COMPETENCE PRACTICE EXAMINATION

AUDIT PRACTISING CERTIFICATE

JUNE 2022

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 - AUDIT

KEMBE FARMS

You are a manager in the audit department of PMK & Co, a firm of Chartered Accountants, and you are responsible for the audit of Kembe Farms (KF). With its Head Office in Mazabuka, Kembe farms produces fruit-based products using agricultural produce grown on its farms.

KF has been an audit client of PMK & Co for the last eight years. Throughout this period, Mr. Ben Luvale has taken personal responsibility for the audit and has managed to increase the total fee income from client to the level where it represented 16.2% if PMK's total income in 2022 (15.4% : 2021). In addition to performing the annual audit, PMK & Co also provided accounting and bookkeeping services for Kembe Farms. This includes the preparation of the monthly payroll for the client and maintaining all of the financial records of one some of smaller farms

Other information

For the audit of the year ended 30th June 2022, Ben Luvale, the audit engagement partner, met with the company's finance director last week to discuss business developments in the year and recent financial performance. The audit team has compiled the following exhibits relevant to the audit:

1. Notes of the meeting which Ben held with the financial director of Kembe
2. A reference document prepared by PMK & Co containing an overview of the accounting requirements applied in the agricultural sector
3. Extracts from latest management accounts of Kembe Farms and accompany notes, including analytical ratios computed by a member of the audit team
4. An email which the audit engagement partner received from Mark Lundu, a production manager working at one of the company's olive farms
5. Audit strategy relating to the joint venture with Olomide Products

Exhibit 1 - Notes of the meeting which Ben held with the financial director of Kembe

a) Business Background

Kembe Farms was established 30 years ago by Jim Kembe, who began processing the fruit grown on his family farm to make a small range of food products including canned fruit and fruit juice. The business was relatively small until ten years ago, when the company began to expand by acquiring more farmland with different crops and building new production facilities. This extended the range of food products which could be processed, which now includes olive oil, packages nuts and frozen fruit. The company sells its products under the "Kembe Gold" brand name, and the goods are sold in major supermarkets and online on the company's website

b) Governance and Listing on LUSE

The company is currently not listed, and the Kembe family members are the company's majority shareholders. Jim Kembe retired several years ago, his daughter, Mia Kembe, is the company's chief executive officer (CEO), and other family members hold positions in senior management. However, given the planned extensive expansion plans, Kembe farms intends to list on the Lusaka Stock Exchange (LUSE) in the next year, as a way of raising finance

The CEO of Kembe Farms, Mia Kembe, has asked your firm for assistance in the preparation of the share prospectus document which will be used to support the company's flotation. The contents of the prospectus document will include the following elements:

- Key historical financial information prepared to 30th June 2022
- Profit forecasts
- A summary of the key risks relating to Pembe Farms
- A business plan outlining the future prospects of the company and recommending the shares to investors

The CEO has also indicated that Kembe Farms is carrying out its annual review of matters relating to audit appointments and would prefer to appoint an audit firm which is capable of taking it through the listing process and providing a full range of services in the future

c) Business Developments

Joint Venture with Olomide Products

Following the signing of a memorandum of understanding between Zambia and DRC, Kembe Farms entered into a joint venture with Olomide Products, a company based in DRC to set up a fruit processing plant in DRC. The plant was completed on I January 2022 and a substantial level of sales have since been achieved.

The results of the joint venture are included in the extract of financial statements in exhibit 3

As most activities relating to the joint venture were undertaken in DRC, it was decided to set up an accounting office in DRC

Online sales

In the last year, sales made through the company's website grew significantly. The finance director believes that this was in response to an advertising campaign costing K2.25m, which promoted the 'Kembe Gold' brand and coincided with the launch of a new online sales portal on the company website designed to make online ordering easier. To encourage online sales, the company has regular special offers, with discounts periodically offered on aselection of product lines, and offers such as 'Buy One Get One Free' for a limited time on some products.

Capitalised Research and development

Recently, concern over the level of plastic used in packaging has encouraged food producers to investigate the useof plastic-free packaging for their products. In July 2021, the board approved a budget of K4m to be spent onresearch and development into new packaging for its products. By 28 February 2022, K2.2m has been spent, with this amount being paid to ProPack, a firm of packaging specialists, to design and develop a range of plastic-free bottles, bags and containers. It is anticipated that the packaging will be ready for use in two years' time at which point the company will introduce it for use across its product range. ProPack is currently testing prototypes of items which have been developed, with encouraging results.

Loan

A loan of K3.75m was taken out during the year to support the company's research and development plans.

Factory damage

One of the company's several factories, used to process fruit and produce fruit juice, was damaged in August 2021 when a severe storm occurred. High winds destroyed part of the factory roof, and heavy rain led to flooding and damage to machinery and processing equipment. The factory has not operated since the storm, and the finance director has performed an impairment review on the building and plant and equipment; details of the impairment review are given in the extract from the management accounts (Exhibit 3).

Use of an auditor's expert

The fruit growing on trees and the harvested agricultural produce are biological assets which were recognised at fair value of K3·1 million in the 2021 audited financial statements. Due to the specialised nature of these assets, an auditor's expert will be used to provide evidence relating to their valuation. A resource document containing an overview of the accounting requirements in relation to the company's activities is provided in Exhibit 2.

Exhibit 2- Extract from PMK & Co's internal technical guidance for audit staff working with clients in the agriculture sector

IAS 16 *Property, Plant and Equipment* – Bearer plants

Definition: A bearer plant is defined under IAS 16 as 'a living plant that:
- is used in the production or supply of agricultural produce;
- is expected to bear produce for more than one period; and
- has a remote likelihood of being sold as agricultural produce, except for incidental scrap sales.'

In line with the requirements of IAS 16, bearer plants are recorded at accumulated cost until they reach maturity and then they are depreciated over their useful life.

IAS 41 *Agriculture* – Biological assets

Produce growing on bearer plants, and harvested agricultural produce are biological assets and should be accounted for under IAS 41. Biological assets are measured on initial recognition and at subsequent reporting dates at fair value less estimated costs to sell, unless fair value cannot be reliably measured. A gain or loss arising on initial recognition of agricultural produce at fair value less costs to sell shall be included in the statement of profit or loss for the period in which it arises.

IAS 2 *Inventories* – Agricultural produce

When agricultural produce enters the production process, it should be accounted for under IAS 2. As bearer plants, fruit trees are accounted for under IAS 16 and Fruit being processed are accounted for under IAS 2

Exhibit 3- Extract from management accounts

Extract from statement of financial position:	Note	As at 30 June 2022 Projected K'M	As at 30 June 2021 Actual K'M
Total assets		**125**	**119**
Included in total assets:			
– Intangible assets	1	5.25	0.5
– Property, plant and equipment	2	61.50	64.70
– Total current assets		33.50	21.90
– Cash included in current assets		7.60	7.50
– Joint venture investment		2.5	0
Current ratio		2.6	1.4
Gearing ratio		28%	32%
Extract from statement of profit or loss			
Total revenue			
Other sales included in total revenue			
Total revenue		**356**	**327.50**
Other online sales included in total revenue		24.95	13.10
Operating margin		28%	26%
Return on capital employed		5%	4.5%
Profit before tax (including from joint venture)		21.00	19.00

Notes:

1. **Intangible assets include the following items:**

	K'M	K'M
Software development costs	0.8	0.5
Advertising costs relating to "Kembe Gold" brand	2.25	0
Development costs in respect of new packaging	2.20	0
	-------	------
Total	5.25	0.5
	===	====

Software development costs of K300,000 were capitalised during the year, which relate to development of the online sales portal. The finance director suggests that both the software development costs and the advertising costs should be capitalised because the increased sales in the year are a direct result of the advertising campaign and improvements in the online sales portal.

The 'Kembe Gold' brand name is not recognised in the statement of financial position, as it is an internally generated asset. This accounting treatment has been confirmed as correct and in accordance with IAS 38 *Intangible Assets*. The notes to the 2021 financial statements disclosed that the estimated fair value of the brand name is K180 million.

2. **Property, plant and equipment - Impairment**

The carrying amount of K61.5 million includes K8.80m relating to the storm-damaged factory (referred to in Exhibit 1) and its fixtures and fittings. The factory is a cash-generating unit for the purpose of impairment testing. The finance director has provided a summary calculation, detailing the following impairment review which indicates that an impairment loss of K2.10m needs to be recognised:

	K'M
Carrying amount at 31st August 2021	8.80

Recoverable amount	
Higher of:	
– Fair values less costs to sell	1.35
– Value in use	6.70
Impairment loss (8.80 – 6.70)	2.10

The fair value less costs to sell has been estimated based on the sales proceeds which could be generated fromselling the damaged machinery. The value in use is estimated based on the future sales which could be generated if the damage to the building is repaired and new machinery is put into the factory. The company is planning oncarrying out the restoration and buying new machinery, at a total estimated cost of K4.5m. This amount has been provided for within current liabilities, with a corresponding entry accounted for as a prepayment.

Exhibit 4 - Email sent from Mark Lundu, employee of Kembe Farms, to Ben Luvale, audit engagement partner

To	**:**	**Ben Luvale**
From	**:**	**Mark Lundu**
Subject	**:**	**Business practices at Kembe Farms**

I obtained your contact details from your firm's website, I hope you don't mind me approaching you directly.

I amemailing to voice some concerns over recent business practices at Kembe Farms.

In my role as production manager in one of the company's factories, I inspect samples of the fruit which comes intothe factory from the company's farms and speak to the farmers on a regular basis. Recently, several farmers told me that they have been instructed to use certain chemicals to spray the fruit trees, which should increase the fruit yield. However, some of these chemicals are prohibited for use in this country because they can be toxic to humans.

While talking to one of my friends who is a production manager from another factory, it transpired that he had also become suspicious that banned chemicals are being used in the farms. He raised the issue with one of the company directors, who allegedly gave him K100,000 and asked him not to discuss it with anyone.

My friend said that I shouldask for the same sum of money, but I felt uncomfortable and thought I should tell someone from outside the company about what is going on.

Please do not mention my name if you decide to investigate this further.

Thank you,

Mark Lundu.

Exhibit 5 – Audit strategy relating to the operations of the Joint Venture

One of the senior auditors was sent to DRC to plan and prepare an audit strategy for the joint venture activities in the DRC.

Audit area	Strategy
Inventory count We were not able to attend the inventory count at the plant at the year-end (Audit team could not be allowed entry without valid DRC Covid certificate)	– Review the stock sheets used during the count – Obtain written representation from management
Planning The transactions for the six months up to 30^{th} June 2022 generated sales and cash that exceeded the budget.	– In the absence of prior period information, analytical review procedures are not considered necessary – Given the size of the joint venture relative to the company as a whole, a relatively lower materiality should be used for the audit of the joint venture operations
Receivables About 37% of the total sales are outstanding as receivables at the end of the year	- A negative confirmation procedure should be carried out to ensure that receivables are not overstated
Income and Expenses A new accounting system was set up for the joint venture with related policies and procedures covering all transactions. The accounting staff at the plant were given some training on the operation of the system at the beginning of January 2022.	- Given the level of transactions during the six month period, a systems based approach should be adopted that should result in reduced substantive testing

Requirements:

1) **In relation to the request for your firm for assistance in the preparation of the share prospectus document which will be used to support the company's flotation**

    a) **Evaluate SIX ethical and other professional issues arising from this request (12 marks)**

    b) **Recommend appropriate action that should be taken (6 marks)**

2) **Using the information provided, evaluate TEN risks of material misstatement to be considered in planning the company's audit. (Ignore matters relating to the joint venture)**

    a) **FOUR risks from analytical review (8 marks)**

    b) **SIX risks from other information (12 marks)**

3) **Design the principal audit procedures to be used in the audit of**

    a) **Impairment - 4 procedures (8 marks)**

    b) **Capitalised development expenditure - 5 procedures (10 marks)**

4) **Discuss the matters to be considered in planning to use an auditor's expert in the audit of the fruit, which are recognized as biological assets of the company (10 marks)**

5) **With reference to the email from Mark Lundu, discuss the relevant audit implications and recommended appropriate action to be taken by the firm under each of the following headings**

    a) **Ethical and other professional issues (4**

marks)

b) **Financial statements** **(5 marks)**

c) **Reporting** **(5 Marks)**

6) **Evaluate the audit strategy and recommend improvements that should be made to the strategy for each of the following items in exhibit 5**

a) **Inventory count** **(5 marks)**

b) **Planning** **(5 marks)**

c) **Receivables** **(5 marks)**

d) **Income and expenses** **(5 marks)**

TOTAL **(100 marks)**

QUESTION TWO – AUDIT

LUZEK & Co

Your name is Mirriam Phiri and you are a manager in Luzek & Co, a firm of chartered accountants registered with the Zambia Institute of Chartered Accountants (ZiCA). During 2022, you have been assigned to four engagements:

- Easy Finance – Ethical, quality control and other professional issues
- Auto Africa – Audit completion – uncorrected misstatements
- FoolProof Co – Audit report
- Pick & Buy – Report to those charged with governance

A. EASY FINANCE

One of your colleagues at Luzek & Co, Stone Chibwe, has been taken ill at short notice and you have been temporarily assigned as audit manager on Easy Finance Co, which is financial institution offering loans and credit facilities to both individuals, commercial and retail customers.

The final audit of Easy Finance Co for the year ended 30 June 2022 is approaching completion and you are in the process of reviewing the audit working papers. The draft financial statements for the year recognise

- Profit before taxation for the year of K54·2 million and
- Total assets of K23·1 million.

You have received an email from the audit supervisor who is currently supervising interim testing on systems and controls in relation to the audit for the year ending 30 June 2022. The following information has been extracted from the email:

i) 'It's great to have you on board as I was beginning to worry that there would be no manager review of our working papers prior to the final audit clearance meeting next week. The audit assistant and myself have done our best to complete all of the audit work but we only saw Stone on the first day of the audit about a month ago when I think he was already feeling unwell. We had a short briefing meeting with him at which he told us

'if in doubt, follow last year's working papers.'

One issue which I wanted to check with you is that Easy Finance Co has introduced a cash-settled share-based payment scheme by granting its directors share appreciation rights (SARs) for the first time this year. This was not identified at planning as a high risk area. The SARs were granted on 1 July 20X7 at which date the client obtained a valuation of the rights which was performed by an external firm of valuers. I have filed a copy of the valuation report and I have looked up the valuers online and have found a very professional looking website which confirms that they know what they are doing. The cost of the SARs scheme based on this valuation is being appropriately recognised over the three-year vesting period and a straight-line expense of K195,000 has been recognised in the statement of profit or loss on this basis. A corresponding equity reserve has also been correctly recognised on the statement of financial position. The amount also seems immaterial and I can't see any need to propose any amendments to the financial statements in relation to either the amounts recognised or the disclosures made in the notes to the financial statements.'

ii) One of the audit team members, Cathy Puta, has provisionally agreed to take out a loan with Easy Finance to finance the purchase of a domestic residence. The loan will be secured on the property and the client's business manager has promised Cathy that he will ensure that she gets 'the very best deal which the bank can offer.'

iii) The payroll manager at Easy Finance has asked the audit supervisor if it would be possible for Luzek & Co to provide a member of staff on secondment to work in the payroll department. The payroll manager has struggled to recruit a new supervisor for the organisation's main payroll system and wants to assign a qualified member of the audit firm's staff for an initial period of six months.

B. AUTO AFRICA

The audit of one of your clients, Auto Africa Co, for the year ended 31 May 2022 is nearly complete and the auditor's report is due to be issued next week. Auto Africa Co is an unlisted, family-owned business which specialises in the service and repair of both commercial and privately owned motor vehicles. Auto Africa has installed specialized diagnostic equipment which require testing and certification every three years

The company operates from seven geographically distinct sites, covering the major cities of Zambia. Each site is considered a separate cash generating unit for impairment review purposes.

The draft financial statements recognise

- Profit before taxation for the year of K2·3 million
- Total assets of K22 million.

The schedule of uncorrected misstatements included in Auto Africa Co's audit working papers and prepared by the audit supervisor is shown below. You are due to attend a meeting with the finance director of Auto Africa Co tomorrow, at which the uncorrected misstatements will be discussed.

Schedule of uncorrected misstatements

		Statement of profit or loss		Statement of financial position	
		Debit	Credit	Debit	Credit
		K	K	K	K
i)	Lease of testing equipment				
	- lease assets			475,000	
	- lease liabilities				475,000
ii)	Legal claim				
	- contingent assets			1,200,000	
	- provision for liabilities				1,200,000
iii)	Asset impairment				
	- assets				85,000
	- expenses	85,000			
iv)	Subsequent event				
	– Expenses	550,000			
	– Liability				550,000
Totals		635,000	–	1,675,000	2,310,000

(i) Lease of testing equipment

In Zambia, all motor vehicles over three years old are required to undergo an annual test of vehicle safety and road-worthiness. The annual test requires specialist testing equipment which is inspected by government officials on a regular basis. Following inspection visits in May 2022, the government inspection report required Auto Africa Co to replace the testing equipment at three of its sites. In order to comply with this requirement, Auto Africa Co has agreed to lease new testing equipment from a leasing company on six-month leases. Under the terms of the leases, the company has no option to purchase the equipment.

The testing equipment was made available for use by Auto Africa Co at each of the three sites on 31 May 2022. The client has capitalised leases with a total carrying amount of K625,000 at two of the sites but has elected to take advantage of the IFRS 16 Leases exemption not to capitalise short-term leases at the largest of the three sites. As a result, the present value of the lease payments of K475,000 relating to this site has not been recognised on the company's statement of financial position.

(ii) Legal claim

A customer of Auto Africa Co successfully sued the company for negligence in April 2022 after suffering a personal injury at one of its sites. The court awarded the customer K1·2 million in damages and this had not yet been paid as at 31 May 2022. The audit working papers include a copy of a verified letter dated 25 May 2022 from an insurance company confirming that the claim is fully covered under Auto Africa Co's public liability insurance policy. On the basis that the company has no net liability as a result of the claim, the finance director has not recognised any amounts in the financial statements and has not made any disclosures in relation to the matter.

(iii) Asset impairment

During the year, a significant new competitor entered the market place at one of Auto Africa Co's seven sites. As a result, the site has experienced a decline in market share and revenue. The company has therefore conducted an impairment test on the site's assets. The company's working papers for the impairment test have been audited and the following figures have been agreed by the audit team:

Site assets	**K'000**
Carrying amount on statement of financial position as at 31 May 2022	3,600
Value in use	2,900
Fair value	3,900
Related costs of selling the assets:	
– legal costs	126
– transaction taxes	174
– costs of removing the assets	85
– costs of reorganising the business following the asset disposals	96

On the basis of the results of these figures, the client has calculated the recoverable amount of the assets as K3·6 million and concluded that the site has not suffered an impairment. No adjustments have therefore been made to the financial statements in this regard.

v) Unfair dismissal

You have also become aware that Auto Africa was being sued by the former Chief Executive Officer for wrongful dismissal before the expiry of his contract. He is claiming an amount of K1.5 million in damages. After consultations with the in-house lawyers, the company made a provision in the financial statements of K560,000. This case was still active in court at the end of May 2022

A few days before signing the audit report, the case was concluded and Auto Africa was found guilty of having wrongly dismissed the former Chief Executive Officer and the court determined that the company pays K910,000 in compensation and also meets the legal feesof the Chief Executive Officer amounting to K200,000.

C. FOOLPROOF

Your firm has asked you to perform an independent review of the working papers of FoolProof Co which has been an audit client of your firm for the last ten years. FoolProof Co, a listed company specialising in the manufacture and installation of sound-proof partitions for domestic and industrial buildings.

The audit fieldwork is almostcomplete and as part of your review, you have been asked to review the draft auditor's report on the company's financial statements for the year ended 31 March 2022

Extracts from the draft auditor's report are shown below:

Independent auditor's report to the shareholders and directors of FoolProof Co

Basis for opinion

We conducted our audit of FoolProof Co in accordance with International Standards on Auditing(ISAs). Our responsibilities under those standards are further described in the auditor's responsibilities for the audit of the financial statements section of our report. We are independent of the Company in accordance with the ZiCA ethical requirements which are relevant to our audit of the financial statements in Zambia, and we have fulfilled our other ethical responsibilities in accordance with these requirements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our opinion.

Opinion

We have audited the financial statements of FoolProof Co (The Company), which comprise the statement of financialposition as at 31 March 2022, and the statement of comprehensive income, statement of changes in equity andstatement of cash flows for the year then ended, and notes to the financial statements, including a summary ofsignificant accounting policies. In our opinion, the accompanying financial statements present fairly, in all material respects, the financial position of the Company as at 31 March 2022, and of its financial performance and its cash flows for the year then ended in accordance with IFRS® Standards.

Material uncertainty regarding going concern

The Company is financed by a long-term loan from its bankers which is due for redemption in August 2022 At the date of this auditor's report, the Company is in the process of renegotiating the loan but has not yet reached a final agreement with its bankers. It is our view that the loan finance is essential to the continued survival of the Company and that at the time of reporting, therefore, the absence of a finalised agreement represents a material uncertainty regarding going concern. The financial statements have been prepared on a going concern basis but do not make any reference to the loan redemption or the ongoing negotiations with the bank. As the external auditor therefore, we are fulfilling our duty by bringing the matter to the attention of users of the financial statements.

Key Audit Matters

There are no matters that were identified as being significant to the audit for the year ended 31st March 2022

Other information

The Company's principal activity is the manufacture and installation of sound-proof partitions for domestic andindustrial buildings. The Company therefore engages in long-term contracts which are incomplete at the reporting date and which are material to its revenue figure. The installation process is complex and significant judgement is applied in assessing the percentage of completeness which is applied to calculate the revenue for the year. The significance of this judgement requires us to disclose the issue as other information which is relevant to the usersof the financial statements.

D. PICK & BUY

Pick & Buy Co is a discount food retailer which operates 30 stores nationally. The financial statements for the year ended 30 April 2022 recognise

- Revenue of K247 million (2021 – K242 million),
- Profit before tax of K14·6 million (2021 – K14·1 million)
- Total assets of K535 million (2021 – K321 million).

After a period of rapid expansion, 2022 has been a year in which Pick & Buy Co has strengthened its existing position within the market and has not opened any additional stores or businesses. The company's draft statement offinancial position for 2022 includes a property portfolio of K315 million all of which are legally owned by the entity. In the current year, the company has chosen to adopt a policy of revaluing its property portfolio for the first time and this is reflected in the draft figures for 2022

The audit work on property, plant and equipment included testing a sample of the revaluations. Luzek & Co requested at the planning stage that independent, external valuation reports should be made available to the audit team at the start of the final audit visit. A numberof these documents were not available when requested and it took three weeks for them to be received by theaudit team. The audit working papers also identify that on review of the non-current asset register, there were fourproperties with a total carrying amount of K11·1 million which had not yet been revalued and were still recordedat depreciated historic cost.

The audit supervisor's review of Pick & Buy Co's board minutes identified that the company has renovated car parking facilities at 17 of its stores which has resulted in a significant increase in customer numbers and revenue at eachof these locations. The total cost of the renovation work was K13·2 million and has been included in operatingexpenses for the current year. The audit file includes a working paper recording discussions with managementwhich confirms that capital expenditure authorisation forms had not been completed for this expenditure.

You are aware that your firm had intended to replace Ms. Judith Bwali the current engagement partner, with Brian Chilangwa, who is Luzek & Co's other specialist in food retail. Unfortunately, Mr Chilangwa was taken ill earlier in the year and will not now be available until next year's audit engagement. As a result, 2022 is the eighth consecutive year in which Judith Bwali has acted as engagement partner.

REQUIREMENTS

1) **LUZEK & CO**
   a) **Identify and evaluate SIX ethical, quality control and other professional issues**
   (15 marks)

   b) **For each issue, recommend appropriate action that your firm should take**

   (9 marks)

2) AUTO AFRICA

a) Comment on the matters to consider and explain the matters which should be discussed with management in relation to each of the proposed adjustments

i) Leasing of testing equipment (8 marks)

ii) Legal claim (6 marks)

iii) Asset impairment (6 marks)

iv) Unfair dismissal of former chief executive (6 marks)

b) For each of the above FOUR matters, assess

i) Whether proposed adjustments are correct (8 marks)

ii) The implications on the auditor's opinion if management does not make the proposed adjustments. (8 marks)

3) FOOLPROOF

Critically appraise the extract from the draft auditor's report for the year ended 31 March 2022 under each of the following items:

(a) Addressee (2 marks)

(b) Basis of opinion and opinion (5 marks)

© Material uncertainty regard going concern (4 marks)

(c) Key Audit Matters (4 marks)

(d) Other information (4 marks)

4) PICK & BUY

From the information provided on the drafting of report to those charged with governance, recommend the

a) FIVE matters which should be included in the report to those charged with governance, and (10 marks)

b) Explain the reason for their inclusion. (5 marks)

SUGGESTED SOLUTONS TO QUESTION ONE - AUDIT

1)

Long association of senior personnel – familiarity threat

Ben Luvale's eight-year tenure as audit engagement partner creates a familiarity threat for Pembe Farms The threat arises because using the same senior audit personnel on an audit assignment over a long period of time may cause the auditor to become too familiar and too trusting with the client resulting in less professional scepticism being exercised and the possibilityof material misstatements going undetected. According to the IESBA *International Code of Ethics for Professional Accountants* (the *Code*), with listed audit clients key audit partners must be rotated after seven years unless exceptional circumstances arise. In this case, the *Code* permits the partner's tenure to be extended for one further year where this is deemed to be necessary inorder to maintain audit quality.

Action

The *Code* also clarifies that if an existing audit client becomes listed, the length of time whichthe partner has already served on the client is included in the period to be considered. In the case of Pembe Farms, therefore, Ben Luvale has already served as a key audit partner for the maximum possible period of eight years and following the listingof the client next year, it would be appropriate for her to be replaced by another audit partner. The code does allow an exception, which states that with the agreement of those charged with governance, she could serve for a maximum of an additional twoyears. After this, she may not serve as a key partner on the audit for a minimum of five further years.

Fee dependence – Self-interest and intimidation threat

Over dependence on an audit client for fee income leads to a self-interest and intimidation threat for the auditor. The self-interest threat arises as the firm will have a financial interest in the client due to its dependency on the client and its concern about theimpact on its business if it were to lose the client. In the case of a listed client, the *Code* states that an audit firm's independenceis threatened and should be reviewed if the total fees from a single client exceed 15% of its total fee income for two consecutive years.

Action

In this case, the 15% limit has been exceeded in both 2021 and 2022 and following the listing of the company's sharesin a year's time. PMK & Co is required to review its dependence on the client. If retained as a client, the level of feesshould be disclosed to those charged with governance and it should be discussed whether prior to the audit opinion being issued, having an independent pre-issuance or post-issuance review performed on the engagement by an external party or bythe firm's professional regulatory body is enough to mitigate the threat.

Provision of bookkeeping and accounting services - Self review threat

The provision of bookkeeping and accounting services for Pembe Farms creates a self-review threat for PMK & Co. The self-review threat arises because the auditor is generating figures for inclusion in the financial statements on which they willthen give an opinion. As a result, the auditor may be less likely to highlight errors if they are aware that another member of the firm has calculated the figures.

Action

For a listed client, the *Code* states that a firm is not permitted to provide accounting andbookkeeping services. The *Code* does, however, make an exception for divisions of a company if the services are of a routineand mechanical nature, a separate team is used and the service which the firm provides relates to matters which are immaterialto the division and the company. Following Pembe Farms's listing in a year's time, therefore, PMK & Co will no longer be able to provide the payroll services for Pembe Farms although it may still be able to maintain the financial records for the small division if the conditions stated in the *Code* are satisfied.

Share prospectus

- **Advocacy threat**

  PMK & Co has been asked to assist in the preparation of the share prospectus document and to provide an accountant's report on financial data, business risks and a business plan which recommends the shares to investors. Performance of these services for Pembe Farms would create an advocacy threat for the auditor. The advocacy threat arises because the auditor is effectively being asked to promote and represent their client's position to the point where the auditor's objectivity is compromised.

  Action

  The *Code* prohibits an auditor from acting in this way for an audit client and PMK & Co should politely decline to assist in the preparation of the document and to endorse the recommendation to investors to purchase the shares. It may be possible, however, for the auditor to provide an accountant's report on some elements of the prospectus. PMK & Co may be able to provide an opinion on the financial information if, for example, it limits the form of opinion to stating that it has been properly compiled on the basis stated within the document and that this basis is consistent with the accounting policies of the company.

- **Management threat**

  The preparation of share prospectus and a business plan may include undertaking management function such as decision making. This generates a management threat

  Action

  PMK & Co should clarify with the client the separate functions of management and providing information. Whereas the audit firm may be expected to provide information required for the compilation of the documents, the auditor cannot be involved in making final decisions. If management is not willing to accept their management responsibilities, the service should be decline

Intimidation - Review of audit appointment

Mia Kembe's comment that Pembe Farms is currently reviewing the audit appointment and that it is looking for an audit firm which is capable of taking it through the listing process and providing a full range of services in the future represents an intimidation threat to the auditor's objectivity. The intimidation threat arises because Mia Kembe is applying pressure on PMK & Co to offer a range of services which will result in breaches of the *Code* for the audit firm. She is effectively intimidating the firm by threatening to appoint another audit firm if PMK & Co does not comply.

Action

PMK & Co should explain its ethical duties to those charged with governance and identify clearly the services which it will not be able to provide if it continues as the company's auditor after the stock market listing in a year's time

2) Evaluation of risks of material misstatement

a) Analytical review risks

Current assets

The limited analytical procedures which have been performed indicate several potential risks of material misstatement. First, the current ratio has increased significantly, from 1·4 in 2021, to a projected figure of 2·6 in 2022. Using the information provided, the current liabilities in 2021 were K15.64 million (K21.9 million/1·4) and are projected to be K12.88 million in 2022 (K33.5 million/2·6).

Current assets are projected to increase by 53% and current liabilities projected to reduce by 17·6%. Given that the management accounts show that the cash balance is relatively static, there is a risk that other current assets, presumably inventory and receivables, could be overstated. However, the increase in current assets can at least partly be explained by the inclusion of the K4.5m prepayment relating to restoring the damaged factory; this is discussed in more detail later.

Current liabilities

There is also a risk that the current liabilities are understated; this risk is particularly significant given that according to the finance director, current liabilities include a provision of K4.5m in relation to restoring the damaged factory.

Gearing

The projected movement in the gearing ratio is small, from 32% to 28%. This fall in the gearing ratio is inconsistent with the fact that the company has taken a loan of K3.75m to finance the research and development. The expectation would be for the gearing ratio to increase, unless there has been a repayment of finance of which we are unaware.

Looking at the operating margin and return on capital employed, both ratios have improved by a small amount. This trend is worthy of scrutiny during the audit as the offers and discounts offered to customers by the company should act negatively on margins and profitability, so the improvements in ratios could indicate a potential overstatement of operating profit.

Online sales

Another trend which is worth further investigation relates to online sales, which are projected to increase by 90·5% in the year. This is a significant increase, and while the finance director has asserted that the increase in sales is due to the success of the advertising campaign, this needs to be corroborated further. There is a risk of overstatement of revenue in relation to online sales which is explored in more detail below. There is also a risk that revenue from other sources is overstated. Excluding online sales, revenue from other sources is projected to increase by 5·3%, a significant increase, which could also indicate overstatement of revenue.

b) Risks from other information

Management bias

This is a private company where a majority of shares are owned by the Pembe family. This brings a risk of management bias, especially as one of the family members is the company's chief executive officer, who is in a position to influence the financial statements. The extract from the management accounts shows that a significant dividend payment is made each year, so there is an expectation from the family members that the company will make sufficient profit to be able to pay these dividends each year. There is therefore a significant inherent risk at the financial statement level that profit will be overstated. The risk that the financial statements are being deliberately manipulated is indicated by the accounting treatment applied to impairment which is discussed in more detail below.

Online sales

The online sales make up an increasing proportion of the company's revenue – according to the management accounts online sales are projected to represent 7% of total revenue in 2022 (4% – 2021).

Online sales can bring a number risks of material misstatement, for instance, cut off and timing of revenue recognition can be problematical. In the case of Pembe Farms, risks attach to the discounts which are offered on online sales as the discounts offered to customers appear to change frequently.

This brings some complexity into the accounting, and the company should ensure that internal controls are operating effectively so that the accounting system is updated whenever the level and range of discounts and offers to customers are changed. Revenue could be over or understated if discounts are not accounted for appropriately, either because a discount is not recorded at all by the accounting system or is applied to the wrong products.

Research and development

In this financial year, K2.2M of research and development costs have been capitalised as an intangible asset. This represents 1·8% of total assets and 10·5% of profit before tax, and would be considered material to the financial statements.

This relates to research and development into new plastic-free packaging. According to IAS 38 *Intangible Assets*, a distinction has to be made between research costs, which must be expensed, and development costs, which should only be capitalised if certain criteria are met including that the technical and commercial feasibility of the asset has been established. It appears that the full amount paid to ProPack has been capitalised, which indicates that no distinction has been made between research costs and development costs.

Only development costs can be capitalised, so there is a potential overstatement of the intangible asset if it includes research costs, which should be expensed. This means that the entity must intend and be able to complete the intangible asset and either use it or sell it and be able to demonstrate how the asset will generate future economic benefits.

There is a further risk of material misstatement because costs which are development costs may have been capitalised but the necessary criteria demonstrating that an asset has been created have not been met. Given that ProPack is only at the stage of testing prototypes, it appears that there is not yet demonstrable evidence that the new packaging is technically feasible or that Pembe Farms will be able to use the packaging. In addition, there may problems in demonstrating that Pembe Farms has control of the development of new packaging, given that the development has been outsourced to another company. In this case, the IAS 38 criteria for capitalisation do not appear to have been met; this will result in overstatement of intangible assets and understatement of operating expenses.

Impaired factory

The carrying amount of the impaired factory is material to the statement of financial position, representing 7% of total assets. The damage to the factory has triggered an impairment review, as required by IAS 36 *Impairment of Assets*. However, the finance director has not prepared the impairment calculations in accordance with IAS 36, specifically the recoverable amount has not been correctly determined. The recoverable amount is the higher of value in use and fair value less costs to sell the asset. However, a review of the calculation provided indicates that the determination of value in use is not correct. According to IAS 36, the cash flow projections which are used to determine the value in use of the impaired asset should relate to the asset in its current condition – expenditures to improve or enhance the asset's performance should not be anticipated. The finance director's estimate of value in use is based on the assumption that the building is repaired and new machinery purchased – neither of these assumptions should be included in the determination of value in use.

It is likely that the value in use, when properly determined, is much lower than the finance director's estimate, meaning that the impairment loss to be recognised is greater than the K210,250 as per the finance director's calculations. There is also a risk that the fair value less cost to sell is overestimated – if the factory is damaged and the machinery needs to be completely replaced, then a value of K135,000 included in management's calculation may be over optimistic. Therefore there is a risk that the impairment loss is understated, and the carrying value of the asset is overstated.

Provision for restoring the damaged factory and acquiring new machinery

Related to the point above, the financial statements include a provision for repairing the factory and buying new machinery. A provision should only be recognised if it meets the criteria of IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*, including that there is a present obligation as a result of a past event, and that a probable future outflow of economic benefit which can be reliably estimated exists. In this case there does not seem to be a present obligation, the company is not contractually obliged to repair the damage and there is no evidence that a constructive obligation exists.

Neither does it appear appropriate to recognise a prepayment for an expense which has not yet been incurred. Therefore, the provision and related prepayment should not be recognised, and unless an adjustment is made to the financial statements, both current assets and current liabilities are overstated. The amount recognised represents 3·6% of total assets and is material to the statement of financial position, though it has no impact on profit.

Software and advertising costs capitalised

During the year, software development costs of K300,000 and advertising costs of K2.25M are capitalised as intangible assets. The advertising costs are material, representing 1·8% of total assets and 10·7% of profit for the year. The advertising costs have been incurred to support the 'Pembe Gold' brand name, and the finance director justifies the capitalisation on the grounds that the advertising expenditure has led to an increase in sales. However, IAS 38 specifically states that advertising and promotional costs must not be recognised as intangible assets and must be expensed. Therefore intangible assets are overstated and operating expenses understated by a material amount.

The software development costs represent less than 1% of total assets and only 1·4% of profit, so are not considered to be material to the financial statements, and therefore in isolation do not represent a significant risk of material misstatement in monetary terms, especially given that according to IAS 38, it is appropriate to capitalise internally developed software costs assuming that the costs incurred give rise to an asset. However, this matter is being highlighted because the finance director has used a similar justification for capitalising the advertising costs, which are likely to be materially misstated, as discussed above, and therefore this gives rise to a general concern over whether all costs relating to intangible assets are being treated appropriately.

Identification and potential misclassification of assets

There is a risk that the agricultural assets are not identified and/or classified appropriately, which will have an implication for the valuation of the assets. For example, it may be difficult to distinguish between bearer plants and fruit growing on the trees, and it might be hard to identify the stage of development of fruit on the trees. This potentially impacts on the valuation of the assets, because bearer plants are measured at cost and depreciated in accordance with IAS 16 *Property, Plant and Equipment*, whereas the fruit should be measured at fair value in accordance with IAS 41 *Agriculture*.

3) Principal audit procedures

a) Impairment factory

- Obtain management's detailed calculations to gain understanding and allow evaluation of the methodology and assumptions used, e.g. the basis of determining the fair value and the future period over which value in use was determined and the discount rate used to calculate the present value of future cash flows.
- Discuss the methodology and assumptions with management to confirm their rationale.
- From the non-current asset register, confirm the carrying amount of the cash generating unit prior to any impairment being recognised, and confirm the carrying amount of each component of the cash generating unit.
- Obtain a copy of the company's insurance policy and review the terms and conditions to confirm whether the buildings and machinery are covered by insurance.
- Develop an auditor's estimate of the fair value less cost to sell and value in use, in accordance with the IAS 36 requirements (i.e. not including the restoration costs and replacement of machinery), and compare to management's estimate. Developing an auditor's estimate would involve the following procedures:
    - Obtain and review the reports from the engineer to confirm the nature and extent of damage caused to the factory.
    - Obtain and review any external valuation report which the company has used as a basis of the fair value less cost to sell, and evaluate the reasonableness of any assumptions used in the valuation.
    - For the value in use, discuss with management to obtain their view as to whether the factory has any value in use at all in its current state.
    - Visit the factory to view the extent of damage caused by the storm and evaluate whether it can be used without any further capital expenditure.
    - Consider whether the use of an auditor's expert is necessary to provide sufficient and appropriate evidence given the materiality of the figures.

b) Research and Development costs

- Discuss the project to develop new packaging with management, to develop an understanding of matters such as how the company intends to use the new packaging, the stage of development reached by the year end and whether the project may need additional funding.
- Obtain and review progress reports and correspondence from ProPack which will indicate the progress made so far.
- Obtain and review the contract with ProPack to determine contractual terms and if the asset will be owned and controlled by Pembe Farms and that ProPack does not have any continuing interest in the development once it is complete.
- After receiving client's permission, arrange to discuss the project with ProPack, to obtain further understanding on a range of matters including technical feasibility and the results of the testing on the prototype.
- Discuss with the company's production and marketing directors to obtain understanding of how the company will use the new packaging.
- Obtain any financial budgets prepared in relation to the project, to confirm the amount of expenditure which has been approved, and that the costs are clearly distinguishable.
- By reference to the company's cash position and available finance, evaluate whether Pembe Farms has sufficient funds to complete the development.
- Obtain samples of the prototype packaging from ProPack, to confirm existence.
- Agree the amount spent to date to invoices submitted by ProPack, and to the company's cash records.

4) **Matters to consider before placing reliance on the work of the auditor's expert**

ISA 620 *Using the Work of an Auditor's Expert* contains requirements relating to the objectivity, competence and capabilities of the auditor's expert, the scope and objectives of their work, and assessing their work.

Objectivity

According to ISA 620, the auditor shall evaluate whether the auditor's expert has the necessary objectivity and this should include inquiry regarding interests and relationships which may create a threat to the expert's objectivity. The audit firm will need to ensure that the expert has no connection to Pembe Farms, for example, that they are not a related party of the company or any person in a position of influence over the financial statements. If the expert's objectivity is threatened, little or no reliance can be placed on their work, and the audit firm should not treat it as a reliable source of audit evidence.

Competence

ISA 620 also requires the competence of the expert to be considered; this should include considering the expert's membership of appropriate professional bodies. Any doubts over the competence of the expert will reduce the reliability of audit evidence obtained. The expert should in this case have experience in valuing the fruit which are the agricultural assets recognised in the statement of financial position, and be familiar with the framework for measuring fair value of these assets in accordance with IAS 41 *Agriculture* and IFRS 13 *Fair Value Measurement*.

Scope of work

ISA 620 requires the auditor to agree the scope of work with the expert. This may include agreement of the objectives of the work, how the expert's work will be used by the auditor and the methodology and key assumptions to be used. In assessing the work performed by the expert, the auditor should confirm that the scope of the work is as agreed at the start of the engagement. If the expert has deviated from the agreed scope of work, it is likely to be less relevant and reliable.

Relevance of conclusions

ISA 620 states that the auditor shall evaluate the relevance and adequacy of the expert's findings or conclusions. This will involve consideration of the source data which was used, the appropriateness of assumptions and the reasons for any changes in methodology or assumptions. The conclusion should be consistent with other relevant audit findings and with the auditor's general understanding of the business. If the work involves using source data which is significant to their workings, the audit team should plan to assess the relevance, completeness and accuracy of that data. Any inconsistencies should be investigated as they may indicate evidence which is not reliable.

5) Email from Mark Lundu – Audit implications and recommended action

Ethical and other professional issues

- **Laws and regulations**

The alleged use of prohibited chemicals raises concerns that the company may not be complying with relevant law and regulations. The auditor needs to consider the requirements of ISA 250 *Consideration of Laws and Regulations in an Audit of Financial Statements*. ISA 250 states that while it is management's responsibility to ensure that the entity's operations are conducted in accordance with the provisions of laws and regulation, the auditor does have some responsibility in relation to compliance with laws and regulations, especially where a non-compliance has an impact on the financial statements.

- **Integrity**

There is also an ethical issue in that one of the production managers may have been bribed by one of the company directors. Clearly, if this is true, it indicates a lack of integrity and would seem to confirm that the chemicals which are being used are prohibited.

Action

The auditor should attempt to find out whether any member of management had issued instructions for these chemicals to be used, i.e. that there is a deliberate breach of law and regulations. ISA 250 suggests that when the auditor suspects management or those charged with governance of being involved with the non-compliance, the matter should be communicated to the next level of 'higher authority' such as an audit committee or supervisory board. Given the family-managed nature of Pembe Farms, it may be that no higher authority exists, in which case the audit firm should take appropriate legal advice if they think that the matter may not be communicated by the entity.

Financial statements

The auditor is required by ISA 315 *Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and its Environment* to gain an understanding of the legal and regulatory framework in which the audited entity operates. This will help the auditor to identify non-compliance and to assess the implications of non-compliance. Therefore the auditor should ensure a full knowledge and understanding of the laws and regulations relevant to the use of chemicals in the company's farms, and the implications of non-compliance.

In addition, there is a risk that the use of chemicals means that inventory of harvested fruit and the fruit trees are contaminated with poisonous chemicals and possibly will need to be destroyed. The assets could therefore need to be written down in value. If any necessary impairment of the assets is not recognised, then non-current assets and current assets could be misstated. The audit team should therefore plan procedures to determine the value of the contaminated assets.

There may be a going concern issue once the non-compliance and its implications has been established and the facts get out into the media. There would be considerable impact on the reputation of the company and its brand; customers may stop purchasing the products for fear of a health risk and this could affect the going concern of the business.

Action

The auditor needs to consider the potential implications for the financial statements. The non-compliance, if proven to have taken place, could lead to regulatory authorities imposing fines or penalties on Pembe Farms, which may need to be provided for in the financial statements. Audit procedures should be performed to determine the amount, materiality and probability of payment of any such fine or penalty imposed.

Reporting

ISA 250 requires that when non-compliance is identified or suspected, the auditor shall obtain an understanding of the nature of the act and the circumstances in which it has occurred, and further information to evaluate the possible effect on the financial statements. Therefore procedures should be performed to obtain evidence about the suspected non-compliance, for example, to speak to the company's farm managers to understand whether the allegations are founded in fact. In addition, the audit team could perform further procedures, for example, reviewing purchase invoices to establish if these chemicals are actually being purchased and used in the business, and if so, on whose authority.

Action

ISA 250 requires the matter to be discussed with management and where appropriate with those charged with governance. Given the potential severity of the situation, and that the chemicals may be toxic, there is the risk of poisoning the company's employees or customers, and the matter should be communicated as soon as possible.

In terms of reporting non-compliance to the relevant regulatory authorities, ISA 250 requires the auditor to determine whether they have a responsibility to report the identified or suspected non-compliance to parties outside the entity. In the event that management or those charged with governance of the company fails to make the necessary disclosures to the regulatory authorities, the auditor should consider whether they should make the disclosure. This will depend on matters including whether there is a legal duty to disclose or whether it is considered to be in the public interest to do so.

Confidentiality is also an issue, and if disclosure were to be made by the auditor, it would be advisable to seek legal advice on the matter. Further advice on disclosure in the public interest is given by the IESBA's pronouncement on *Responding to Non-Compliance with Laws and Regulations* (NOCLAR). The guidance gives examples of situations where disclosure might be appropriate. These examples include references to an entity being involved in bribery and breaches of regulation which might impact adversely on public health and safety. The standard also clarifies that in exceptional circumstances where the auditor believes there may be an imminent breach of a law or regulation, they may need to disclose the matter immediately. The decision to disclose will always be a matter for the auditor's judgement and where the disclosure is made in good faith, it will not constitute a breach of the duty of confidentiality under s.140 of the IESBA *Code of Ethics for Professional Accountants*.

6) Audit strategy

(i) Inventory count

Evaluation of strategy

The auditor is required to obtain sufficient appropriate evidence to support the opinion on the financial statements. Failure to attend the inventory count should result in alternative procedures being considered

It is not enough that only a review of the stock sheets used during the count was done and written representations obtained from management. Both of these are internally generated evidence and are not as reliable as external or auditor generated evidence

Further procedures

The auditor should conduct alternative procedures involving

- Physical inventory of the items as they stand at the current date

- Testing of movements in inventories – issues and receipts during the period up to the year end
- Reconciliation of inventories from the inventory count to the inventory sheets of the client
- Addressing all the queries arising

(ii) Planning

Evaluation of strategy

Analytical reviews are required to be performed to the extent of the information available. The absence of prior period information is not enough justification for not undertaking analytical reviews

Materiality is based on risk assessment and not necessarily on the size of the activities being audited

Further procedures

- Analytical procedures should be performed month by month and also with comparison to budgets and auditor expectations
- Any unusual changes should be investigated
- Materiality should be set with reference to the revenue, profit before tax and total assets of the joint venture.
- Materiality should be based on the risk assessment, and given that the joint venture activities are new, the risk should relatively be considered higher. This should result in a relatively lower materiality, especially with the accounting system being new

(iii) Receivables

Evaluation of strategy

37% of revenue is outstanding as receivables, making this significant in terms of the total revenue for the period. The auditor is required obtain sufficient appropriate evidence to support the opinion on the financial statements. For receivables, the recommended procedure is confirmation which is considered more reliable.

A negative confirmation is adopted where the auditor is satisfied that the system of For Pembe, there is no evidence to justify the use of negative confirmation procedure. In any case the new accounting system is likely to have inherent problems

Further procedures

- A positive confirmation should be arranged where responses will be required from all receivables.
- Non-responses should be followed up
- It is not clear what policy exists regarding provision for bad debts. At 37%, this suggests that some receivables may be outstanding for long periods of time
- All disputed balances should be provided against
- Inspect after day receipts

(iv) Income and expenses

Evaluation of strategy

A systems-based strategy should only be adopted in situations where the risk is low and the systems are fully documented and tested for effectiveness

In the context of the joint venture, this a new system dealing with new transactions and being operated by staff for the first time. Accordingly, it should be expected that the inherent risk is high

Further procedures

A risk-based approach should be adopted to address the following assertions

- The systems should be fully documented and tested for effectiveness
- All sampled transactions were authorized in accordance with stated policies and procedures
- Analytical procedures should be carried out to support evidence with auditor generated evidence. The analytical procedures should also relate to the budgeted information
- Transactions should also be tested for
    - Completeness
    - Arithmetic and accuracy
- Cut off procedures should also be included to ensure that sales and purchases are not misstated

Question 2

1) **LUZEK & CO**
    a) **Ethical, quality control and other professional issues**
    b) **Appropriate action that your firm should take**

Planning - Share-based payment scheme – risk assessment

The failure to identify the new cash-settled share-based payment scheme as a potentially high risk area indicates inadequate planning and a lack of consultation with the client. The share-based payment scheme is a complex and judgemental area and given that the scheme was only introduced in the year, it should have been identified as a key area of audit risk. This is a sign of inadequate planning or lack of knowledge It is possible that the previous manager was affected by the illness

Action

Luzek should ensure that planning is done in accordance with applicable auditing standards, reviewed and approved before the commencement of the field work.

According to ISA 315 (Revised 2019) Identifying and Assessing the Risks of Material Misstatement, planning should involve understanding of the business and risk assessment to identify areas of possible material misstatement. The requirement to deal with a new standard (IFRS 2) suggests possible risk of misstatement especially with the need to deal with fair values.

Staffing of the audit

The assignment of a part-qualified supervisor to the audit of a listed entity is also indicative of poor audit planning. The audit supervisor appears to have inadequate skills and expertise to audit this public interest entity. This is evidenced by the incorrect treatment of the share-based payment scheme and the audit supervisor's comment that basing the expense in the profit or loss account on the valuation at the date of grant is appropriate and that the recognition of an equity reserve on the statement of financial position is correct in the email to the audit manager.

According to IFRS 2 Share-based Payments, the valuation of the share appreciation rights for a cash-settled scheme should be updated at the reporting date and the standard requires recognition of the cumulative cost of the scheme as a liability, not as an equity reserve.

The staffing levels on the audit also appear to be inadequate given that there are only two audit team members. This is again indicative of poor audit planning. In addition, it is clear that the audit manager should have been replaced earlier and that Easy Finance Co has failed to provide adequate direction and supervision of the audit.

The audit supervisor also fails to recognise that a share-based payment scheme with the directors of Easy Finance Co constitutes a related party transaction. While the supervisor is correct in saying that the cost of the scheme this year of K195,000 is immaterial on a quantitative basis (it represents only 0·36% of profit before taxation and 0·84% of total assets), as a related party transaction with directors, the scheme should be considered to be material by nature and should be fully disclosed in the notes to the financial statements in accordance with IAS 24 Related Party Disclosures. The related party disclosures are particularly important for a listed entity such as Easy Finance Co. In line with ISA 450 Evaluation of Misstatements Identified During the Audit, all misstatements should be accumulated and therefore the error should also have been included in the audit working papers and adjustment should have been requested.

Action

Luzek & Co should ensure that staff allocated to each assignment and audit area have the requisite qualification and experience to adequately audit that area. This should be reenforced with adequate supervision and review

Direction /briefing

The original audit manager, Stone Chibwe, has also provided an inadequate briefing meeting prior to the commencement of the audit work. The advice to follow last year's working papers is inappropriate as the auditor must always be on the look out for new situations and issues such as the new share-based payment scheme. It is questionable as to whether Stone Chibwe was well disposed to handle this audit.

It is also possible that the implications of Stone being suddenly taken ill were not fully taken into account

Action

As part of the process of implementing the audit strategy and audit plan, the audit management should provide adequate guidance and briefing to the audit team reflecting the demands of the current audit. In the circumstances, a total review of the planning done by Stone should have been done.

Supervision

Luzek & Co has also failed to monitor the progress of the audit and therefore to update and change the audit plan as necessary during the course of the audit as required by ISA 300 Planning an Audit of Financial Statements. This is evidenced by the fact that the audit clearance meeting is scheduled for next week and the initial manager review is only just taking place. In addition, there appears to be no evidence of engagement partner oversight over the course of the audit fieldwork and it is the engagement partner's responsibility to ensure that they have reviewed the documentation to ensure that sufficient appropriate evidence has been obtained and that the auditor's report issued in the circumstances is appropriate.

Action

Luzek & Co should ensure that each audit is adequately supervised and progress monitored on a regular basis, taking into account the particular demands of the assignment. In addition to the supervisor in the field, there must be some oversight by the manager and the engagement partner

Evidence re valuation of options

There appears to be a lack of audit evidence in relation to the firm of external valuers which has been used to value the share options. ISA 500 Audit Evidence requires the auditor to obtain sufficient and appropriate audit evidence that the valuation work performed by the management expert is adequate for the purposes of the audit.

Action

The auditor must therefore evaluate whether management's expert possesses the necessary competence, capabilities and objectivity to perform the valuations and whether the scope of their work is satisfactory for audit purposes. The 'checking out' of the expert online with reference to a website is clearly inadequate for audit purposes and this again reflects the inexperience and lack of expertise of the audit supervisor and poor audit planning with respect to the staffing on the audit.

Loan to member of the audit team - Self-interest

According to the IESBA Code of Ethics for Professional Accountants (the Code), a loan to a member of the audit team may create a threat to the auditor's independence. If the loan is not made under normal lending procedures, and terms and conditions, a self-interest threat would be created as a result of Cathy Puta's financial interest in the audit client. The selfinterest threat arises because of the potential personal benefit derived which may motivate the audit team member to behave in a manner aimed at protecting that benefit. Such a threat would be so significant that no safeguards could reduce the threat to an acceptable level. It follows therefore that the audit team member should not accept such a loan or guarantee. The Code, however, also states that a loan from an audit client which is a bank or similar institution to a member of the audit team which is made under normal lending procedures, is acceptable. Examples of such loans include home mortgages, car loans and credit card balances.

Action

It is possible therefore that the secured loan may be ethically acceptable and the key issue is whether 'the very best terms which the bank can offer' fall within Easy Finance's normal lending procedures, and terms and conditions. The bank's standard lending terms and conditions should be obtained and reviewed alongside the documentation for Cathy Puta's loan. Ultimately, the audit engagement partner is responsible for ensuring that ethical principles are not breached, so the partner should be involved with the discussions. The matter should be discussed with Cathy and the client's business manager in order to establish whether the loan is to be made under the bank's normal lending procedures. Cathy should be advised of the outcome of the review and Easy Finance's business manager should be advised of this decision, explaining the rationale and ethical rules behind it.

Temporary staff assignment - Self review

The Code states that the lending of staff to an audit client may create a self-review threat to auditor independence. The self review threat arises when an auditor reviews work which they themselves have previously performed – for example, if the external auditor is involved in the process of preparing the payroll figures for inclusion in the financial statements and then audits them. As a result, there is a risk that the auditor would not be sufficiently objective in performing the audit and may fail to identify any shortcomings in their own work.

Temporary staff assignment - Management responsibilities

In addition, there is a risk of the staff member assuming management responsibilities if they are involved in making judgments and decisions which are the remit of management.

Such assistance can only therefore be given for a short period of time and the audit firm's staff must not assume management responsibilities and must not be involved in any activities specifically prohibited. According to the Code, an audit firm cannot provide accounting and bookkeeping services (including payroll) to an audit client which is a public interest entity unless the services relate to matters which are collectively immaterial to the financial statements.

Action

In this case Easy Finance is a listed financial institution and is therefore a public interest entity. The assignment of a qualified member of staff as a supervisor on the client's main payroll system is likely to be material to the financial statements of a service industry client such as a bank and, in addition, may also involve management responsibilities. The audit manager should therefore discuss details of the proposed role of the seconded member of staff with the payroll manager and other key client contacts in order to establish the significance of the role and its materiality to the financial statements.

Assuming that the role is material, the audit manager should decline the proposed staff assignment.

2) AUTO AFRICA

i) Leasing of testing equipment

Matters to consider

The lease at Auto Africa Co's largest site is material to the statement of financial position at 2·2% of total assets. The leases at the other two sites are also material at 2·8% of total assets. The general recognition and measurement requirements of IFRS 16 Leases require lessees to recognise a right-of-use asset and a lease liability at the commencement date of the lease at the present value of the lease payments. The standard defines the commencement date as the date the asset is available for use by the lessee. Given that the commencement date is 31 May 2022 therefore, it is appropriate on this basis to recognise the lease on the statement of financial position as at this date.

It is significant, however, that IFRS 16 also contains an optional exemption for short-term leases of less than 12 months' duration with no purchase option. If Auto Africa Co elects to apply this exemption, it does not recognise the leased assets or lease liabilities on the statement of financial position but rather, it recognises the lease payments associated with those leases as an expense in the statement of profit or loss for the year on either a straight-line basis over the lease term or another systematic basis. However, IFRS 16 also requires that if this exemption is taken, it must be applied consistently by each class of underlying asset. Hence in this case, the client must either capitalise the leases across all three of the sites or apply the exemption consistently and not capitalise the leases across any of the sites. On either of these bases, as the commencement date of the lease coincides with the reporting date, there would not yet be any impact on Auto Africa Co's statement of profit or loss for the year.

Discussion with management

The audit manager should discuss the option of taking the short-term lease exemption with the finance director at tomorrow's meeting. The client should be advised to select one policy and consistently apply that policy to all the leased assets, in accordance with the requirements of IAS 8, accounting policies, estimates and errors

Adjustment to the financial statements

(i) if the client elects not to take the exemption across the three sites, assets and liabilities will be materially understated. Hence the audit supervisor's proposed adjustment is correct and a right-of-use asset and lease liability of K475,000 should be recognised on the statement of financial position.

(ii) Alternatively, if the client does elect to take the exemption across all three sites, then assets and liabilities are materially overstated and right-of-use assets and lease liabilities of K625,000 should be derecognised on the statement of financial position.

Impact on audit opinion:

If the client does not make any adjustment to the financial statements, the statement of financial position is materially misstated on the basis of misapplication of an accounting standard and the audit opinion should be qualified on this basis with an 'except for' opinion.

ii) Legal claim

Matters to consider

The legal claim is material to the statement of financial position being 5·5% of Auto Africa Co's total assets.

Following the requirements of IAS 37 Provisions, Contingent Liabilities and Contingent Assets, a provision should be recognised when: an entity has a present obligation (legal or constructive) as a result of a past event; it is probable that an outflow of resources embodying economic benefits will be required to settle the obligation; and a reliable estimate can be made of the amount of the obligation. In this case the customer has already won the action against the company, the amount of the claim has been agreed by the courts and settlement is still outstanding at the reporting date. Hence, a provision of K1·2 million should be recognised on the statement of financial position.

IAS 37 also states that contingent assets are not recognised in financial statements since this may result in the recognition of income which may never be realised. However, the standard continues by stating that when the realisation of income is virtually certain, then the related asset is not a contingent asset and its recognition is appropriate. With respect to Auto Africa Co's insurance claim therefore and the verified letter dated 25 May 2022, the settlement of the claim as at the reporting date is virtually certain and an asset should be recognised separately on the statement of financial position.

Discussion with management

The finance director should also be advised that the financial statements should include full disclosure of the facts and amounts surrounding the provision for the legal claim together with full details of the expected reimbursement from the insurance company recognised as an asset.

Adjustment to the financial statements

The audit supervisor's proposed adjustment is correct and the finance director should therefore be requested to adjust the financial statements to include the separate recognition of the asset and the provision. If the adjustment is not made, both assets and liabilities will be materially misstated. There is no net impact on the statement of profit or loss for the year.

Impact on audit opinion:

If the client does not make any adjustment to the financial statements, the statement of financial position is materially misstated and the audit opinion should be qualified on this basis with an 'except for' opinion.

iii) Asset impairment

Matters to consider

The asset impairment of K85,000 is not material in isolation to either the statement of financial position (0·4% of total assets) or the statement of profit or loss for the period (3·7% of profit before taxation).

According to IAS 36 Impairment of Assets, an entity should assess at the end of each reporting period whether there is any indication that an asset or a cash generating unit may be impaired. If any such indication exists, the entity shall estimate the recoverable amount of the asset. The standard states that potential impairment indicators include external sources of information such as significant changes in the market in which the entity operates. As each of Auto Africa Co's sites is considered a cash generating unit for impairment review purposes it seems appropriate therefore for the company to have conducted an impairment review at this site.

IAS 36 states that an asset or cash generating unit is impaired when the carrying amount exceeds the recoverable amount and it defines recoverable amount as the higher of the fair value less costs of disposal and the value in use. In the case of Auto Africa Co, the auditor has agreed figures for carrying value and value in use and the key issue is the correct calculation of fair value less costs of disposal. Following IAS 36, the costs of disposal should include legal costs, transaction taxes and the costs of removing the assets but should exclude the costs associated with reorganising a business. The correct amount for fair value less costs of disposal is therefore K3,515,000 (K3·9 million – K126,000 – K174,000 – K85,000).

Given that this is higher than the value in use of K2·9 million, the recoverable amount of the assets is also K3,515,000 and therefore the assets are impaired by K85,000 (K3·6 million – K3,515,000). The client appears to have incorrectly omitted the costs of removing the assets from its calculation of fair value less costs of disposal and as a result the statement of financial position and the statement of profit or loss for the year are both overstated by K85,000.

Discussion with management

Management should be advised of the need to carry out impairment reviews of he income generating unit whenever there is an indication of impairment and at the end of each year. The impairment should be taken into account and assets written down to their recoverable amount in accordance with IAS 36, Impairment, especially the calculation of fair value which take into account all direct disposal costs

Adjustment to the financial statements

The audit supervisor's proposed adjustment is therefore correct and the finance director should be advised of this error at tomorrow's meeting. Even though the amount is immaterial to both the statement of financial position and statement of profit or loss for the year, it is appropriate to request that the adjustment is made to the financial statements.

Impact on audit opinion:

Given that assets and profits are both immaterially overstated, if no adjustment is made to the financial statements, it follows that there will be no impact on the audit opinion in relation to this matter in isolation.

iv) Unfair dismissal of former chief executive

Matters to consider

The additional provision of K560,000 is 23.9% of profit before tax and 2.5% of total assets and is therefore material.

The provision of K560, 000 that was made in the financial statements was appropriate in line with IAS 37 Provisions, contingent liabilities and contingent assets. This was an accounting estimates based on management's assessment ofthe likely outcome of the case.

The determination of the case by the court that the company should pay K1.11 million confirms the amount that should have been provided at the year end. This is an adjusting event giving evidence of conditions that existed at the year end.

Discussion with management

Management should be advised to comply with IAS 10, subsequent events and recognize the additional liability of K550,000 as an adjustment event. Management should be requested to adjust the figure of provision and increase it byK550, 000 to bring the total provision to K1, 110,000.

Adjustment to the financial statements

An additional liability of K550,000 should be recognized. The proposed adjustment is correct

Impact on audit opinion

If the client does not make any adjustment to the financial statements, the statement of financial position is materially misstated and the audit opinion should be qualified on this basis with an 'except for' opinion as the matter is material and not pervasive

3) FOOLPROOF

Addressee

The structure and format of the auditor's report is prescribed by ISA 700 *Forming an Opinion and Reporting on Financial Statements*. The auditor's report should be addressed solely to the shareholders of the reporting entity and the title should not include any reference to the directors of FoolProof Co.

Basis of opinion and Opinion paragraphs

The first two paragraphs are presented in the incorrect order, the Opinion paragraph should precede the Basis for Opinion paragraph. In addition, the absence of any disclosure in the financial statements in relation to the uncertainties regarding going concern is grounds for a modification of the auditor's opinion. The modification is due to a material misstatement in relation to the absence of this key disclosure. If, in the auditor's professional judgement, the impact of this non-disclosure on the financial statements is material but not pervasive, a qualified 'except for' opinion should be issued. In this case, the opinion paragraph should be headed 'qualified opinion' and this should be followed immediately by a 'basis for qualified opinion' paragraph.

If, on the other hand, the auditor believes that the impact on the financial statements of the non-disclosure is both material and pervasive, an adverse opinion should be given. The opinion paragraph should then be headed 'adverse opinion' and should be followed immediately by a 'basis for adverse opinion' paragraph.

In addition, details of the uncertainty regarding going concern should be given in the basis for qualified or adverse opinion paragraph.

Material uncertainty regarding going concern

ISA 570 *Going Concern* provides guidance on how an auditor should report uncertainties regarding going concern in the auditor's report. According to ISA 570, if adequate disclosure about the material uncertainty is not made in the financial statements, the auditor should express a qualified opinion or adverse opinion as appropriate.

The use of a 'material uncertainty regarding going concern' paragraph in the draft auditor's report extract is therefore incorrect. This paragraph should only be used when adequate disclosure has been made by the directors in the financial statements and would include a cross reference to this disclosure. Given that this disclosure has not been made, this is therefore not appropriate in this case.

In this case, therefore, the absence of any disclosure in the financial statements in relation to the uncertainties regarding going concern is grounds for a modification of the auditor's opinion and the full implications explained in the basis for opinion and opinion paragraphs as stated above

Key Audit Matters (KAM)

The extract from the draft auditor's report states that significant judgement is applied in assessing the percentage of completenessof material long-term contracts and that this percentage is then applied in calculating the revenue for the year. This is a matter of high risk requiring significant auditor attention and given that FoolProof Co is a listed entity, it would be appropriate for this to be disclosed in the KAM section of the auditor's report. The KAM section of the auditor's report should begin with an introductoryparagraph explaining what a KAM is. The KAM section should then explain why this matter is considered to be a KAM due tothe significant judgement involved in assessing the percentage completeness of the long-term contracts and the high risk ofmaterial misstatement associated with this judgement process.

The KAM section should also include an explanation of how theKAM was addressed by the audit process. In this case, this might include, for example, an evaluation of the controls designed and implemented by FoolProof Co to monitor the progress of and the amounts owing on service and construction contracts; a review of the financial performance of key contracts against budgets and historical trends; and challenging management's estimates and judgements in respect of the progress to date on the contracts.

Other information - Long-term contracts

The use of the 'other information' section in this context is inappropriate. This section should be used to describe the auditor'sresponsibilities for 'other information' (e.g. the rest of the annual report, including the management report) and the outcome of fulfilling those responsibilities.

The disclosure regarding long-term contracts is more in line with the requirements of ISA 701 *Communicating Key Audit Matters in the Independent Auditor's Report*, where key audit matters are those which in the auditor's professional judgement were of most significance to the audit. In determining which matters to report, the auditor should take into account areas ofsignificant auditor attention in performing the audit, including:

- Areas of higher assessed risk of material misstatement, or significant risks identified in accordance with ISA 315 (Revised)
  Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment.
- Significant auditor judgements relating to areas in the financial statements which involved significant management judgement, including accounting estimates which have been identified as having high estimation uncertainty.
- The effect on the audit of significant events or transactions which occurred during the period.

4) PICK & BUY

A report to those charged with governance (TCWG) is produced to communicate matters relating to the external audit to thosewho are ultimately responsible for the financial statements. ISA 260 *Communication With Those Charged With Governance* requires the auditor to communicate many matters including independence and other ethical issues and the significant findingsfrom the audit.

The contents of the report include:

(a) Significant Findings from the Audit

- The auditor's views about significant qualitative aspects of the entity's accounting practices, including accounting policies, accounting estimates and financial statement disclosures.

- Significant difficulties, if any, encountered during the audit;
- Material audit adjustments
- Significant internal control deficiencies

(b) Auditor independence

In the case of Pick & Buy Co, the matters to be communicated would include the following:

i) Revaluation of property portfolio – Qualitative aspects in relation to accounting policies

In the case of Pick & Buy Co, therefore, the significant findings from the audit would relate to the changes in the accounting policy in relation to the revaluation of property and related material misstatements and the following matters should be communicated:

IAS 16 *Property, Plant and Equipment* states the revaluation policy should be consistent across a class of assets. However, four properties, which are material to the statement of financial position at 2·1% of total assets, are still carried at depreciated historic cost. This therefore represents a breach of IAS 16 and a material misstatement, which will impact on the form and content of the auditor's report.

Justification

According to ISA 260, the significant findings from the audit include the auditor's views about significant qualitative aspects of the entity's accounting practices including accounting policies and any circumstances which affect the form and content of the auditor's report.

ii) Valuation reports (Evidence delay) not available

The independent external valuation reports requested by Luzek & Co at the planning stage were not available when requested by the auditor and it took three weeks before they were received by the audit team. The auditor should report this delay to those charged with governance, detailing its impact on the efficiency of the audit process together with any resulting increase in the audit fee.

Justification

According to ISA 260, the significant findings from the audit also include significant difficulties encountered during audit such as information delays.

iii) Renovation of car parking facilities – Qualitative aspects of accounting policies

The renovation expenditure on the car parking facilities at Pick & Buy Co's properties should be recognised as an asset according to IAS 16 if it is probable that future economic benefits associated with the item will flow to the entity and the cost of the item can be measured reliably. In Pick & Buy Co's case, the cost has been quantified as K13·2 million and it has already derived economic benefits in the form of a significant increase in customer numbers and revenue at each of these locations. The expenditure should therefore be capitalised and its inclusion in operating expenses is not in compliance with IAS 16.

Justification

The amount of K13·2 million is also material to1 the statement of financial position at 2·5% of total assets. The incorrect application of IAS 16 and the material misstatement should be included in a report to TCWG as a significant finding from the audit which will impact on the form and content of the auditor's report.

iv) Unauthorised expenditure

The audit file includes a working paper recording discussions with management which confirms that capital expenditure authorisation forms for the K13.2 million had not been completed for this expenditure

The lack of authorisation indicates a lack of management oversight and a serious weakness in control which could allow fraud to occur. Furthermore, the lack of integrity shown by management in going ahead with the renovation works without the necessary permission is an example of management override and could be indicative of the tone set throughout the organisation. This therefore represents a high risk matter and they may wish to implement controls and procedures to prevent further breaches. The report to those charged with governance should include full details on this significant deficiency in internal control and should include recommendations to management in order to reduce the associated business risk.

Justification

ISA 265 *Communicating Deficiencies in Internal Control to Those Charged With Governance and Management* requires the auditor to communicate appropriately to those charged with governance deficiencies in internal control which the auditor has identified during the audit and which, in the auditor's professional judgement, are of sufficient importance to merit their respective attentions.

v) Long association of audit partner – Auditor independence

Judith Bwali has acted as audit engagement partner for Pick & Buy Co for eight consecutive years. According to the IESBA *Code of Ethics for Professional Accountants* (the *Code*), her long association with the audit client creates both familiarity and self-interest threats to auditor independence. The familiarity threat arises due to the long and potentially close relationship which she has with the staff of Pick & Buy Co leading to her being too sympathetic to their interests or too accepting of their work. This in turn gives rise to a self-interest threat in that her long association and close relationship with the client create a personal interest which may inappropriately influence her professional judgement or behaviour. In order to address these risks, the *Code* requires that an audit partner in a listed entity should be rotated at least every seven years and therefore her eight-year tenure as the audit partner of Pick & Buy Co appears to be in clear breach of this provision.

However, the *Code* does allow for an engagement partner to serve for an additional year if the required rotation is not possible due to unforeseen circumstances such as the illness of the intended engagement partner, in this case Brain Chilangwa. In these circumstances, safeguards should be applied such as the independent review of the engagement which is being performed and this should be communicated to those charged with governance. Going forward beyond the current year, if it remains impossible to rotate the audit partner due to a lack of alternative expertise within the firm, it may be possible for Judith Bwalii to continue as the audit partner if special dispensation is received from the relevant regulator and the necessary safeguards are applied such as the engagement is subject to regular review by an independent, external expert.

Justification

As discussed above, ISA 260 requires the auditor to communicate matters in relation to auditor independence. Judith Bwali has acted as audit engagement partner for Pick & Buy Co for eight consecutive years. According to the IESBA *Code of Ethics for Professional Accountants* (the *Code*), her long association with the audit client creates both familiarity and self-interest threats to auditor independence and this apparent conflict with ethical requirements should be brought to the attention of TCWG