely that the payments in advance should be treated as deferred revenue at the point when the payment is received as the conditions for recognition of revenue are unlikely to have been met at this point in time.

6) Revenue Recognition – possible cancellation of contract.

There is additional audit risk created if a customer were to cancel a contract part way through its completion, the bespoke work in progress may be worthless and would need to be written off according to IAS 2 Inventories. There is therefore a risk of overstated work in progress.

7) Possible errors – new inexperienced finance director

During the year, several new non-executive directors were appointed, as well as a new finance director. While this may serve to strengthen the corporate governance structure, including the control environment, equally the introduction of new personnel could mean inexperience and a control risk, particularly if the finance director is lacking in experience. Some of the suggestions and accounting treatments made by the finance director indicate that their knowledge of the applicable financial reporting framework is weak, signaling that errors may occur in the preparation of the financial statements.

8) IFRS 2 – Cash settled share based payments

Cash-settled share-based payment scheme This falls under the scope of IFRS 2 Share-based Payment which states that the liability in respect of the plan should be measured at fair value at the year end. The increase in the share price from K2·90 at flotation to K3·50 (projected) at the year-end indicates that a liability should be recognised at 31 December 2015 based on the fair value of the liability which has accrued up to that date, with the expense recognised in the statement of profit or loss. This accounting treatment has not been followed leading to understated liabilities and overstated profit, and the disclosure in respect of the plan may not be sufficient to meet the requirements of IFRS 2 which requires extensive disclosures including the effect of share-based payment transactions on the entity's profit or loss for the period and on its financial position.

9) Revaluation – Determining fair values

Revaluation of property The decision to revalue the company's manufacturing sites creates several risks. First, revaluation involves establishing a current market price or fair value for each property included in the revaluation, which can be a subjective exercise, leading to inherent risk that the valuations may not be appropriate.

10) Revaluation – Completeness

A risk also arises in that IAS 16 Property, Plant and Equipment requires all assets in the same class to be revalued, so if any properties which are manufacturing sites have not been included in the revaluation exercise, the amounts recognised will not be correct.

11) Revaluation – Depreciation

There is also a risk that depreciation has not been recalculated on the new, higher value of the properties, leading to overstatement of non-current assets and understatement of operating expenses.

12) Revaluation – Disclosure

IAS 16 also requires a significant level of disclosure in relation to a policy of revaluation, so there is a risk that the necessary disclosures are incomplete. The revaluation gain recognised in equity represents 3·9% of total assets and is therefore material to the financial statements.

13) Deferred tax recognition

IAS 12 Income Taxes requires deferred tax to be recognised in respect of taxable temporary differences which arise between the carrying amount and tax base of assets and liabilities, including the differences which arise on the revaluation of non-current assets, regardless of whether the assets are likely to be disposed of in the foreseeable future. The finance director's suggestion that deferred tax should not be provided for is therefore incorrect, and at present liabilities are understated, representing an error in the statement of financial position. There is no profit impact, however, as the deferred tax would be recognised in equity. Depending on the rate of tax which would be used to determine the necessary provision, it may not be material to the financial statements.

14) Accountability and reporting framework – Change in Accounting policy

According to IAS 8, Accounting policies, Accounting Estimates and Errors, an entity must select and apply accounting policies consistently for similar transactions. An entity should only change its accounting policies if the change:

a) Is required by a standard or interpretation
b) Results in reliable and more relevant information – true and fair view

There is risk that accounting policies are not changed appropriately

15) Accountability and reporting framework – Prior year adjustment

New accounting standards will normally prescribe the accounting treatment requiring the adoption of new policies. According to IAS 8, the new policy should be dealt with retrospectively – adjusting opening figures and comparatives as if the new policy had always been applied. This requires the inclusion of a statement of financial position at the beginning of the earliest period reported or effecting the change on the opening statement of changes of equity as a prior year adjustment. There is a risk that this is not effected correctly

16) Government grant – recognition

The government grant represents 11·1% of total assets and is material to the financial statements. A risk arises in relation to the recognition of the grant. IAS 20 Accounting for Government Grants and Disclosure of Government Assistance requires that a grant is recognised as income over the period necessary to match the grant received with the related costs for which they are intended to compensate. Therefore, the K2 million relating to costs incurred this year should be recognised as income, but the remainder should be released to profit on a systematic basis; in this case it would seem appropriate to release on a straight line basis until July 2020. The risk is that the grant has been recognised on an inappropriate basis leading to over or understated profit for the year. The part of the grant not recognised in profit should be recognised in the statement of financial position. IAS 20 allows classification as deferred income, or alternatively the amount can be netted against the assets to which the grant relates.

17) Government grant – Presentation and Disclosure

There is therefore also a risk that the amount is recognised elsewhere in the statement of financial position, leading to incorrect presentation and disclosure. If the terms of the grant have been breached, the grant or an element of it may need to be repaid. There is therefore a risk that if there is any breach, the associated provision for repayment is not recognised, understating liabilities.

18) Inventory Valuation

Inventory valuation Work in progress is material at 13·3% of total assets and has increased by 26·3% in the current year. The valuation of work in progress is likely to be complex as many different jobs for different customers are ongoing at the year end, and each will have a different stage of completion and cost base at the year end. There are also issues more generally with the valuation of inventory, due to the customer returns of items which have recently occurred showing that there are problems with the quality of the goods supplied. For items which have been returned, the net realisable value is likely to be less than the cost of the item indicating that a write-off may be necessary to reduce the value of the inventory according to IAS 2.

19) Provision for returned goods

Provision in respect of returned goods A provision should be recognised where a reliable estimate can be made in relation to a probable outflow of economic resources and an obligating event has taken place. The fact that Mpundu Holdings replaces faulty products free of charge indicates that a provision should be recognised based on the best estimate of the future economic outflow. The risk is that no provision or an insufficient provision in relation to the warranty has been recognised, leading to understated liabilities and operating expenses.

b) Audit risk evaluation – Preliminary analytical review of results

1) Stock exchange listing and pressure on results – Increase in revenue and profits

Revenue has increased by 2·2% and profit before tax by 6·5%, which may indicate overstatement. There is a risk that revenue and profits may be overstated. The listing obtained during the year can create inherent risk at the financial statement level because management may feel under pressure to achieve good results in this financial year. The flotation raised equity capital, so there will be new shareholders who will want to see strong performance in the expectation of a dividend pay-out.

2) Share price – possible overstatement

The introduction of the cash-settled share-based payment plan motivates management to produce financial statements which show a favourable performance and position which is likely to lead to an increase in the company's share price.

3) Increase in the inventory holding period

The increase in the inventory holding period, as demonstrated by the increase in inventory days, shows that inventory has become more slow-moving during the year also indicating that inventory may be overstated. According to IAS 2 Inventories – inventories should be stated a the lower of cost and net realizable value

4) Liquidity – working capital

The preliminary analytical review reveals that Mpundu Holdings is struggling to manage its working capital. The liquidity ratios provided show that the operating cycle has increased from 165 days in 2014 to 205 days in 2015. The company may be finding it difficult to collect cash from customers, as the receivables period has increased by 20 days, and in turn the payment period to suppliers has increased by five days. This trend may lead to doubts over the going concern of Mpundu Holdings

5) Provision for bad debts

The receivables days have increased by 20 days. If there is doubt over the collectability of receivables, then certain balances may need to be written off, and there is a risk of overstatement of receivables and understatement of operating expenses if bad debts are not recognised.

c) Materiality

A matter is considered material if its omission or misstatement can affect the economic decisions of users taken on the basis of the financial statements. Materiality is significant as it directs the audit to identify and focus on risks of material misstatement. Materiality is set based on the following benchmarks:

• Sales	0.5% - 1%
• Profit before tax	5% - 10%
• Total assets	1% - 2%

For Mpundu Holdings, these parameters would produce the following possible materiality amounts

Revenue = K138m		**Profit before tax = K9.8m**		**Total Assets = K90m**	
0.5% = K0.69m		**5% = K0.49m**		**1% = K0.9m**	
1% = K1.38m		**10% = K0.98m**		**2% = K1.8m**	

Materiality set
Where the risk profile of a client is assessed to be high, materiality would be set at a relatively lower amount. Accordingly. materiality is set at the lowest value, being K0.49 or K0.69

Justification
Materiality is based on the understanding of the entity, the understanding of systems, policies and procedures as well as the risk assessment. In the context of Mpundu holdings, the following factors indicate possible misstatements:

- Perceived high risk profile
- Becoming a listed a company

- Changes in corporate governance
- Changes in reporting framework, including new finance director

These factors suggest a relatively lower level of materiality

d) Planning materiality and performance materiality

It is unlikely that auditors will be able to design tests that identify individually material misstatements. It is much more common that misstatements are combined – in aggregate. For these reasons auditors work with what is called a performance materiality. For this purpose

- The auditor sets performance materiality at a value lower than overall materiality and uses this lower threshold when designing and performing audit procedures
- In using this lower threshold, the auditor is more likely to identify misstatements
- This reduces the risk that the auditor will fail to identify misstatements that are material in combination

4) Professional Skepticism and Audit Procedures

a) Professional Skepticism

According to ISA 200. Professional skepticism refers to an attitude that includes a questioning mind, being alert to conditions which may indicate possible misstatement due to error or fraud, and a critical assessment of audit evidence. This requires that the auditor is alert to:

- Audit evidence that contradicts other evidence
- Information that brings into question reliability of documents and responses to enquiries to be use as audit evidence
- Conditions that may indicate possible fraud
- Circumstances that suggest the need for audit procedures in addition to those required by ISAs

In the context of Mpundu holdings, the following factors indicate possible misstatements:

- Perceived high risk profile
- Becoming a listed a company
- Changes in corporate governance
- Changes in reporting framework, including new finance director

Accordingly, Mundia & Co should apply professional skepticism. This may include staffing the audit with more experienced personnel, relying more on external evidence and auditor generated evidence as well as using experts wherever possible

b) Substantive procedures

i) Revenue recognition – Bespoke machinery

For a sample of contracts with customers:

- Inspect and review that all IFRS 15 conditions are met, including:
  - The contract has been approved by the parties to the contract;

    - Each party's rights in relation to the goods or services to be transferred can be identified;
    - It is probable that the consideration to which the entity is entitled to in exchange for the goods or services will be collected.
- Identify the performance obligations in the contract and determine the proper assessment of the design and development of machinery
- Determine the transaction price to which Mpundu Holdings is entitled to in exchange for the design and development of equipment
- Allocate the transaction price to the performance obligations in the contract
- Inspect to verify that the 30% deposit has been properly deferred until an appropriate proportion of performance obligation has been achieved
- As Mpundu Holdings uses the input method as a basis for revenue recognition, inspect and review to verify that this method has been consistently applied to all the contracts
- For revenue recognized
    - Re-compute to verify that the revenue is in proportion to the costs incurred to date
    - Inspect and discuss with management to verify that the amount of revenue recognized is the amount allocated to that performance obligation
    - As the performance obligation is performed over time, verify that only those pieces of equipment for which Mpundu has transferred control of are included in the assessment of progress to date.
- For costs incurred for which no revenue has been recognized, inspect to verify that the costs incurred are to fulfill the contract and only recognized as an asset if and only if all of the following criteria are met:
    - The costs relate directly to a contract (or a specific anticipated contract);
    - The costs generate or enhance resources of the entity that will be used in satisfying performance obligations in the future; and
    - The costs are expected to be recovered.
- Perform cut-off procedures to verify that revenue recognized for the year ended 31 March 2017 is in respect of performance obligations achieved only up to that date

ii) The valuation of work-in-progress

- Obtain a schedule itemising the jobs included in work in progress at the year end, cast it and agree the total to the general ledger and draft financial statements.
- Agree a sample of items from the schedule to the inventory count records.
- For a sample of jobs included on the schedule:
    - Agree costs to supporting documentation such as supplier's invoice and payroll records;
    - For any overheads absorbed into the work in progress valuation, review the basis of the absorption and assess its reasonableness;
    - Assess how the degree of completion of the job has been determined at the year end and agree the stage of completion of the job to records taken at the inventory count;
    - Agree the details of the job specification to customer order; and

- Confirm that net realisable value is greater than cost by agreeing the contract price and cash received from the customer post year end.

- To assess the completeness of work in progress, select a sample of customer orders and trace through to the list of jobs included in work in progress.

iii) The recognition and measurement of the government grant

- Obtain the documentation relating to the grant to confirm the amount, the date the cash was received, and the terms on which the grant was awarded.
- Review the documentation for any conditions attached to the grant, for example, is there a requirement that a certain number of people are employed at the manufacturing plant?
- Discuss with management the method of recognition of the amount received, in particular how much of the grant has been recognised in profit and the treatment of the amount deferred in the statement of financial position.
- For the part of the grant relating to wages and salaries, confirm that the grant criteria have been complied with by examining payroll records and timesheets to verify that K2m has been spent on wages in the deprived area.
- For the part of the grant relating to continued operation of the manufacturing site, determine the basis on which this is being released into profit and recalculate to confirm accuracy of management's calculations.
- Review forecasts and budgets in relation to the manufacturing site to assess the likelihood of its continued operations until 2020.
- Using the draft financial statements, confirm the accounting treatment outlined by discussion with management has been applied and recalculate the amounts recognised.
- Confirm the cash received to bank statement and cash book.

SUGGESTED SOLUTIONS AUDIT COMPETENCE EXAMS
QUESTION TWO

1) **Quality control policies and procedures and recommendations.**

   a) **Leadership responsibilities for quality control**

   Each manager on the audit is expected to ensure that suitable quality control procedures are adopted on each audit. The responsibility for quality control has not been assigned to any specific person.

   Recommendation
   According to ISQC 1, the firm shall establish policies and procedures - to recognize that quality is essential in performing engagements, to require that:

   - The firm's chief executive officer assumes ultimate responsibility for the firm's system of quality control.
   - Any person (s) assigned operational responsibility for the firm's system of quality control has sufficient and appropriate experience and ability, and the necessary authority, to assume that responsibility

   b) **Human resources**

   Evaluation
   There is nothing wrong in promoting gender balance and equal opportunities for all provided that this based on requisite qualifications and experience. Additionally, it should be the responsibility of Trump Associates to determine training and development needs of its personnel taking into account the expected needs of its clients.

   Whilst remuneration should be competitive, it should be more based on appraisal and performance evaluation as well as consideration for career development and promotion opportunities

   The allocation of staff to engagement teams should depend on the needs of the client.

   Recommendation
   According to ISQC 1, the firm shall establish policies and procedures designed to provide it with reasonable assurance that it has sufficient personnel with the competence, capabilities, and commitment to ethical principles necessary to:

- Perform engagements in accordance with professional standards and applicable legal and regulatory requirements; and
- Enable the firm or engagement partners to issue reports that are appropriate in the circumstances.

This is achieved through appropriate selection and assignment of engagement teams

c) Engagement performance

Evaluation
The standard of performance should be determined by the firm and not each partner on the audit. It should be necessary to modify audit strategies and audit plans where for example unexpected misstatements arising from either fraud or error are discovered during the audit. Appropriate supervision and review procedures should detect this early in the audit.

This should demand a higher risk perception combined with heightened professional scepticism

Recommendation
According to ISQC 1, the firm shall establish policies and procedures designed to provide it with reasonable assurance that engagements are performed in accordance with professional standards and applicable legal and regulatory requirements, and that the firm or the engagement partner issue reports that are appropriate in the circumstances. This includes:

- Matters relevant to promoting consistency in the quality of engagement performance;
- Supervision responsibilities; and
- Review responsibilities

Consultation and Engagement Quality Control reviews should also be instituted

d) Monitoring
There is no separate quality control unit and reviewers are involved in the audits they are reviewing. There appear to be no systematic plan of independent reviews

Recommendation
According to ISQC 1, the firm shall establish a monitoring process designed to provide it with reasonable assurance that the policies and procedures relating to the system of quality control are relevant, adequate, and operating effectively. This requires

- Ongoing consideration and evaluation of the firm's system of quality control including, on a cyclical basis, inspection of at least one completed engagement for each engagement partner;
- Assignment of responsibility for the monitoring process to be assigned to person with sufficient experience and authority in the firm to assume that responsibility; and
- Engagement quality control reviews are not involved in inspecting the engagement

2) Acceptance to become external auditors of Bwino Millers (BM)

a) Ethical and other professional issues that should have been considered

The following ethical and other professional issues should have been considered

Professional competence and due care
Trump Associates seem to have experience with clients in the trading sector. Bwino Millers are in the manufacturing sector.

According to ZiCA ethical guidelines, members should not accept or perform work which they are not competent to undertake and should carry out their professional work with due, skill, care diligence and expedition. Members should have a continuing duty to maintain professional knowledge or skill at a level required to ensure that a client or employer receives competent professional service based on current developments in practice, legislation and techniques. Members should act diligently and in accordance with professional requirements.

Corruption allegations
This brings into question the integrity of management of BM. According to ZiCA ethical guidelines members should do not associate with clients with negative publicity.

Corruption allegations may also suggest possible money laundering activities

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

It is not up to the client to determine whether the auditor should rely on their internal audit.

b) Safeguards

Professional competence and due care – possible safeguards

- Acquiring technical knowledge relating to the milling sector
- Assigning specific members of staff who possess particular skills and experience in the milling sector
- Consider using external experts in accordance with ISA 620
- Increasing the expected duration of the engagement to allow for learning time and gaining experience
- Ensuring that the documentation of the engagement is comprehensively reviewed once the field work has been completed

Corruption allegations – possible safeguards

- Performing due diligence in accordance with money laundering procedures
- Obtaining detailed knowledge about BM and its shareholders and directors before accepting the nomination. This should include
    - Proper identity, owners and legality of business
    - Names, location, addresses,
    - Certificates of incorporation, register of directors
- Securing BM's commitment to implementing strong internal controls and the highest standards of corporate governance
- Allocating the senior partner of the firm to be the engagement partner rather than a more junior partner

Reduction in audit fees

Mr Bwino should be advised that it is the decision of Trump of Associates to rely on the internal audit or not and that there are a number of factors that should be taken into account. The internal auditor reports to the Chief Executive and there is risk that the work of internal audit may be influenced by Mr. Bwino. For this reason, it is unlikely that any reliance may be placed on internal audit

Mr. Bwino should also be advised that the fees are otherwise determined based on the time and other resources allocated to the audit as well as the qualifications and experience of the audit team.

3) Internal audit at BM

a) Acceptability of internal auditors at BM being involved in pre-audit work

ZiCA have noted that internal auditors in government, statutory bodies and some private sectors are being involved in pre-audit work, which raises serious questions on the independence of the internal auditor, as an agent of good corporate governance practices in organisations. Recent publicised cases of misapplication of funds in some government ministries implicated some internal auditors. This is because, such officers are involved in pre-audit which makes them to be part of management when they are supposed to provide checks and monitoring on behalf of Audit Committees in organisations and protecting the interests of the public by ensuring that control systems are adhered to. Internal auditors should focus their energies in systems audit and quality assurance.

Internal auditors are therefore advised to avoid getting involved in pre-audit work but focus on post audit. By so doing they will be more objective in their work and protect public interest. Internal auditors are the first line of defence as they are close to the area of activity; they can raise a red flag way before external auditors carry out their work.

b) Extent of reliance on internal audit

According to ISA 610, the following factors should be taken into accounting in determining the extent of reliance to be placed on the internal auditor:

- **Organisational status** of internal auditing in the organization. Should report to the highest level of management such as a board. In addition, internal auditors should be free to communicate fully with the external auditor

  In the context of BM, the internal auditor reports to the chairman and the chief executive of the company. The chief executive is in charge of day to day operations and therefore is likely to influence the work of internal audit. Ideally, the internal auditor should report to an Audit Committee comprising non-executive directors, as this would promote a more independent status to internal audit.

- **Scope of function.** The nature and external of internal auditing functions performed. The external auditor is likely to place reliance on internal audit if they involved in functions that are relevant to financial statements.

  In the context of BM, the internal audit team at BM is involved in monitoring the effectiveness of internal controls as well as value for money audits. This work would be of interest to the auditor. However. the involvement in pre-audits would appear to make them part of the implementation of internal controls.

- **Technical Competence.** Professional qualifications, technical training and competency of internal audit will also determine extent of reliance.

In the context of BM, Jo is qualified and experienced in the design and monitoring of internal control.

- **Due professional care.** Whether internal auditing is properly planned, supervised, reviewed and documented is another factor to consider in determining extent of reliance.

  In the context of BM, it is not clear whether the internal audit team carries out its work with due professional care. When the auditor intends to use specific work of internal auditing, the external auditor should evaluate and test that work to confirm its adequacy for the external auditor's purposes

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

a) **Ethical threats and the ZiCA position on compulsory rotation of auditors**

Ethical threats - familiarity

It is not uncommon for firms to act as auditor for a client for a number of years. However, the ZiCA ethical argues that using the same senior personnel on an assurance engagement over a long period of time may create a familiarity and self-interest threat. The significance of the threat will depend upon factors such as:

- The length of time that the individual has been a member of the assurance team; – The role of the individual on the assurance team;
- The structure of the firm;
- The nature of the assurance engagement;
- Whether the client's management team has changed; and
- Whether the nature, complexity of the client's accounting and reporting issues have changed.

The problem of long association is that a familiarity threat to objectivity is created. The senior personnel risk losing their professional scepticism, and may cease to challenge the client on significant matters. A close relationship will be built up between the senior audit personnel and senior members of the client's management team, so the auditors become too sympathetic to the interests of the client.

Safeguard – ZiCA guidelines

Following numerous queries ZiCA has received regarding the tenure of office for external auditors as well as the maximum period that external auditors can be retained by the client, ZiCA has guided as follows, which is in compliance with the guidance of the International Federation of Accountants.

According to Code of ethics for professional Accountants, there is no limit to the number of years that a client can retain an external auditor. However, “In respect of an audit of a public interest entity, an individual [auditor] shall not be a key audit partner for more than seven years. After such time, the individual [auditor] shall not be a member of the engagement team or be a key audit partner for the client for a further two years. During that period, the individual shall not participate in the audit of the entity, provide quality control for the engagement, consult with the engagement team or the client regarding technical or industry specific issues, transactions or events or otherwise directly influence the outcome of the engagement.”

The Code requires that for public interest clients, the key audit partner should be rotated after a pre-determined period of seven years, as a means to safeguard against the familiarity threat. After such time, the key audit partner shall not be a member of the engagement team or be a key audit partner for the client for two years. During that period, the individual shall not participate in the audit of the entity, provide quality control for the engagement, consult with the engagement team or the client

b) Advantages of compulsory rotation

The main argument in favour of compulsory rotation of audit firms is that it should work to eliminate the familiarity threat. By not only rotating the key partner, but the entire audit firm, it is argued that the auditor’s independence is not compromised, and that this adds credibility to auditors’ reports and to the profession as a whole.

It can also be argued that clients would benefit from a ‘fresh pair of eyes’ after a number of years. A new audit firm can offer different insights from a fresh point of view.

c) **Disadvantages of compulsory rotation.**

However, there are significant disadvantages to compulsory rotation of the audit firm. Firstly, from the audit firm’s perspective, there will be a loss of fee income when forced to resign as auditor.

Also, the firm may be unwilling to make investments that may increase the quality or efficiency of a particular audit (for example, investing in bespoke audit software for a client), as the rewards would only be in the short-term.

Audit effectiveness depends upon the audit firm’s accumulated knowledge of, and long-term experience with, the client’s operations and financial reporting issues. Compulsory rotation undermines this accumulation of knowledge and experience.

Audit problems are more likely to occur when the audit firm lacks this base. In the first few years auditors will know less about the client company and its management, and will be in a weaker position in making judgements about reporting issues. This severely detracts from the quality of the audit, and creates higher levels of risk exposure for the firm. Compulsory rotation of audit firms increases audit costs and creates significant practical problems. With each rotation, a new audit team must be brought up to speed on the client's operations and reporting issues, involving significant management time.

Systems will need to be documented and evaluated. The increase in costs is likely to be passed onto the client in the form of a higher audit fee.

Finally, from the client's perspective, as well as facing increased audit fees and a potential loss of audit quality, the periodic rotation of audit provider could be disruptive to the business.

On balance, it would seem that the disadvantages to both the audit firm and the client would outweigh the perceived benefits of compulsory rotation. The best safeguard to reduce familiarity threat is partner rotation, which allows the audit firm to continue in office, but avoids close relationships being built up.

5) With regard to reporting on Kadson Insurance

a) Importance of the concept of Key Audit Mattes (KAM)

The purpose of communicating KAM is to enhance the communicative value of the auditor's report as the key deliverable addressing the output of the audit process for users of audited financial statements. ZiCA recognizes the importance of the concept of KAM in the auditor's report to:

- Increase transparency on how the audit was performed and reporting on key audit matters is a means of achieving this;
- Focus users on areas in the financial statements that are subject to significant management judgment and significant auditor attention. This may assist the users to better understand the entity and financial statements as well as the outcome of the audit as reflected in the auditor's opinion;
- Provide users a basis to further engage with management and those in charged with governance, about certain matters related to the entity, the audited financial statements, or the performance of the audit;
- Renew auditor focus on matters to be communicated, which could indirectly result in an increase in professional skepticism, among other contributors to audit quality.

b) THREE examples of entities that may be included in this category

Considering the significance of Statutory bodies and Public Interest Entities (PIEs) in contributing to the national economy and their responsibility for maintaining and providing important functions that affect citizens, it is MANDATORY for all auditors of these entities to report on KAM in the auditor's report on financial statements as required under ISA 701.

For this purpose, statutory bodies are defined as all organisations created by an Act of Parliament or Cabinet Resolution with authority to check over other persons' actions.

For the purpose of this pronouncement, PIEs include:

1. All listed entities; and
2. Any entity:
    - Defined by regulation or legislation as a public interest entity; or
    - For which the audit is required by regulation or legislation to be conducted in compliance with the same independence requirements that apply to the audit of listed entities. Such regulation may be promulgated by any relevant regulator, including the Zambia Institute of Chartered Accountants as Zambia's audit regulator; and

3. Any entity that holds assets in a fiduciary capacity;

c) Appraisal of the report issued on Kadson Insurance for the year ended 31st March 2017

Format

- According to ISA 701, the format of the report should follow this sequence Opinion first, followed by basis of opinion followed by key audit matters. The proposed report is not in accordance with this format
- If the opinion is adverse, the opinion paragraph should read "adverse opinion" and the basis of opinion should read "basis for adverse opinion"

Language

- Stating that we believe the treatment is not in accordance with standards suggest that this is a matter of opinion on the part of the auditors instead of the requirements of the applicable reporting framework, including accounting standards
- The applicable standard should be stated in full – in this case – IAS 37, Provisions, Contingent Liabilities and Contingent Assets instead of just referring to IFRSs

Content

- The note should be identified by the relevant number, including the page number of the financial statements where appropriates
- The report should specify in what respects the accounting treatment does not comply with IFRSs – in this case the fact that there is no past obligating event as required by IAS 37

Appropriateness – Evaluation of matters arising

- Although the report state that profit has been understated and liabilities overstated, there is no assessment as to whether the error is material or pervasive, to provide a basis for the type of modified report to be issued.
- K3 million is about 6.5% of profit before tax and less than 1% of total assets. This misstatement may be considered material but not pervasive
- In the circumstances, a more appropriate opinion would be a qualified except for opinion

Basis of opinion

- According to ISA 701, the basis of opinion should be provided whether the opinion is modified or not and should include confirmation of ethical and independence position of the auditor

Key Audit Matters

- The report state that there are no key audit matters. In accordance with ISA 701, key audit matters include matters giving rise to an adverse opinion as well as the effect of new International Financial Reporting Standards (IFRSs). During the year Kadson Insurance adopted IFS 15 for the for the first time

- According to ISA 701, new accounting standards may be introduced by the International Accounting Standards Board (such as IFRS 15, *Revenue from Contracts with Customers)* that will involve a material change of accounting treatment. For example, IFRS 15 requires the application of a new framework in respect of revenue recognition, and hence the implementation of IFRS 15 may give rise to the new accounting requirements becoming a KAM as they will impact on the reporting entity's financial position and performance.

Signing of the audit report

- The report has only been signed and dated
- According to the ZiCA pronouncement on this matter, the Practitioner's signature should have: the personal name of the Practitioner; the practicing certificate number; and the name of the firm.

6) IEL

a) Procedures and action

- Inspect the latest correspondence with customers and discuss the implications with management. According to IAS 10, *Events after the Balance Sheet Date,* the intended non-renewal of contracts by customers is non-adjusting event as it does not provide any additional information relating to going concern.
- Re-compute and assess the impact of the reduction - A reduction of 60% would be considered both material and pervasive and should be disclosed.
- Given the significance of the matter, it also constitutes a condition which cast doubt over the going concern of the Group.
- Discussion should be held with management to determine that if Suarez Group is to still be regarded as a going concern, the following disclosures should be made:
    - That a material uncertainty exists
    - Description of the uncertainty and impact of going concern
    - Planned action to resolve the uncertainty

    - Review the disclosure to ensure that it is adequate in accordance with ISA 570

b) Reporting implications

Under ISA 570 (Revised), if the use of the going concern basis of accounting is appropriate but a material uncertainty exists and management have included adequate disclosures relating to the material uncertainties the auditor will continue to express an unmodified opinion, but the auditor must include a separate section under the heading 'Material Uncertainty Related to Going Concern' and:

- draw attention to the note in the financial statements that discloses the matters giving rise to the material uncertainty, and
- state that these events or conditions indicate that a material uncertainty exists which may cast significant doubt on the entity's ability to continue as a going concern and
- that the auditor's opinion is not modified in respect of the matter.