COMPETENCE PRACTICE EXAMINATION

AUDIT PRACTISING CERTIFICATE

DECEMBER 2020

TIME ALLOWED: 5 HOURS

INSTRUCTIONS TO CANDIDATES

1. This paper has Two Questions.

2. You are required to attempt ALL the two questions

3. Each question has Sections:
   Question one has two sections: A and B

   Question two has two sections: A and B

4. All the two questions carry equal marks.

5. The Examination is divided into sessions of $2^1/_2$ hours each. There will be a 30 Minutes break in between the sessions.

6. Please use your Membership number and your National Registration Card number on the front of the answer booklet. Your name must NOT appear anywhere on your answer booklet.

7. This is an open book examination.

QUESTION ONE

HBO & CO

Your name is Harry Mumbula and you are an audit manager in HBO & Co which is an international firm of Chartered Certified Accountants with branches in other parts of Zambia. The firm offers a range of audit and assurance services to its clients. Your responsibilities include reviewing ethical matters which arise with audit clients, and dealing with approaches from prospective audit clients.

You have received the following e-mail your senior partner, Mark Kombe

To	:	Harry Mumbula
Subject	:	Promotion to Senior manager

Harry,

As you are aware, a decision has been made by the firm to accelerate your promotion to senior manager. Accordingly, the firm has decided that your final assessment will be based on the performance of the audit engagements for the previous year and the current year. For the current year you are assigned to the following engagements:

1. **Zambia Steel Limited – Planning and Acceptance**
2. **Temwani Holdings - Audit strategy and Evidence Evaluation**
3. **Poyota Motors Limited - Reporting**

Good luck
MK

1. ZAMBIA STEEL LIMITED (ZS)

Background

Zambia Steel is an award winning steel manufacturer in Zambia which started operations in 2017. Since then, Zambia Steel has endeavoured to exceed customer expectations by offering sustainable solutions to the building construction and engineering industry.

The company has been awarded a Leadership in Energy and Environmental Design (LEED) certificate. The steel firm has also been recognized by the Zambia Bureau of Standards (ZBS) for its high quality products. The company produces a range of steel products such as Round and square bars, rectangular tubes, square tubes etc.

There are plans for the company to open plants in all towns along the line of rail, including exporting to regional countries. The expansion program is to be financed through bank loans

Invitation to tender for the audit

The management of Zambia Steel Co has invited HBO & Co to submit an audit proposal (tender document) for their consideration. Zambia Steel Co was established only two years ago, but has grown rapidly, and this will be the first year that an audit is required. In previous years a limited assurance review was performed on its financial statements by an unrelated audit firm.

Zambia Steel Co has limited staff in its finance department with only one accountant. An off-the-shelf accounting package is used to record transactions and to prepare financial information. The company has a financial year ending 30th September 2020.

The following comment was made by Engineer Barby Chushi, the company's founder and Chief Executive Officer, in relation to the audit proposal and potential audit fee:

'I am looking for a firm of auditors who will give me a competitive audit fee. I am hoping that the fee will be quite low, as I am willing to pay more for services that I consider more beneficial to the business, such as strategic advice. I would like the audit fee to be linked to Zambia Steel Co's success in expanding locally and regionally as a result of the audit firm's advice. Hopefully the audit will not be too disruptive and I would like it completed within four months of the year end.'

Draft Financial Statements - Extracts

	2020 (K'000)	**2019 (K'000)**
Sales	25,000	20,400
Cost of sales	17,000	11,550
Administration	2,500	1,500
Distribution	1,400	1,000
Total Assets	14,500	12,800

This is the first time that your firm will be associated with Zambia Steel.

Economic Out look

Global crude steel production decreased by 1.4% in the first 3 months of 2020 compared to the same period in the previous year. Although steel was declared an essential industry in several countries; including Zambia, demand for steel production has fallen sharply during the COVID-19 pandemic.

Many non-essential construction projects have been halted as a result of the COVID-19 outbreak which has also negatively affected demand for steel. The management of ZS are under pressure to sustain previous revenue levels, with Zambia at risk of degenerating into recession

Additionally, complex legislation has also been introduced to ensure that the quality of steel available in Zambia meets international standards

However, there are signs that China, the largest metal consumer in the world, is moving towards recovery with imports of semi-finished steel increasing over the last two months.

REQUIRED:

In relation to the bidding and planning of the audit of Zambia Steel

a) **Explain the specific matters to be included in the audit proposal (tender document), other than those relating to the audit fee; and** **(10 marks)**

b) **Assuming that HBO & Co is appointed to provide the audit service to Zambia Steel Co, discuss the issues to be considered by the audit firm in determining a fee for the audit including any ethical matters raised.** **(8 marks)**

c) **Identify and evaluate FIVE business risks for ZS** **(5 marks)**

d) **Identify and evaluate EIGHT audit risks related to ZS** **(16 marks)**

e) **Based on the results in (d) above**

i) **determine an appropriate level of planning and performance materiality** **(6 marks)**
ii) **Recommend and justify an appropriate audit strategy for ZS** **(5 marks)**

2. TEMWANI HOLDINGS

Temwani Holdings is a manufacturing company which supplies fibreglass components to a wide range of industries. The company's financial year ended on 31 July 2020 and you are reviewing the audit work which has been completed on a number of material balances and transactions: assets held for sale, capital expenditure and payroll expenses.

A summary of the audit strategy and the work which has been performed is given below and in each case the description of the audit work indicates the full extent of the audit procedures carried out by the audit team.

ISSUE AND AUDIT STRATEGY	WORK DONE
Issue: Assets held for sale Due to the planned disposal of one of Temwani Holdings's factory sites, the property and associated assets have been classified as held for sale in the financial statements. A manual journal has been posted by the finance director to reclassify the assets as current assets and to adjust the value of the assets for impairment and reversal of depreciation charged from the date at which the assets met the criteria to be classified as held for sale. **Audit Strategy**: Obtain sufficient appropriate evidence to obtain reasonable assurance that this has been accounted for in accordance with IFRS 5, *Non-Current Assets held for sale and Discontinued Operations*	✓ The finance director asked the audit senior to check the journal before it was posted on the basis of there being no one with the relevant knowledge to do this at Temwani Holdings. ✓ The planned disposal was discussed with management. A brief note has been put into the audit working papers stating that in management's opinion the accounting treatment to classify the factory as held for sale is correct. ✓ The manual journal has been arithmetically checked by a different member of the audit team, and the amounts agreed back to the non-current asset register

ISSUE AND AUDIT STRATEGY	WORK DONE
Issue: Capital Expenditure During the year, there were several items of property, plant and equipment acquired. All acquisitions were material **Audit Strategy**: As we have not relied on systems and controls in the audit area of capital acquisition, a risk based approach should be adopted as follows: ✓ Review the policies and procedures relating to capital acquisitions and update systems notes ✓ Test the effective operations of the procedures ✓ Obtain a sample of acquisitions during the year and confirm assertions as per the checklist for capital acquisitions	✓ When auditing the company's capital expenditure, the audit team selected a material transaction to test and found that key internal controls over capital expenditure were not operating effectively. ✓ Authorisation had not been obtained for an order placed for several vehicles, and appropriate segregation of duties over initiating and processing the transaction was not maintained. ✓ Management suggested that the auditors should are expected to share some responsibility relating to the detection and prevention of fraud and error ✓ The audit team noted details of the internal control deficiencies and updated the systems notes on the permanent audit file to reflect the deficiencies. ✓ The audit work completed on this order was to agree the purchase of the vehicles to purchase invoices and to the cash book and bank statement.

ISSUE AND AUDIT STRATEGY	WORK DONE
Issue: Payroll Expense The payroll function is outsourced to Dove Processing, a service organisation which processes all of Temwani Holdings's salary expenses. Temwani Holdings employs a few casual workers who are paid in cash at the end of each month and are not entered into the payroll system. **Audit Strategy**: ✓ Review and test the control environment at Dove Processing to determine extent of reliance on the system ✓ Perform substantive procedures to obtain reasonable assurance that payroll expense is not overstated ✓ For the cash payment, consider attending the payment processes to observe and confirm existence of casual workers	✓ The payroll expenses recognised in the financial statements have been traced back to year-end reports issued by Dove Processing. ✓ The audit team has had no direct contact with Dove Processing as the year-end reports were sent to Temwani Holdings's finance director who then passed them to the audit team. The management of Dove processing refused for the auditors to review the systems as some of the aspects of the system and information were considered confidential, even after getting the management of Temwani Holdings to intervene ✓ For the casual workers, the audit team has agreed the cash payment made back to the petty cash records and the amounts involved are considered immaterial. Therefore, other procedures were not considered necessary

REQUIRED:

In respect of each of the three matters described above:

a) **Identify and evaluate ethical and other professional issues arising** **(6 marks)**

b) **Comment on the sufficiency and appropriateness of the audit evidence obtained; (10 marks)**

c) **Recommend further audit procedures to be performed by the audit team** **(9 marks)**

QUESTION TWO

Your name is Maambo Maambo (MM) and you are the audit manager in GDM Chartered Accountants with four offices in the country and a total number of six partners.

You have just attended a management meeting in which the senior partner expressed concern over the quality of audits that have been carried out recently. This is as a result of the ZiCA reviews which highlighted a number of areas for improvement, including

- Quality control policies and procedures
- Planning and risk assessment
- Reporting to the shareholders
- Reporting to those charged with governance

For the 2020 audits, you have been assigned to the following assignments

- **Earthmovers Equipment Limited (EEL)– Risk assessment and quality control**
- **Patriotic Construction Ltd (PCL) – Reporting to shareholders**
- **Tata Holdings plc (THplc)- Reporting to those charged with governance**

EARTHMOVERS EQUIPMENT LIMITED (EEL)

EEL is one of your recently acquired clients. EEL is based in Solwezi and the company supplies earthmoving equipment largely to the mines. The company imports heavy equipment spares and assembles heavy duty equipment at its assembly in Solwezi.

You are currently planning the audit of the financial statements for the year ended 31st October 2020.

Your firm was appointed as auditor of EEL in June 2020

The following figures were extracted from the financial statements of EEL

	2020 (K'million)	**2019 (K'million)**
Revenue	673,750	555,170
Warranty provision	13,475	12,936
Profit before tax	30,184	27,489

EEL assembles equipment for its customers on receipt of a single contract from the customer. On average it takes the company three months to finish assembling each unit. The company does not to stock finished equipment which has no customer and therefore, has a policy that on signing the contract of sale, the customer makes a 50% down payment and the balance is due one month after delivery of the equipment. The company raises sales invoices for the initial deposit amount received and a final invoice is raised at the time of delivery.

Contracts with Customers

When equipment is sold to customers, it is supplied with a one-year warranty. A warranty has been recognised in the statement of financial position amounting to K13,475m. The warranty provision is computed based on the sales made during the year and based on previous experience of claims made by customers

At 31 October 2020, there is an amount outstanding of K2,430m from Kariba Mines, one of the customers of EEL. This amount is in relation to the final payment after delivery of the equipment. The mine has refused to pay this amount because the equipment supplied did not meet the specification requested by the mine and was not performing according to expectation.

Mulyashi Mine another one of EEL's customers lodged a claim of K2,190m in September 2020 against the company for an accident involving equipment recently supplied to it which resulted in the injury of the operator. Investigations conducted by Mulyashi Mine suggest that the accident was a result of poor workmanship on the part of the EEL. You have been told by the Chief Executive of EEL that they have not made any provision for damage because this claim is the first time that Mulyashi Mine has had an accident

Joint Venture

EEL sells equipment to another company, Nshimbi Light Equipment, which EEL jointly controls with another entity. As at 31st October 2020, a total value of K121m was due from Nshimbi Light Equipment Ltd and this amount is included in the receivables figure and there is no other mention of this amount anywhere in the financial statements

Payables and inventories

At the end of the year, the company owed a foreign supplier for parts and components that it had ordered and not yet paid for. The amount owing and payable is $1.5m and the liability is included in payables at the Kwacha equivalent of the original invoice value converted at the exchange rate on the date of receipt of spares three months earlier

The company holds large quantities of spares and components used in the assembly of equipment. The inventory count of the materials was conducted on 24th October. The book record of inventory value at the 31st October was used as the closing inventory value in the financial statements of EEE as at 31st October 2020

On 31st October, EEE also had equipment being assembled and this is classified as work-in-progress. The valuation of work-in-progress is undertaken by the Chief Engineer of EEL

Annual General Meeting – 5th December 2020

The reporting timetable for the audit of financial statements is tight and the Chief Executive of EEL has indicated that GDM should finalise the audit by 28 November as the Annual General Meeting is scheduled for 5th December 2020. You feel this is a very tight timetable especially in view of the fact that this the first year to audit EEL

REQUIRED

a) **Discuss the reason why your firm should concern itself with risk before undertaking the audit of the financial statements of EEL** **(6 marks)**

b) **Using the information provided about EEEL, identify and explain the principal audit risks and any other matters to be considered when planning the final audit for EEL for the year ended 31 October 2020** **(16 marks)**

c) **Explain the audit procedures to be performed during the final audit in respect of the estimated warranty provision in the statement of financial position of EEL as at 31st October 2020** **(6 marks)**

d) **Identify and describe SIX quality control procedures that should be applied to the audit of EEL** **(12 marks)**

e) **With regard to related parties**

   i) **Discuss why the identification of related parties, and material related party transactions can be difficult for your firm** **(4 marks)**

   ii) **Recommend SIX audit procedures to be performed by your firm in relation to related parties and transactions** **(6 marks)**

PATRIOTIC CONSTRUCTION LIMITED (PCL)

PCL is based in Lusaka and is involved in the purchase and sale of building materials and the construction of housing complexes for companies and housing units for individuals. It sources its building materials locally and these are stored at centralised strategic locations in New Kasama, Chalala and Matero. The company's year end is 30th September 2020

The audit of PCL is nearing completion and the audit senior has submitted the working papers for your review and at your request, they have also suggested the impact of the following matters on the audit report

a) Building materials held for sale at Chalala

PCL planned to conduct a physical inventory count on 30th September 2020 for the building materials held at Chalala. These building materials are for sale

On 27th September, an electrical fault in the warehouse caused a fire which destroyed 40% of the inventory, together with all the inventory records. PCL could not reliably determine the value of the remaining inventory as all cost records were destroyed and they could only estimate inventory values based on selling prices and profit margins for each type of building material.

The audit senior stated that he was not able to obtain any reliable evidence on the value of inventory which he considered material to the financial statements

The audit senior has recommended that a qualified audit opinion should be issued with emphasis of matter

b) PHI Ltd

One of PCL customers, PHI Ltd, went into liquidation in mid-November. At a meeting of creditors for PHI Ltd, the liquidator Brant Thornton announced that all payables would only get 20% of the amounts that PHI Ltd owes.

PCL refused to amend the receivables figure arguing that as at the period end, PHI Ltd owed PCL the amount outstanding. 20% of the amount owing is considered material but not pervasive

The audit senior agreed with the accounting treatment of PCL and recommended that an unmodified audit opinion should be issued

c) Housing units included at cost

At the year end, the PCL has a large number of unsold housing units. Due to the onset of COVID-19, the level of expected orders and sales for housing units had dropped drastically between March 2020 and September 2020. In the same vein, the purchasing power for most households has been eroded significantly. PCL would be very fortunate to recover the cost of constructing the housing units.

During the audit, it was established that PCL valued its entire inventory at cost. Any potential write downs would be considered material and not pervasive

The audit senior has recommended that the audit opinion should be modified by way of a disclaimer of opinion

d) Housing units included in tangible non-current assets

During the audit, it was established that the value of eight housing units constructed for resale were included in tangible non-current assets instead of inventory. The value of these housing units represent 80% of the total assets. The value of the housing units is considered both material and pervasive

The audit senior has recommended that a qualified opinion be issued clearly stating that except for the value of the eight housing units, the financial statements show a true and fair view.

REQUIRED
ISA 705 (Revised) Modifications to the opinion in the independent auditor's report gives guidance to the auditor when issuing a modified opinion

Comment on the suitability of the recommended audit report implications for each of the following matters

a)	**Building materials for sale at Chalala**	**(5 marks)**
b)	**PHI Ltd**	**(5 marks)**
c)	**Housing units included at cost**	**(5 marks)**
d)	**Housing units included in tangible non-current assets**	**(5 marks)**

TATA HOLDINGS plc (TH plc)

You and the engagement partner have been involved in the audit of TH plc for the last five years. TH plc is one of your more significant clients and contributes about 9% of your firm's total recurring fees

TH plc, which is a listed entity on the Lusaka Stock exchange (LUSE), operates in distribution, supply chain and logistics management and is headquartered in Livingstone. TH plc's strategy is to strengthen its market share and grow revenue in a sustainable manner by expansion into emerging markets within the region. There are three main business divisions: post and parcel delivery, commercial freight and supply chain management, each of which historically has provided approximately one-third of TH plc's revenue.

Innovation

TH plc has invested in automating its warehousing facilities, and while it still employs more than 250 staff, many manual warehouse jobs are now performed by robots. 45 staff were made redundant early in this financial year due to automation of their work. Other innovations include increased use of automated loading and unloading of vehicles, and improvements in the technology used to monitor and manage inventory levels.

Integrated reporting

TH plc is proud of this innovation and is keen to highlight these technological developments in its integrated report. TH plc audit committee has appointed the finance director to lead a project tasked with producing TH plc's first integrated report. The finance director has sent the following request to the audit engagement partner:

'We would like your firm to assist us in developing our integrated report, and to provide assurance on it, as we believe this will enhance the credibility of the information it contains. Specifically, we would like your input into the choice of key performance indicators which should be presented, how to present them, and how they should be reconciled, where relevant, to financial information from the audited financial statements.'

The publication of an integrated report is not a requirement in Zambia, but there is a growing pressure from the Lusaka Stock Exchange and others stakeholders for an integrated report to be produced by listed reporting entities.

If GDM accepts the engagement in relation to TH plc's integrated report, the work would be performed by a team separate from the audit team.

Matters arising during the audit:

a) **Modified opinion**

The operations of TH plc have been adversely affected by the Covid-19 pandemic with revenue levels reduced by 20% and expected to reduce further. This required a review of various balances:

- Receivables for impairment
- Inventories for net realisable value
- Non-current assets for impairment – newly installed equipment is highly specialised

As management is not willing to undertake these reviews, your firm expects to issue a modified report, given the expected significance of resulting adjustments

b) **New accounting standards and policies**

TH plc has adopted fair value model for its investment properties and property, plant and equipment and has implemented International Financial Reporting Standards 13, *Fair Value Measurement* (IFRS 13) in full

c) **Deficiencies in internal control**

During the audit, the audit team came across several instances where there were no supporting documents for certain transactions such as imported equipment. Similar matters have been raised in previous audits with no apparent improvement

REQUIRED

a) In relation to the request to assist with the development of the integrated report

i) Identify and evaluate potential ethical matters arising (8 marks)

ii) Recommend the action that your firm should take (4 marks

b) Based on matters arising during the audit recommend and justify the matters that should be included in the report to those charged with governance for TH plc (10 marks)

c) Given that you expect the audit opinion on THL will be modified, comment on further matters that your firm should consider in continuing with a professional relationship with TH plc (6 marks)

d) Explain the difference between the report to those charged with governance and Key Audit Matters (2 marks)

3. POYOTA MOTORS LIMITED

Poyota Motors is a family owned, unlisted company which imports motor cars. The company buys cars from a variety of car manufacturers for sale to car dealerships and vehicle leasing companies within Zambia. Poyota Motors has been a client of your firm for the last three years. The company's year-end is 31 August 2020. The audit for the current reporting period is nearing completion and you are reviewing the working papers of the going concern section of the audit file.

Extracts from the draft financial statements and other relevant information are given below. Statement of financial position

	31 August 2020 Draft K million	31 August 2019 Actual K million
Assets		
Non-current assets		
Property, plant and equipment	13·5	14·6
	13·5	14·6
Current assets		
- Inventory	5·8	3·7
- Trade receivables	3·7	2·6
- Cash at bank and in hand	–	0·6
	9·5	6·9
Total assets	**23·0**	**21·5**

Equity and liabilities		
Equity		
Share capital	1·0	1·0
Retained earnings	1·3	4·7
	2·3	5·7
Non-current liabilities		
Long-term borrowings	11·2	12·4
Provisions	3·5	0·5
	14·7	12·9
Current liabilities		
Trade payables	4·2	2·9
Bank overdraft	1·8	–
	6·0	2·9
Total equity and liabilities	23·0	21·5

Statement of profit or loss for the year

	31 August 2020 Draft K million	**31 August 2019 Actual K million**
Revenue	11·3	8·8
Cost of sales	(4·4)	(2·9)
Gross profit	6·9	5·9
Other operating expenses	(9·1)	(1·3)
Operating (Loss) /profit	(2·2)	4·6
Finance costs	(1·5)	(0·7)
(Los) /profit before taxation	(3·7)	3·9
Taxation	0·3	(1·3)
Net (loss)/profit for year	(3·4)	2·6

You have also ascertained the following information during your review:

1. Poyota Motors has undergone a period of rapid expansion in recent years and is intending to buy new warehousing facilities in January 2021 at a cost of K4·3 million.

2. In order to finance the new warehousing facilities, the company is in the process of negotiating new finance from its bankers, ABBSA. The loan application is for an amount of K5 million and is to be repaid over a period of four years.

3. The provision of K3·5 million in this year's statement of financial position relates to legal actions from five of Poyota Motors's largest customers. The actions relate to the claim that the company has sold cars which did not comply with Zambia's Carbon print regulations.

4. A major new competitor has moved in to Poyota Motors's market in October 2020.

5. The going- concern working papers include a cash flow forecast for the 12 months ending 31 August 2021. The cash flow forecast assumes that Poyota Motors's revenue will increase by 25% next year and that following the reorganisation of its credit control facility, its customers will pay on average after 60 days. The forecast also assumes that the bank will provide the new finance in January 2021 and that the company will have a positive cash balance of K1·7 million by 31 August 2021.

6. The financial statements have been prepared on a going concern basis. A disclosure note has been included in the financial statements making reference to the significant and pervasive uncertainties in relation to going concern.

REQUIRED:

In relation to the audit finalisation of Poyota Motors:

(a) Evaluate the matters which may cast doubt on Poyota Motors's ability to continue as a going concern. Use analytical review where appropriate (10 marks)

(b) Explain the audit evidence in respect of the cash flow forecast which you would expect to find in your review of the audit working papers on going concern. (9 marks)

(c) Comment on the possible implications for the auditor's report assuming that:
i) You are not satisfied with the disclosure note relating to going concern (3 marks)
ii) You are satisfied with the disclosure note relating to going concern (3 marks)
(Total 25 marks)

ZiCA
Competence, Integrity and Virtue
Zambia Institute of Chartered Accountants

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SUGGESTED SOLUTIONS

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QUESTION ONE

HBO & CO

a) Matters to be included in the audit proposal

Outline of HBO & Co
A brief outline of the audit firm, including a description of different services offered, and an outline of the firm's international locations. This will be important to Zambia Steel given that it wishes to expand into overseas markets and will be looking for an audit firm with experience in different countries. The document should also outline the range of services which HBO & Co can provide, and any specialism which the firm has in auditing companies in the steel industry

Identify the audit requirements of Zambia Steel
There should be an outline of the statutory audit requirement in Zambia, to confirm that the company is now at the size which necessitates a full audit of the financial statements. As this is the first time an audit is required, it will be important to outline the regulatory framework and the duties of auditors and of management in relation to the audit requirement.

Audit approach
A description of the proposed audit approach, outlining the stages of the audit process and the audit methodology used by the firm should be given. The description should state that the audit will be conducted in accordance with ISA requirements. HBO & Co should emphasise the need for thorough testing of opening balances and comparatives given that this is the first year that the financial statements will be audited. The risk-based nature of the audit methodology should be explained, and that it will involve an assessment of accounting systems and internal controls. Controls may not be good given the limited resources of the accounting function, so the audit approach is likely to be substantive in nature.

The audit firm may at this stage wish to explain that while the audit should not be 'disruptive', the audit team will require some input from Zambia Steel's employees, especially the accountant, and other personnel including Barby. The employees may need to make themselves available to respond to the audit firm's requests for information and to discuss matters relating to the audit. The proposal should outline the various communications which will be made with those charged with governance during the audit process, and highlight the value added from such communications, for example, recommendations on any control deficiencies.

Deadlines
The audit firm should clarify the timescale to be used for the audit. Barby has requested that the audit is completed within four months of the year end. This seems to be reasonable; it should be possible for the audit of a relatively small company with simple transactions and a full-time accountant to be completed within that timeframe.

Quality control and ethics
HBO & Co should clarify its adherence to IESBA's Code of Ethics for Professional Accountants, and to International Standards on Quality Control. This should provide assurance that the audit firm will provide an unbiased and credible audit report. This may be important for the venture capitalists who will wish to gain assurance on the financial information which they are provided with in relation to their investment.

Additional non-audit and assurance services
The audit proposal should describe the various non-audit and assurance related services which HBO & Co would be able to offer Zambia Steel. These may include, for example, business consultancy and

corporate finance advice on regional expansion and obtaining any necessary additional funding to help the planned regional expansion. This discussion should clearly state and emphasise that the provision of such services is subject to meeting ethical requirements and will be completely separate from the audit service.

b) Matters to be considered in determining the audit fee and ethical matters

Audit fee

HBO & Co needs to consider a number of matters in determining the audit fee.

ZiCA guidelines
The firm should ensure that the guidelines issued by the Zambia Institute of Chartered Accountants are complied with

Commercial considerations – fee structure
The commercial need for the firm to make a profit from providing the audit service needs to be considered alongside the client's expectations about the fee level and how it has been arrived at.

First, the audit firm should consider the costs of providing the audit service. This will include primarily the costs of the audit team, so the firm will need to assess the number and seniority of audit team members who will be involved, and the amount of time that they will spend on the audit.

There may be the need for auditor's experts to be engaged, and the costs of this should be included if necessary. HBO & Co will have standard charge out rates which are used when determining an audit fee and these should be used to estimate the total fee. Other costs such as travel costs should also be considered.

Ethical Matters

Client expectations – quality control considerations
Barby Chushi has made some comments in relation to the audit fee which have ethical and other implications.

First, he wants the audit fee to be low, and says that he is willing to pay more for other services. One of the problems of a low audit fee is that it can affect audit quality, as the audit firm could be tempted to cut corners and save time in order to minimise the costs of the audit.

Offering an unrealistically low audit fee which is below market rate in order to win or retain an audit client is known as lowballing, and while this practice is not prohibited, the client must not be misled about the amount of work which will be performed and the outputs of the audit. The issue for the client is that an unrealistically low audit fee is unlikely to be sustainable in the long run, leading to unwelcome fee increases in subsequent years.

Contingency fees
The second issue is that Barby Chushi has suggested that the audit fee should be linked to the success of the company's regional expansion program, on which he wants the audit firm to provide advice. This would mean that the audit fee is being determined on a contingent fee basis. IESBA's Code of Ethics for Professional Accountants defines contingent fees as fees calculated on a predetermined basis relating to the outcome of a transaction or the result of the services performed by the firm.

The Code states that a contingent fee charged by a firm in respect of an audit engagement creates a self-interest threat which is so significant that no safeguards could reduce the threat to an acceptable level. Accordingly, a firm shall not enter into any such fee arrangement.

HBO & Co should explain to Barby Chushi that the audit fee will be determined by the level of audit work which needs to be performed, and cannot be in any way linked to the success of Zambia Steel or advice which may be given to the firm by its auditors. The fee will be determined by the grade of staff who make up the audit team and the time spent by each of them on the audit.

c) FIVE business risk for ZS

i) Going concern - Recession

The recession seems to have affected the profitability of ZS. As per analytical review **(Appendix 1)** below, even though sales have increased, the increase in costs is relatively higher. If the recession persists and the downward trend of profitability continues, this would affect the going concern of ZS. This is compounded by the experienced fall in demand

ii) Demand

Fall in demand will make it difficult to achieve objectives relating to increase in market share and related profitability.

iii) Complex legislation

Existence complex legislation makes it likely that ZS may fail to comply resulting in fines and penalties and possibly revocation of licensing requirements

iv) **Rapid Expansion – Overtrading**

The company has expanded rapidly and seems to be showing signs of overtrading. In the light of recent adverse developments, management may fail to sustain this rapid growth

v) Financing

The growth is to be funded through bank loans. With the recession and fall in demand, ZS is at risk of failing to repay the loan and may be forced into receivership

d) **AUDIT risks for ZS**

1) New and complex legislation – IAS 37

This may result in fines and penalties which should be provided in accordance with *IAS 37, provisions, contingent liabilities and contingent assets.* There is a risk that the non-compliance is not assessed for possible provisions

2) Inventories – IAS 2

The fall in demand will affect sales resulting in more inventories being held. According to *IAS 2, I*nventories, inventories should be valued at the lower of cost and net realisable value (NRV). In times of falling demand, it is more likely that NRV will be lower than cost. If this is not taken into account, the inventories will be overstated

3) Plant and Equipment – IAS 36

Fall demand will result in machinery not being used at the expected level of capacity. According to *IAS 36, Impairment* – this is an indication of impairment that should be necessitate an impairment review. If this is not done, plant and equipment may be overstated

4) **Pressure to sustain revenue levels – IFRS 15**
Management is under pressure to sustain revenue levels. They may overstate revenue through misapplication of cut off and such procedures. Revenue should only be recognised in accordance with *IFRS 15 – Revenue from contracts with customers*

Analytical review – see below – Appendix 1

5) Higher increase in cost of sales compared to increase in revenue, Higher increase in administration costs

These costs have increase relatively higher compared to other items of cost and expenditure. It is possible that there could be misallocation of expenditure resulting in misstatements

6) **Fall in gross and operating margins**
The fall in gross and operating margins- perhaps occasioned by the recession and related fall in demand may threaten the going concern ZS

Detection risk is the risk that the procedures performed by the auditor to reduce audit risk to an acceptably low level will not detect a misstatement that exists that could be material. For ZS these include:

7) ZS has insisted that the audit should be completed within four months of the year-end. This may to put pressure on the auditor and may affect quality of work

8) This is the first time the firm is auditing Zambia Steel. The auditor will need to spend more time to understand the business and its environment. It should be expected that the level of knowledge can only improve over time

9) New and complex legislation has been introduced in the steel industry – This places further pressure on the auditor to identify and assess the risk implications of the new legislation

e) Materiality

i) Determining planning and performance materiality

	(K'000)	2020		
			0.50%	**1.00%**
Sales		25,000	**125.00**	**250.00**
Cost of sales		17,000		

		8,000		
Administration		2,500		
Distribution		1,400		
		-----------	5.00%	10.00%
Operating profit		4,100	**205.00**	**410.00**
			1.00%	2.00%
Total Assets		14,500	**145.00**	**290.00**

Planning materiality

A matter is considered material if its omission or misstatement is likely to affect the decisions of users taken on the basis of the financial statements. It is unlikely that auditors will be able to design tests to identify individual material misstatements. It is much more common that misstatements are combined in aggregate. For this reason, auditors work with what is called a performance materiality

As the risk profile for ZS is high because of it being a new audit and other financial statement risks of material misstatement, the materiality is to be set at relatively lower amount. In this case the lowest parameter being K125,000 (1/2 % of sales) will be set as planning materiality

Performance can then be set at 75% of planning materiality, i.e. 94,000

ii) Audit strategy for ZS

An audit strategy is the overall audit approach based on the understanding of the entity and the ensuing risk assessment process. Typical strategies include the systems approach, substantive approach and the risk based approach. According to ISA 300, the auditor should develop and document an overall audit strategy describing the expected scope and content of the audit and sufficiently detailed to guide the development of the audit program.

A systems based would be justified on the basis that internal controls systems have been tested and confirmed to be operating effectively and throughout the accounting period. On the other hand, a substantive approach is where all transactions and balanced are subjected to detailed testing regardless of the risks involved

Given the high risk profile of ZS, a risk based audit strategy should be considered more appropriate where the auditor will focus on designing appropriate procedures that reduce potential misstatements arising from the risks identified

Appendix 1

ANALYTICAL REVIEW
(‘000)

	2020	**2019**		**2020**	**2019**	
Sales	25,000	20,400	Sales increase	23%		
Cost of sales	17,000	11,550	Cost of sales increase	47%		
	8,000	8,850	Gross margin	32%	43%	Decreased by 11%
Administration	2,500	1,500	Increase	67 %		
Distribution	1,400	1,000	Increase	40%		
Operating profit	4,100	6,350	Operating margin	16%	31%	Decrease by 15%
Total Assets	14,500	12,800				

QUESTION TWO – TEMWANI HOLDINGS

Assets held for sale

a) Ethical and Other professional issues arising

The finance director asked the audit senior to check the journal before being posted. This gives rise to the following threats

Self-review threat
As the audit senior is involved in the audit, this poses a self-review threat as it amounts to the provision of accounting services

Management threat
Authorising a journal of a client may be seen as the auditor performing a management function. The finance director should be advised of their responsibility to authorise transactions.

Fraud and Error
The fact that there is no one in Temwani Holdings to deal with an IFRS 5 transactions implies that they may be other errors in other transactions and balances, requiring the auditor to approach the audit with heightened level of professional scepticism

The threat associated with the request cannot be mitigated against. Accordingly, the audit senior should politely decline the request to check the journal being posted

b) Audit evidence obtained

The evidence does not appear to be sufficient to draw a conclusion on the appropriateness of classifying the property and any other related assets and liabilities as held for sale. A discussion with management regarding the accounting treatment is relevant, as the audit team will need to understand management's rationale. However, management's explanation should not be accepted at face value and should be corroborated through further audit procedures. It is not sufficient to simply put management's justification for the accounting treatment on the audit file and conclude that it is correct. For example, the factory can only be classified as held for sale if it is available for immediate sale in its current condition, which may not be the case. In terms of the manual journal, checking that it is arithmetically correct, while relevant, is not sufficient evidence.

Further evidence should be obtained in order to conclude that the basis of the calculation is in accordance with *IFRS 5 Non-current Assets Held for Sale and Discontinued Operations* and there should be consideration as to whether other requirements of the standard other than those related to the reclassification and measurement of the asset have been complied with. For example, the results specific to the factory may need to be disclosed as a discontinued operation in the statement of profit or loss and the statement of cash flows.

No audit evidence appears to have been obtained in respect of these issues.

c) Further audit procedures

- Review board minutes to confirm that the sale of the factory has been approved and to agree the date of the approval to the board minutes and relevant staff announcements.
- Obtain correspondence with estate agents to confirm that the factory is being actively marketed.
- Obtain confirmation, for example, by a review of production schedules, inventory movement records and payroll records, that production at the factory has stopped and thus it is available for immediate sale.

– Use an auditor's expert to confirm the fair value of the property and agree that this figure has been used in the impairment calculation.
– Using management accounts, determine whether the factory is a separate major line of business in which case its results should be disclosed as a discontinued operation.

Capital expenditure

a) Ethical and other professional issues

Responsibility towards detection of fraud and error

The statement that the auditor should share the responsibility towards fraud error may lead to a management threat. It should be emphasised to management that it is their responsibility to put in place appropriate policies and procedures to prevent and detect fraud.

The auditor's responsibility is to plan the audit to detect material misstatements arising from fraud or error. Where fraud or error is suspected, the auditor is excepted to exercise due care and professional scepticism, including bringing this to the attention of management

b) Audit work performed

The audit work has revealed that internal controls have not been operating and this should have led to more extensive testing of capital expenditure, rather than the audit programme being completed as planned. Generally, the audit team should extend audit testing on capital expenditure, for example, by extending sample testing and reducing the level of materiality applied in audit tests.

The audit team should also investigate why the controls are not operating, considering whether they are being deliberately ignored or overridden, whether time pressure or lack of resources is making the controls difficult to operate, or if there is a suspicion of collusion and possible fraud.

The procedures on the purchase of the vehicles do not appear to cover all relevant assertions, for example, there is nothing to confirm that Temwani Holdings has correctly depreciated the vehicles or that they are actually owned and being used by the company, or even that they exist.

c) Further audit procedures

- Obtain the insurance documents to confirm that Temwani Holdings is paying the relevant insurance for the vehicles.
- Physically verify the vehicles and confirm that they are being used by employees on company business.
- Obtain the log book/vehicle registration document and other relevant ownership documents such as those issued by the vehicle licensing body, to confirm the right of Temwani Holdings to recognise the vehicles.
- Trace the vehicles to the company's non-current asset register.
- Recalculate the depreciation which should have been charged on the vehicles and agree to the statement of profit or loss for the year.

Payroll

a) Ethical and other professional issues

Refusal to review systems at Dove Processing constitutes a limitation of scope and this should be discussed with management, including highlighting the implications for the audit.

If the payroll expense is considered material, this would lead to a qualified, except for option and a disclaimer if the payroll expense is considered pervasive

Additionally, the integrity of Dove Processing and Temwani Holdings may be questioned as the rules of confidentiality do not apply to the auditor who is supposed to have the right to access all information and documents that they consider necessary for their audit

The firm may be advised to consider whether it should continue this professional relationship with Temwani Holdings

b) Audit work performed

The audit work in respect of the payroll needs to be much more thorough; simply agreeing the amounts to the reports issued by Dove Processing provides no evidence on the completeness, accuracy or validity of the payroll figures recognised in the financial statements.

The audit team seems to have relied on Dove Processing's year-end reports as being accurate and the requirements of *ISA 402 Audit Considerations Relating to an Entity Using a Service Organisation* do not appear to have been followed.

The audit team needs to obtain assurance on the controls which Dove Processing has implemented in order to assess the risk of material misstatement in the payroll figures and to respond to the risk with appropriate audit procedures. The controls which Temwani Holdings uses to verify the information received from Dove Processing also need to be understood. With the permission of Temwani Holdings, the audit team should contact Dove Processing with the objective of obtaining more information which can be used to assess how the payroll has been processed, and the controls which are in place. The controls in place at Temwani Holdings should be documented and tested.

It is recommended that further substantive procedures should be carried out to provide a wider range of evidence on the payroll expense recognised in the financial statements.

In relation to the casual employees, the fact that the amount involved is immaterial means that the audit team does not need to perform any further detailed audit procedures as there is no risk of material misstatement. However, as there is a risk over the completeness of these costs, the controls in place to ensure this process is effectively managed should be discussed with management and documented.

c) Further audit procedures

- Review the service agreement between Temwani Holdings and Dove Processing to understand the exact work which is conducted by Dove Processing as a service organisation.
- Read all reports made by Dove Processing during the year to identify any risks of misstatement in the payroll figure.
- Discuss and document relevant controls in place at Temwani Holdings over the information received from Dove Processing and the management of casual employees, and perform tests of controls on a sample basis.

- The amount of unpaid taxes in respect of the casual workers should be quantified by recalculations of the amounts due.
- Read any user manuals or systems overviews to assess the efficacy of controls in place over the processing of payroll.
- If necessary, obtain a type 1 or type 2 report from Dove Processing to obtain further assurance on the controls which the service organisation has in place.
- Perform a substantive analytical review on payroll, preparing an auditor's expectation of the payroll figures and comparing it to that recognised in the financial statements and discussing any variance with management.
- Perform test of detail by selecting a sample from the payroll records and agreeing the amounts to payslips and HR records.

QUESTION THREE

POYOTA MOTORS

a) Going concern indicators

There are a range of matters which cast doubt on Poyota Motors' ability to continue as a going concern. In particular, the company appears to be exhibiting many of the indicators of a business which is overtrading.

Revenue and profitability

Poyota Motors has experienced a significant increase in revenue of 28·4% which may not be sustainable in the short to medium term without additional external sources of finance. The company is also experiencing a significant decline in its operating profit margin and net profit margin. It is notable that even after taking account of the provision, other operating expenses have increased by more than 4·3 times ((9·1 – 3·5)/1·3) resulting in an overall loss of K3·4 million in the current reporting period. It is possible that the company has had to reduce its selling prices in order to achieve the high level of sales growth and that this has resulted in a negative net profit margin this year of (30·1%).

Liquidity and working capital

Poyota Motors has also suffered a decline in liquidity as evidenced by a fall in its current ratio from 2·4 to 1·6 and in its acid test ratio from 1·1 to 0·6. A review of the company's working capital ratios indicates long and worsening inventory holding periods (481 days in 2020 compared to 466 days in 2019) and overall inventory has increased by 57% which may be indicative of problems in relation to the saleability of inventory which is in breach of domestic regulations.

The company is currently taking on average 120 days to collect its trade debts (108 days in 2019) and requires an average of 348 days in 2020 (365 days in 2019) to pay its trade payables. Although this is a fall in the average payment period compared to the prior year, it still appears to be a long period which may be related to ongoing payment disputes in relation to the regulatory breaches noted previously.

Overall, trade payables have increased by 44·8% on the prior year and the company may struggle to settle this liability given its worsening cash position, which may in turn result in a loss of goodwill with its suppliers and a refusal to supply or to withdraw credit in the future which would severely restrict the company's operations.

The poor working capital management and declining liquidity have resulted in Poyota Motors's cash position deteriorating from a positive position of K0·6 million in 2019 to an overdraft of K1·8 million in 2020 which is significant at 7·8% of total assets.

Gearing and finance

In addition to problems with short-term finance and liquidity, Poyota Motors is also exhibiting a significant increase in gearing as evidenced by the increase in debt to equity from 2·3 in 2019 to 6·4 in 2020 and a fall in interest cover from 6·6 times to (1·5) times over the same period, indicating that the business is unable to service its current levels of finance.

The company's finance costs as a percentage of long-term borrowings have increased from 5·6% in 2019 to 13·4% in 2020. This may be due at least in part to the interest on the overdraft proving to be an expensive way of financing the entity's operations and if the overdraft has not been agreed with the bank, the company may be incurring additional penalties and charges thereby putting additional strain on the company's cash flows. The increasing finance costs may also reflect lenders already perceiving Poyota Motors to be a high credit risk. It is also notable that non-current assets have decreased by 7·5% this year which suggests that the business is also struggling to replace and renew its existing capital expenditure levels. If this is the case, it may cast further doubt on the feasibility of the planned expansion of its operations.

Legal claim

Given Poyota Motors's current financial position, it seems unlikely that the business will be able to settle the legal claim of K3·5 million which threatens to place severe demands on the company's cash flow. Indeed, if there is a prospect of more claims arising in the future, the problems with the saleability of inventory and management of working capital as a result of the regulatory breaches discussed earlier may worsen further leading to a greater deterioration in the company's cash flow position.

Cash flow forecast

Overall, Poyota Motors's ability to continue to trade appears to be dependent on obtaining the new bank finance which it has assumed in its cash flow forecast. The bank financing is needed to meet existing liabilities and it is doubtful whether sufficient funding will be available in order to finance the proposed expansion. Moreover, the forecast itself appears to be unrealistic in its other assumptions. In particular, the assumption that the business's revenue will grow by 25% seems optimistic given the arrival of a major competitor in its market place and the projected trade receivable collection period of 60 days may well be unachievable on the basis of the historic ratios identified above.

A return to a positive cash position is dependent on these assumptions and obtaining the new bank finance which may not be forthcoming based on the bank's assessment of the business's current financial position and performance.

b) Audit evidence on the cash flow forecast

The audit working papers should include sufficient evidence that appropriate audit procedures have been conducted in relation to the assumption that Poyota Motors is a going concern at the reporting date, including the following:

- Evidence of agreement of the opening cash position to the cash book and bank reconciliation.
- Re-performance by the audit team of the client's calculations in preparing the forecast in order to check its arithmetic accuracy.
- Details of a review of the results of any market research which has been conducted by Poyota Motors for the next 12 months in order to assess the potential impact of the new competitor.
- Notes from meetings with management detailing discussion of the key assumptions made by management in the preparation of the forecast (including the growth rate and receivables days) and an assessment of the consistency of the assumptions with the auditor's knowledge of the business

and with management's intentions regarding the future of the company and corroborating evidence of assumptions.

- Evaluation by the audit team of previous profit and other financial forecasts and their outcome in order to assess the consistency of the cash flow forecast with other prospective information prepared by management.
- A comparison of the cash flow forecast for the period October to November 2020 with management accounts for the same period in order to assess the accuracy of the forecast compared to actual data to date.
- Results of analytical review of the items included in the cash flow forecast including, for example, a detailed review of the breakdown of different categories of expenses in order to identify any items which may have been omitted.
- A review of correspondence with Poyota Motors's lawyers in relation to the legal claims in order to assess the likelihood of losing the actions, the likely cost and the possibility of further claims arising in the future.
- Based on the review of legal correspondence, confirmation that the settlement of the legal claims has been appropriately included in the cash flow forecast. – A review of correspondence with Poyota Motors's bankers and supporting documentation for both the company's existing loan facilities and the proposed new loan.
- Minutes of discussions with management in relation to the likelihood of obtaining the new loan.
- Based on these reviews and discussions, a recalculation by the auditor of the finance cost and confirmation that the finance cost and the receipt of the loan have been accurately reflected in the cash flow forecast.
- Working paper detailing the review of the documentation in relation to the new warehousing agreeing the cost and checking that the cash outflow is included in the forecast at the correct amount and at the correct date.
- A review of board minutes in relation to the company's current trading position and the ongoing negotiations for the proposed new bank finance.
- A consideration of the impact on cash flows and liquidity when the company is incurring the additional costs of compliance with all laws and regulations. – Obtain written representations from management confirming the reasonableness of the cash flow forecast.

c) Implications for the auditor's report

i) Assuming the auditor is not satisfied with the disclosures

ISA 705 Modifications to the Opinion in the Independent Auditor's Report requires the auditor to modify the opinion in the auditor's report when they conclude that, based on the audit evidence obtained, the financial statements as a whole are not free from material misstatement. The failure to include disclosures regarding material uncertainties in relation to going concern in Poyota Motors's financial statements represents a material omission which will therefore require a modification of the auditor's opinion. In this case, the auditor must exercise professional judgement and assess whether the absence of this disclosure is material but not pervasive to the financial statements or whether it is material and pervasive to the financial statements.

Material and pervasive

The auditor may conclude that the omission of the required disclosures as discussed above is material and pervasive to the financial statements, as in the auditor's opinion the lack of these disclosures will have a fundamental impact on the users' understanding of the financial statements.

On this basis, an adverse audit opinion on the grounds of material misstatement is appropriate. The auditor will include an 'Adverse Opinion' paragraph at the start of the auditor's report which will state that the financial statements are not presented fairly in all material respects. The adverse opinion paragraph will be followed immediately by a 'Basis for Adverse Opinion' paragraph which will give details of the going concern uncertainties in relation to Poyota Motors and explain that in the opinion of the auditor, the omission of key disclosures in this respect are fundamental and pervasive to the financial statements and therefore require an adverse opinion.

It should be noted that matters relating to going concern are more likely to be both material and pervasive

ii) Assuming that the auditor is satisfied with the disclosure note

The auditor will consider the adequacy of the disclosures made in the financial statements by management. If the auditor considers that the going concern basis is appropriate and that the disclosures are adequate, then the audit opinion will be unmodified and the auditor's report will include a section headed 'Material Uncertainty Related to Going Concern' which explains the uncertainty.

The Material Uncertainty Related to Going Concern section will follow the Basis for Opinion paragraph and will cross-reference to the relevant disclosure in the financial statements. It will also state that the auditor's opinion is not modified in respect of this matter.

Tutorial note: Key audit matters (KAM) disclosures are not relevant for Poyota Motors as a result of its unlisted status.

Part 2

QUESTION ONE

EARTHMOVERS EQUIPMENT LIMITED (EEL)

f) Why concern for risk of EEL

The auditor carries out an audit with a view to forming an opinion on the financial statements. The auditor only tests a sample of items and concludes on the whole population based on the results of the sample. The auditor faces the risk that he may issue an inappropriate opinion at the conclusion of the audit. For example, he may conclude that the financial statements of EEL give a true and fair view when in fact they do not and vice versa. The auditor can face litigation for giving an inappropriate opinion

It is therefore important that before carrying out an audit, the auditor carries out a risk assessment on the client entity. If the risk of giving an inappropriate audit opinion is too high and cannot be reduced to an acceptable level, then the auditor should decline the engagement or resign when he is already and auditor

Having assessed the risk, the auditor

- Will decide whether or not continue with the audit
- Will pay more attention to areas that are more risky
- Will exercise more due care and heighten professional scepticism and assign staff with suitable skills and experience to audit the areas that are assessed as high risk

g) Principal audit risks of EEL

The timing and recognition of revenue

According to *IFRS 15 Revenue from contracts with customers,* revenue should only be recognised when the company has the right to receive it and this is when the company has performed its part of this contract. In this case this does not appear to be the case as regards equipment not delivered at the period end. According to IFRS 15 the initial deposits received should be treated as deferred income, a liability representing the obligation EEEL has under this contract

EEL raises invoices and recognises revenue at the time when customers pay the initial deposit or signing the sales contract. It takes approximately three months to complete the assembly of the equipment and deliver. There is a risk that at the period end, there will be equipment not completed and delivered but for which deposits have been received and included in revenue for the current year as per company policy

Disputed accounts receivable K2,430m

The amount of K2,430m owed and disputed by Kariba mine is material in the financial statements at 8% of profit before tax. There is a risk that the receivables balance is overstated, in view of the no impairment being recognised for the disputed amount

Legal claim of K2,190m - Mulyashi Mine

According to *IAS 37, Provisions, Contingent Liabilities and Contingent Assets*, a provision should be made if it is certain and probable that a liability would ensue and disclosure made if there is only a possibility that such a liability exists. The amount is 7.2% of profit before tax and therefore material.

There is a case that is in court at the period end and the fact the Chief Executive feels that the company will not be held liable because of the poor safety record of Mulyashi Mine is not conclusive enough to suggest that the court will rule in favour of EEL. If it is proved that the fault is with EEL the company may be found liable

There is a risk that EEL has not provided for damages in the financial statements in the current year. The fact that the warranty provision in each year is substantial means that the company recognises that it does have poor workmanship in some cases and hence could be found liable

There is a risk that no provision has been made or any provision that has been made may be misstated due to the fact its determination is largely subjective

Legal costs arising from defending legal claim

There is a risk that EEL may not have accrued for any legal expenses that may rise in defending the legal suit by Mulyashi Mine. Since the litigation began in the current period year end and at the period end the case is still on, an estimate of the related legal costs should be recognised in the current year

There is a risk that expenses and liabilities are understated in view of the fact that legal costs have not been provided for

Work-in-progress at the period end

There is a risk that work-in-progress valuation at the period end is not done correctly. This is dependent on the person valuing WIP and in particular depends on the costing methods in use. For example, the absorption of labour costs and overheads into each uncompleted machine could be a complex matter

There is a risk that work-in-progress may be misstated at the year end

Inventory count of parts

There is a risk that the valuation of parts and components at the period end is wrong The inventory value at the year-end should represent inventory held on 31st October 2020. The fact that inventory count was conducted seven days earlier poses a risk that inventory movements in the intervening period may not have been correctly done resulting in an over or understatement of inventory and current assets

Liability in foreign currency

According to IAS 21, *The effects of changes in foreign exchange rates,* the foreign trade payable should be retranslated at the exchange rate ruling at the period end. There is a risk that EEL has not done so resulting in trade payables being significantly over or under valued depending on the movement in the exchange rate between the date of purchase and the year-end

Warranty provision

There is a risk that the warranty provision in the financial statements of EEL is misstated. The increase in the warranty provision from 2019 and 2020 is only 4% whereas revenue has increased significantly by 21%. There is supposed to be a relationship between the increase in revenue and the warranty provision

The warranty provision is expected to move in line with the increase in revenue. The fact that the warranty provision has not increased as expected would be indicative of the understatement of the warranty provision

Related party transactions

According to *IAS 24 Related party Disclosures*, transactions between related parties should be disclosed in the financial statements. Details of the dealings between EEL and Nshimbi Light Engineering Ltd should be disclosed in the notes to the financial statements

There is a risk that not all related party transactions have been disclosed by the management of EEL. Further, any disclosure made may not be at the correct value

Timetable of completing the audit

The request by the Chief Executive that the audit by concluded by 28th November 2020 will put pressure on the audit team to finish the work. The audit team may not manage to complete the assignment within this time and complete all the necessary procedures or there may not be time for adequate reviews to be carried out on the work that has been performed

As a result of time pressure, the detection risk may increase resulting in the overall audit risk increase

h) Audit of warrant provision

ISA 540 *Auditing Accounting Estimates, including fair value accounting estimates, and related disclosure requirements* requires that auditors obtain sufficient audit evidence as to whether accounting estimates, such as warranty provision, are reasonably given the due care required.

The following audit procedures may be applied in auditing warranty provisions:

- Review the contracts signed between EEL and the customers so that you understand so that you understand the obligation of EEL
- Review any correspondence with customers so that you gain an understanding of any claims that may have been made already

- Carry out analytical procedures to compare the level of warranty provision year on year, and compare actual and budgeted provisions
- Recalculate the amount of provision at the period end based on assumptions used by the entity
- If a percentage is used to arrive at the provision, agree the percentage applied in the calculation to the stated accounting policy of EEL
- Review the board minutes for any discussion on warranty claims and provisions and the approval of the amount provided
- Use the management accounts of EEL to ascertain the normal level of warranty rectification costs during the year
- Confirm that the assumptions used in determining the provision are in line with the auditor's understanding of the business
- Compare the prior year provision with the actual expenditure on warranty claims in the accounting period. This will help determine the accuracy of management estimates
- Compare the current year provision with the prior and discuss any significant fluctuations with management
- Review the subsequent events in the following accounting period which confirm the estimate made and specifically:
  - Review the rectification works carried out post year end on specific faults that were provided for. Ensure that all costs are included in the year end provision
  - Go through any customer correspondence received after year end for any claims received since the year end which may not have been provided for

i) Quality control procedures at the individual audit level

ISA 220 Quality Control for audit of financial statements provides guidance in this area. Procedures include:

Recently acquired - Client acceptance procedures

There should be full documentation and conclusion on, ethical and client acceptance issues in each audit assignment. The engagement partner should consider whether members of the audit team have complied with ethical requirements. For example, whether all members of the audit team are independent of the client. Additionally, the engagement partner should conclude whether all acceptance procedures have been followed. For instance, that the audit firm has considered the integrity of the principal owners and key management of the client

Also ensure that:

- Obtained professional clearance from previous auditors
- Consideration of any conflict of interest
- Money launder procedures as may be applicable

Planning – allocation of Engagement team

There must be procedures in place to ensure that the engagement team on the audit of EEL has the requisite skills, competence and time to perform the audit engagement. For example the engagement partner should assess the audit team that has:

- The appropriate level of technical knowledge for the industry of EEL
- The experience of the audit engagement of similar nature and complexity
- The ability to apply professional judgement

- Understands the professional standards and regulatory and legal requirements

Planning - Direction of the audit

The engagement partner should direct the engagement team. For example, a planning meeting should be undertaken to ensure that the team understands:

- Their responsibilities
- The objectives
- The nature of the business of the client
- Risk related issues
- How to deal with any problems that may arise
- The detailed approach to the performance of the audit

This planning meeting should be led by the partner and all people involved with the audit should attend. There should be a discussion of the key issues identified at the planning stage.

Supervision of the audit

Supervision should continuous during the assignment. Any problems that arise during the audit should be rectified as soon as they arise. Attention should be focused on ensuring that members of the audit team are carrying out their work in accordance with the planned approach to the engagement. Significant matters should be brought to the attention of senior members of the audit team. There should be documentation of key decisions made during the audit engagement.

Review of work carried out

The review process of work carried out is one of the key quality control procedures. All work performed must be reviewed by a more senior member of the audit team. The following should be considered during the review:

- Whether work has been performed in accordance with professional standards.
- Whether the objectives of the procedures performed have been achieved
- Whether the work supports the conclusions drawn and is appropriately documented

The actual review process must be documented and evidenced in writing

Consultation

The engagement partner should arrange consultations on difficult and contentious matters. Consultation can start with the engagement audit team and there should be procedures whereby the matters can be discussed with professional outside the engagement team, and at times even outside the audit firm. Any consultations must be documented to show:

- The issue on which the consultation was sought
- The results of the consultation which must be documented

j) Related parties and transactions

i) Difficulties in identifying related parties

Related parties and associated transactions are often difficult to identify, because it can be hard to establish exactly who, or what, are the related parties of the entity.

IAS 24 Related party disclosures contains the definition which theoretically provide a framework for identifying related parties, but deciding whether a definition is met can be complex and subjective. For example, related party status can be obtained via significant interest, but in reality it can be difficult to establish the extent of influence that potential related parties can actually exert over a company.

The directors may be reluctant to describe to the auditors the existence of related parties or transactions. This is an area of the financial statements where knowledge is largely confined to management and the auditors often have little choice but to rely on full disclosure by management in order to identify related parties.

Identification of material related party transactions

Related party transactions may not be easy to identify from the accounting systems. Where accounting systems are not capable of separately identifying related party transactions, management need to carry out additional analysis, which if not done make the transactions extremely hard for auditors to find. For example, sales to a related party may not be differentiated from 'normal' sales in the accounting systems

Related party transactions may be concealed in whole or in part, from auditors for fraudulent purposes. A transaction may not be motivated by normal considerations, for example, a transaction may be recognised in order to improve the appearance of the financial statements by window 'dressing'. Where management deliberately conceals the true nature of these items, it will be extremely difficult for the auditor to discover the rationale behind the transaction and to consider the impact on the financial statements

Other reasons why it is hard to identify related parties and transactions include:

- Related party transactions may take place without any charge and as such will not be recorded in the financial statements
- Related party transactions may be with a party that auditors would not reasonably be expected to know is a related party
- In situations where the corporate structure to which the entity belongs is complex with unclear relationships

ii) Recommended the audit procedures

ISA 550 Related parties gives guidance in this area. The auditors are expected to carry out the following procedures in relation to related parties and related party transactions

- Enquire from management and those charged with corporate governance whether related party transactions have taken place

- Ensure that any related party transactions identified have been disclosed as required in the financial statements. In the case of EEL, ensure that management makes full disclosure of the existence of Nshimbi as related party and also disclosed separately in the financial statements its dealings with the related part and the amount involved
- Review prior year working papers as they may contain names and details of known related parties
- Review minutes of meetings of shareholders and directors and other relevant statutory records such as the register of director's interests. This review may reveal related parties
- Review third party confirmations such as the bank confirmation. They may reveal details of guarantees for loans to the entity which can help determine relationships with EEL
- Enquire as to the affiliation of directors and officers with other entities
- Review invoices and correspondence from lawyers for indicators of the existence of related parties or related party transactions
- Obtain representations from management confirming that they have
    - Disclosed to the auditors the identity of the entity's related parties
    - Disclosed the related party transactions that they are aware of
    - Appropriately accounted for and disclosed such relationships and transactions in accordance with the requirements

PATRIOTIC CONSTRUCTION LIMITED (PCL)

e) Building materials for sale at Chalala

The form of modification will depend on two factors. The materiality of the matter and whether it is pervasive to the financial statements. The scenario state the matter is material but it does not state whether or not the matter is pervasive

In the event that the matter is material and not pervasive, the appropriate opinion would be a modified report with a qualified opinion on the grounds of an inability to obtain sufficient evidence appropriate evidence.

If the matter is both material and pervasive, then the opinion will be a disclaimer of opinion

f) PHI Ltd

The event of a significant customer PHI Ltd going into liquidation after the year end is an adjusting event according to IAS 10, *Events after the reporting period,* as this provided additional information relating to conditions existing at the reporting date

The fact that the customer has gone into liquidation and the amount to be settled to payables determined gives additional information of the conditions as the period end. There is a need to make a provision for the amount that may not be collected from the liquidator

The auditor has a responsibility under ISA 560 Subsequent events to identify any such events and ensure they are correctly accounted for by management. Management's refusal to make provision is not correct and the auditor should ensure correct treatment is applied

Conclusion

The audit senior is not right in suggesting that an unmodified opinion be issued.

As the matter is considered material and not pervasive, the appropriate opinion would be a modified report with a qualified opinion on the grounds of material misstatement

g) Housing units included at cost

IAS 2 Inventories, requires that inventories should initially be recognised at cost and subsequently valued at the lower of cost and net realisable value. The standard recognises that if inventory is overvalued, the result is a direct overstatement of profits

Since it is clear that PCL will not be able to sell the housing units at more than cost, then the housing units should be valued at net realisable value

Further, the auditors have gathered sufficient appropriate evidence and therefore cannot use a disclaimer of opinion which is only used when the auditor has not obtained sufficient appropriate audit evidence

Conclusion

The audit senior is wrong in suggesting a disclaimer of opinion should be used. As the matter is assessed as being material and not pervasive, the appropriate opinion will be a qualified "except for" opinion

h) Housing units included in tangible non-current assets

Capitalising housing units intended for sale is an error of principle and will cause misstatement of the financial statements. The value of the housing units in question accounts for 80% of the total assets and is considered both material and pervasive

The value of the misclassification of inventory as an intangible asset is material and pervasive. The management should be requested to correct the mistake and if they refuse, then the auditor should modify the audit opinion for material misstatement

Conclusion

The appropriate form of modification is an adverse opinion that the financial statements do not give a true and fair view. The audit senior is not right by suggesting that a qualified opinion be issued

TATA HOLDINGS plc (TH plc)

a) Ethical and professional implications of the request to provide a non-audit service on the integrated report

i) Ethical issues arising

There are several issues to consider with regard to providing this service.

A significant issue relates to auditor objectivity. The Zambia Institute of Chartered Accountants (ZiCA) Code of Ethics for Professional Accountants provides guidance on situations where the auditor is asked by the client to provide non-assurance services. GDM needs to evaluate the significance of the threat and consider whether any safeguards can reduce the threat to an acceptable level.

Self-review threat

While the integrated report is not part of the audited financial statements, the report will contain financial key performance indicators (KPIs), and the TH plc has asked for input specifically relating to the reconciliations between these KPIs and financial information contained in the financial statements.

There is therefore a potential self-review threat to objectivity in that the audit firm has been asked to provide assurance on these KPIs which are related to figures which have been subject to external audit by the firm. The team performing the work will be reluctant to raise queries or highlight errors which have been made during the external audit when assessing the reconciliations of KPIs to audited financial information.

Management responsibility

It could also be perceived that GDM is taking on management responsibility by helping to determine content to be included in the integrated report, which is a threat to objectivity. The Code states that the audit firm shall not assume management responsibility for an audit client and that the threats created are so significant that safeguards cannot reduce them to an acceptable level. While the Code does not specifically state that helping the client to determine the content of its integrated report is taking on management responsibility, certainly there could be that perception as the auditor will be involved in setting measurements which the company will benchmark itself against.

Familiarity

Additionally, working with management on the integrated report could create a familiarity threat to objectivity whereby close working relationships are formed, and the auditor becomes closely aligned with the views of management and is unable to approach the work with an appropriate degree of professional scepticism.

Other information

There is a potential problem in terms of compliance with *ISA 720 The Auditor's Responsibilities Relating to Other Information*, should GDM accept the engagement. ISA 720 requires that auditors read other information in order to identify any material inconsistencies between the financial statements and information in the other information. ISA 720 applies only to other information in the annual report, and it is not stated whether the TH plc's integrated report will be included in the annual report, or as a standalone document.

ii) Recommended Action

Based on the above, it would seem unlikely that GDM can provide this service to the TH plc, due to the threats to objectivity created. However, should the firm decide to take on the engagement, safeguards should be used to minimise the threats. For example, a partner who is independent should be involved in reviewing the audit work performed.

Aside from ethical issues, GDM must also consider whether they have the competence to perform the work. Advising on the production of an integrated report is quite a specialist area, and it could be that the audit firm does not have the appropriate levels of expertise and experience to provide a quality service to the TH plc. The fact that the TH plc wants to highlight its technological achievements, and presumably will select a range of non-financial KPIs and technological issues to discuss in the integrated report, makes the issue of competence more significant, as the audit firm may not have the necessary technical knowledge to provide advice in this area.

Aside from competence, the firm should also consider whether it has resources in terms of staff availability to complete the work to the desired deadline and to perform appropriate reviews of the work which has been completed.

Finally, given that the TH plc is a listed entity, it should comply with relevant corporate governance requirements. This means that the audit firm may be prohibited from providing services in addition to providing the external audit to the TH plc. The audit committee should consider the TH plc's policy on the engagement of the external auditor to supply non-audit services, the objective of which should be to ensure that the provision of such services does not impair the external auditor's independence or objectivity. The TH plc's audit committee will need to pre-approve the provision of the service, and in making this decision they should consider a number of matters, for instance, the audit committee should consider whether the skills and experience of the audit firm make it the most suitable supplier of the non-audit service, whether there are safeguards in place to eliminate or reduce to an acceptable level any threat to objectivity and the level of fees to be incurred relative to the audit fee.

b) Matters that should be included in the report to those charged with governance

According to ISA 260, there are four types of matters that should be included in the report to those charged with governance. These relate to:

i) Auditor's responsibilities in relation to financial statements
ii) Planned scope and timing of the audit
iii) Significant findings from the audit
iv) Auditor independence

Based on matters arising from the audit of TH plc, the two matters relevant are:

- ✓ **Significant findings from the audit**
- ✓ **Audit Independence**

Significant findings from the audit

Significant findings include:

- The auditor's views about accounting policies, accounting estimates and financial statement disclosures
- Significant difficulties, if any, encountered during the audit (e.g. delays in the provision of required information, brief time in which to complete the audit and unavailability of required information
- Circumstances that affect the form and content of the auditor's report

For TH plc,

i) Modified opinion

Management's unwillingness to apply impairment and provision requirements to receivables, non-current assets and inventories should be a matter for concern as these affect the form and content of the auditor's report and also questions the integrity of management. These should be highlighted in the report to those charged with corporate governance

ii) New accounting standards and policies

Adoption of a new accounting standard is a significant event that should be highlighted, including a discussion on the implications for the audit and financial statements, such as the need for prior year adjustments that may be required

iii) Deficiencies in internal control

Evidence of supporting documents transactions such as imported equipment was not made available. This is a significant deficiency in internal controls that should be highlighted in greater and specific detail for each significant omission. Additionally, GDM should include the implications of this deficiency as well as recommending appropriate control procedures

Auditor Independence

For listed companies like TH plc, matters should include

- A statement that relevant ethical requirements regarding independence have been complied with
- All relationships, including total fees, for the audit and non-audit services which may reasonably be thought to bear on independence
- The related safeguards that have been applied to eliminate identified threats to independence

Accordingly, the auditor must

- Confirm to the audit committee annually that the firm and partners, senior managers and managers, conducting the audit are independent
- Discuss with the audit committee the threats to independence and the safeguards applied

For TH plc, the following ethical issues need to be included:

i) **Total fees for audit**
ii) **Independence of manager and partner**

Total fees for the audit

GDM has received 9% of the recurring fess from TH plc. This potentially creates a self- interest threat, which is likely to increase with the provision of other services such as the assistance required with the integrated report

Accordingly, GDM must:

- Confirm to the audit committee the significance and impact of the audit fee to the independent position of the GDM
- Discuss with the audit committee how GDM has mitigated against the self-interest threat related to the potential undue-dependence position of the fees

Long association – manager and engagement partner

Given that the manager and partner on TH plc have been associated with this audit for the last five years, this raises potential self-interest and familiarity threats relating to long association.

Accordingly, GDM must:

- Confirm to the audit committee annually that the manager and the engagement partner involved on the audit are independent

- Discuss with the audit committee how GDM has mitigated against the long association threats related to the audit management and engagement partner

c) Further matters to consider

According to ISA 705 (Revised), If the auditor expects that the audit opinion will be modified, they must communicate the circumstances surrounding the modification with those charged with governance. Further matters to consider include:

i) External consultation

If a modified opinion is expected, then the auditor may need to consider consulting externally on the impact of this, e.g. with legal counsel under legal privilege, or anonymously with ZiCA. As TH plc is listed, GDM is well advised to seek legal counsel

ii) Management integrity

The other thing to consider is whether the matter in question suggests that management may not have the required integrity. This is particularly relevant where the scope of the audit has been limited by management. Lack of supporting documentation for imported equipment may question management integrity in this regard.

iii) Withdrawal from engagement

If the matter to which the auditor's report is to be modified is sufficiently serious, then it may be necessary to seek to withdraw from the audit engagement, otherwise seek legal counsel. The matter relating to lack of supporting documentation has been raised before and may be regarded as now being more serious. Accordingly, GDM should consider withdrawing from the engagement

d) Difference between the report to those charged with governance and Key Audit Matters

According to ISA 260 (revised), the report to those charged with governance is intended to report matters that came to the attention of the auditor during the auditor

The term 'key audit matters' is defined in ISA 701 as those matters that, in the auditor's professional judgment, were of most significance in the audit of the financial statements of the current period. Key audit matters are selected from matters communicated with those charged with governance