COMPETENCE PROFESSIONAL EXAMS - AUDIT

QUESTION ONE

SUGGESTED SOLUTIONS

1) MEMCHEM LIMITED

a) Adequacy of the quality management policies and procedures

i) Overall responsibilities for quality management of the audit

According to ISA 220 revised, the engagement partner should take overall responsibility for managing and achieving overall quality on the audit engagement. The engagement partner is required to have sufficient and appropriate involvement throughout the audit engagement such that the engagement partner has the basis for determining that the significant judgments made and the conclusions reached are appropriate given the nature and circumstances of the engagement

In the scenario, the overall quality management of the auditor seem to have been delegated to the audit manager. It should be expected that for a new client such as MemChem, for which the firm does not have adequate experience, the engagement partner's involvement in quality management should be significantly more

ii) Inventory count – lack of supervision

According to ISA 220 revised, the engagement partner shall determine that the nature, timing and extent of direction, supervision and review is adequate and responsive to the nature and circumstances of the audit engagement and the resources assigned or made available to the engagement by the firm

In the scenario, the two trainees took only 2 hours to deal with what is evidently material (at 30% of total assets) levels of inventories maintained by MemChem. Given that the previous auditors took a whole-day, it should be expected that more time should have been spent to obtain reasonable assurance that inventory quantities are not misstated. There was a lack of adequate supervision resulting in high detection risk

iii) Inventory count – staffing

According to ISA 220 revised, the engagement partner shall determine that sufficient and appropriate resources to perform the engagement are assigned or made available to the engagement team in a timely manner, taking into account the nature and circumstances of the audit engagement, the firm's policies or procedures, and any changes that may arise during the engagement.

In the scenario, two juniors were assigned to attend the count of material levels of inventory. Given the materiality of inventory, being 30% of total assets, more qualified and experienced staff should have been allocated to this task, especially with the need to identify those inventories affected by storage and usage regulations for net realizable considerations

iv) Supervision of the audit – Thresa

According to ISA 220 revised, the engagement partner shall take responsibility for the direction and supervision of the members of the engagement team and the review of their work.

In the scenario, Thresa the supervisor had only visited the team twice and spent most of her time at the firm's office. In addition, she seemed to have been involved with more assignments that she could to enable adequate supervision to be undertaken. The audit of MemChem appear not have been sufficiently supervised

v) Inventory valuation – consultation

According to ISA 220 revised, the engagement partner shall determine that members of the engagement team have undertaken appropriate consultation during the audit engagement, both within the engagement team, and between the engagement team and others at the appropriate level within or outside the firm.

In the scenario, the determination of net realizable values for specialized inventories required the consultation of an expert. Although the expert was made available, this consultation was not sought until the final stages of the audit.

vi) Resource allocation – Dean – knowledge and experience

According to ISA 220 revised, the engagement partner shall determine that members of the engagement team collectively have the appropriate competence and capabilities, including sufficient time, to perform the audit engagement.

In the scenario, Dean faced challenges to obtaining evidence relating to the audit of inventories and payables because he appeared not to have sufficient competence and capability. This results in high detection risk

vii) Time allocation

According to ISA 220 revised, if the engagement partner determines that time allocated to the audit is insufficient or inappropriate in the circumstances of the audit engagement, the engagement partner shall take appropriate action, including communicating with appropriate individuals about the need to assign or make available additional time

In the scenario, the field work was discontinued as soon as the planned time was exhausted when more time should have been allocated. There is a risk that sufficient and appropriate evidence was not obtained

b) Need for the appointment of an engagement quality reviewer

According to the International Standard on Quality management 2 (ISQM 2), an Engagement Quality Review (EQR) is a firm-level response to an assessed quality risk that is implemented by the engagement quality reviewer on behalf of the firm. This is required on

- Audits of financial statements of listed entities
- Audits or other engagements for which an engagement quality review is required by law or regulation (see below)
- Audits or other engagements for which the firm determines that an engagement quality review is an appropriate response to address one or more quality risk(s)

The following risk features of the MemChem audit suggest the need for an Engagement Quality review (EQR):

- Professional etiquette procedures revealed that the outgoing auditors did not want to accept re-appointment because of a number of **disagreements** with directors, especially those relating to the need to write down inventories to net realizable amounts.

- In the response to the etiquette letter, ProBe Associates hinted that it was likely that the audit for the year ended 31st March 2023 would detect errors committed in the previous years. This implies that **prior year adjustments** may be necessary

- This is the **first time that DBO i**s being involved with a client in the cleaning and hygienic industry

c) Eligibility of Mr. Janis Tembo's appointment as the engagement reviewer for the audit

According to ISQM 2, the Engagement Quality Reviewer:

- Must have the competence and capabilities, including sufficient time, and the appropriate authority
- Comply with relevant ethical requirements so that threats to objectivity are eliminated or reduced to an acceptable level
- Comply with requirements of law and regulation that are relevant to the eligibility of the engagement quality reviewer (local requirements)

Mr. Daka is a recently appointed junior partner working closely with the engagement partner on the MemChem Audit. It is likely that he may be intimidated by Chimba – the engagement partner. Additionally, as a junior partner, it is unlikely that he would commend requisite authority required to conduct the EQR objectively. The other problem is that Mr. Data does not seem to have the relevant competence and capability for cleaning and hygienic industry.

In conclusion Mr. Daka does not meet the eligibility criteria to act as the EQReviewer

d) **Areas of focus for the Engagement Quality R**eviewer

According to ISQM 2, the reviewer is required

i) To review and understand the **significant judgements** made by the engagement team. They will assess whether the audit engagement documentation supports those judgements and whether the conclusions reached are appropriate.

ii) To evaluate whether the engagement team has **exercised professional skepticism** in reaching those conclusions in areas where significant judgement was exercised

iii) To evaluate whether appropriate consultation has taken place on difficult or contentious matters.

iv) To evaluate whether the engagement partner has sufficient and appropriate involvement on the audit engagement to be able to assess the judgements and conclusions reached by the engagement team.

The MemChem audit was likely to involve significant judgements, especially in the area of determining the write down of inventories, for which appropriate professional skepticism would need to be applied. In addition, the evident lack of timely consultation with the expert and apparent insufficient involvement by the engagement partner on the overall quality of the engagement should be other areas of focus

2) Dotv LIMITED

a) Analytical Review

		2023	2022	
Revenue increase		25.6%		
Gross margin	(7.84/98)	8%	9%	(7.02/78)
Operating margin	(6.01/98)	6.1%	7.9%	(5.87/78)
Revenue per customer	98.1.05)	K93	K96	(78.0.807)
Return on Intangible assets	(6.01/58)	10.4%	14%	(5.87/42)

b) Audit risks and materiality

i) Overstatement of profit – overstatement of revenue and understatement of expenses

The annual incentive scheme gives rise to an inherent risk at the financial statement level. Employees whose bonus payment is linked to profitability have an incentive to maximise profit, and given that senior executives are involved with the scheme, thereis a risk of management bias in the financial statements. The audit team should therefore be alert to situations where revenue could be overstated and expenses understated.

ii) Misstatement of accruals - liability

There is also an audit risk relating to the obligation for Dotv to pay the bonus, which should be recognised as an accrual at the year end. There is a risk that the liability recognised is over or understated in value given the potential complexity involved in calculating the bonus payment, the calculation of which is based on a range of selected targets for different employees.

Materiality

The amount to be recognised in respect of the annual incentive scheme could be material given that the bonus can be as much as 5% of employees' salary. Based on prior year's figures, the total bonus payable would have been K900,000, representing about 15% of prior year's profit before tax, and therefore material to the financial statements.

iii) Legal case

In JUNE 2022, a legal case was brought against Dotv. From the information provided, it is not possible to determine if it is material, however, there should be appropriate consideration as to whether the court case gives rise to an obligation at the reporting date.

According to IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*, a provision should be recognised as a liability if there is a present obligation as a result of past events which gives rise to a probable outflow of economic benefit which can be reliably measured. There is therefore an audit risk that if any necessary provision is not recognised, liabilities and expenses will be understated.

If there is a possible obligation at the reporting date, then disclosure of the contingent liability should be made in the notes to the financial statements. There is a risk of inadequate disclosure if Dotv finance director refuses to make appropriate disclosure in the notes – this is an audit risk whether the situation gives rise to a provision or a contingent liability, as provisions also have disclosure requirements which may not be complied with.

Materiality

The expected legal cost of K500,000 is 8% of profit before tax and is therefore material

iv) Dotv finance director's attitude

There may be a further issue related to the legal case regarding the attitude of Dotv finance director, who appears to have dismissed the accounting implications of the legal case and is reluctant to discuss the matter with the audit team. This could indicate that Dotv finance director is deliberately obstructing the work of the audit team, and perhaps has something to hide. This indicates a potential wider issue, that Dotv finance director is imposing a limitation on the scope of the audit. Dotv audit strategy should consider this issue, and the audit engagement partner may wish to discuss the issue with Dotv audit committee as a matter of urgency.

This increases the risk that the legal claim will not be recognised appropriately in the financial statements, and the audit team must approach this issue with a heightened degree of professional skepticism.

v) Trend in revenue – Significant increase in revenue

The financial information shows that total revenue is projected to increase by 25·6% this financial year. This is a significant increase and it could indicate that revenue is overstated. However, the number of subscription members is projected to increase by 30·1%, so possibly the increase in revenue is simply as a result of Dotv attracting more customers – but this is a very significant increase and will need to be substantiated.

However, when looking at revenue per customer per year, this is projected to fall from K96·65 in 2022 to K93·33 in 2023. Revenue per customer per month is therefore projected to fall from K8·05 in 2022 to K7·78 in 2023. These trends seem to contradict the introduction of the new premium subscription package, which should bring in additional revenue per customer. Possibly the premium subscription has not been taken up by many customers. It is, however, unusual to see a downwards trend in revenue per customer per month, given that the price of a regular subscription has remained the same as in the previous year, at K8·20 per month. Possibly the figures are impacted by the free trial period offered to new customers. These trends will need to be investigated to ensure that revenue is being measured appropriately and recognised at the correct point in time.

Materiality

The increase in revenue is 25.6% and is material

vi) Revenue recognition – advance subscriptions

There is also a risk arising from Dotv invoicing customers in advance, with revenue recognised when the bill is sent to the customer. Possibly this could lead to early recognition of revenue, i.e. recognising prior to Dotv providing a service to its customers. IFRS 15 *Revenue from Contracts with Customers* requires that revenue is recognised when a performance obligation is satisfied by transferring a promised good or service to a customer, and when providing a service over time, it can be difficult to determine how much service has been provided and therefore the amount of revenue which can be recognised at a particular point in time. There is therefore a risk of overstatement of revenue if the requirements of IFRS 15 are not adhered to.

vii) Amortisation of licences

The licences recognised as intangible assets are highly material to Dotv, representing 74·4% of total assets. Given that each licence is for a fixed period, it is appropriate to amortise the cost of each licence over that fixed period in accordance with IAS 38 *Intangible Assets*, which requires that the cost of an intangible asset with a finite useful life should be amortised on a systematic basis over its life.

Therefore, Dotv's accounting policy to amortise all licences over a five-year period may be too simplistic, especially given the significance of the balance to Dotv financial statements. Some of the licences have a shorter life, as the licences vary between three and five years, indicating that the determination of amortisation for the class of assets as a whole may not be accurate, leading to overstatement of intangible assets and overstatement of profit.

The finance director's assertion that the accounting policy is 'the most prudent' is not appropriate.

The accounting policy should be based on the specific, relevant IAS 38 requirements. It could be a means of earnings management, i.e. to minimise the amortisation charge and maximise profits.

Materiality

Given the significance of the intangible assets reported (74% of total assets), it is likely that the related amortization would be material

viii) Impairment of licences

Although the finance director has indicated that no provision should be provided on licences because of improved performance, the ratios computed in (a) above suggest otherwise with profitability ratios and expected return on intangible assets before tax having decreased from 2022 levels. Accordingly, this should be taken as an indicator of impairment and provision should be considered, otherwise the existing intangible assets may be overstated. In any case, IAS 38 – impairment requires impairment reviews to be undertaken regardless of the improvement in performance.

ix) Consistent application of accounting policy

The auditor should also consider whether this issue has arisen in previous years' audits. Dotv may have changed its estimation technique with regard to amortisation of intangible assets; if this is the case, the rationale for the change must be understood and obtain reasonable assurance that the issue has been properly addressed in accordance with IAS 8, Accounting Policies, Estimates and Accounting Errors

x) Impairment of content from Mollyhood

The new content bought from Molly should be subjected to impairment review immediately as evidence suggests that their carrying value may be more than the recoverable amount due to expected reduction in viewership

c) Substantive tests on the acquired content licences from Mollyhood

Assertion – occurrence – acquired during the year

- Inspect board minutes to verify that purchase was authorized
- Verify payment to bank statement

Assertion – Valuation - accounting treatment

- Discuss with management to confirm utilization of licence as an asset to confirm recognition as an intangible asset in accordance with IAS 38 – Intangible Assets
- Inspect invoice and agree cost for initial measurement
- Trace the recording of the intangible asset in the financial statements as being stated at cost less amortization
- Discuss the amortization policy with management to confirm consistence of application

- Re-compute the amortization charged and compare with the client's calculation
- Discuss with management the need to provide for impairment and ensure this is taken into account in accordance with IAS 38
- Obtain management representation to conform consistency of policy and impairment

Assertion – Existence

- Confirm the existence of acquired content by reviewing income generated from use and any feedback from viewers

Assertion - Rights

- Inspect contract of purchase and licence documents to verify that licences are in Dotv name and that Dotv has the right of use and control of the content acquired

3) In relation to the audit of CMS Limited

a) FOUR risks of fraud in accounting and stores management at the Regional Offices of the CMS

Fraud is more likely to occur when there are pressures on management, or when there are opportunities for fraudulent activities, or when attitudes encourage or tolerate fraud. It is possible that there is a tolerance for petty theft in the Regional offices, but the greatest risk comes from opportunity, due to the failure to segregate accounting functions from stores management functions.

Lack of segregation of duties

Accounting officers in the Regional offices are responsible for receipts into stores, issues from stores and general management of stores. They are also responsible for accounting for receipts and issues, and make payments to suppliers.

Failure to segregate duties combined with non- maintenance of stores and un performance of inventory counts means that they are opportunities for over paying for goods received or pay for the drugs and medical supplies which are not delivered. Employees could also steal the drugs and medical supplies and sell privately.

The risk of fraud can be reduced by system improvement e.g. effective segregate of duties between accounting staff and stores personnel.

Absence of documentation

It is difficult to establish a proper audit trail and to verify completeness, validity and accuracy of procurements. This situation promotes fraud

Susceptibility of certain drugs to theft

Many of the drugs stored by medical facilities can easily be stolen as they are portable and can easily fit into a pocket or small bag. With no evidence of rigorous security cameras, theft is significant risk.

Unplanned procurements
Without proper planned procurements, there is a risk that drugs not required can be acquired fraudulently and this may in turn result in increased incidences of expired drugs as is the case presently

b) Impact of the absence of documentation and remedial measures

Impact on audit risk

Audit risk is the risk of material misstatement in the financial statements (due to inherent risk or control risk) and failure by the auditor to detect misstatements (detection risk). When it is known that some documents are not available for inspection, the possibility of material misstatements due to inherent risk and inadequate controls is greater. It also makes the task of the auditor to detect misstatements more difficult. Audit risk is therefore greater, depending on the extent to which documents are not available.

Procedures to take

- Carry out more extensive procedures to obtain sufficient appropriate evidence to reach an audit opinion, relying more on documentary evidence that is available, and on other sources of external evidence such as procurement contracts and supplier's statements
- Increase the size of the sample
- Extensive reconciliations between supplier statements and underlying records
- Under-take inventory counts and compare with underlying records, with extensive investigations of any differences
- Analytical procedures might be used, for example to compare the cost of procurement with costs in previous years or in other regions or countries.
- Written representations can be obtained from external suppliers, to confirm payments made and outstanding amounts payable. However, there may be somerisk of fraud, and the auditor will need to consider the reliability of representations received.
- If the audit team cannot obtain sufficient appropriate evidence for an unmodified opinion, the auditor's report will contain a qualified or disclaimer opinion.

AUDIT – QUESTION TWO

SUGGESTED SOLUTIONS

SWAN ASSOCIATES

1) In relation to the audit of the Lusaka Lime Company (LCC)

a) Evaluation of ethics and related action

i) Ethical issues and ii) Action

	Ethical and other professional issue	Action / Response
1	**Opening balances – potential errors** As this is the first time that an audit would be carried out, there may be errors relating to the opening balances as a review is not as rigorous as an audit in detecting potential errors.	Swan Associates should obtain reasonable assurance that opening balances are correct and have been properly incorporated in the financial statements. This issue should be approached with heightened professional skepticism
2	**Employment in client company – Familiarity and intimidation** An audit manager of Swan Associates is being interviewed for the position of financial controller at LLC. This creates a potential ethical threat. According to IFAC's and ZICA Code of Ethics for Professional Accountants, familiarity or intimidation threats may be created by employment with an audit client. The familiarity threat is caused by the relationship that Laura Bowa will have with the audit team, having worked at the firm. This may cause the audit team to lose objectivity, fail to challenge her sufficiently and lose professional scepticism. The more junior members of the audit team may also feel intimidated by her as her previous position was as audit manager. She will also be aware of the firm's audit methodology and procedures, making it easier for her to circumvent procedures.	IFAC's Code states that if a former member of the audit team or partner of the firm has joined the audit client in a position that can influence the preparation of the financial statements, and a significant connection remains between the firm and the individual, the threat would be so significant that no safeguards could reduce the threat to an acceptable level. Therefore it is crucial that Swan Associates ensures that no significant connection between the audit firm and Laura Bowa remains, for example, by ensuring that she does not continue to participate or appear to participate in the firm's business or professional activities, and by making sure that she is not owed any material sum of money from the audit firm. If a significant connection were to remain, then the threat to objectivity would be unacceptably high, and Swan Associates would have to consider resigning as auditors of LLC. In the event of Laura Bowa accepting the position and no significant connection between her and the firm remaining, the existence and significance of familiarity and intimidation threats would need to be considered and appropriate safeguards, such as modifying the audit plan and changing the composition of the audit team, put in place. Swan Associates should have in place policies and procedures which require members of an audit

		team to notify the audit firm when entering employment negotiations with the client, as required by ZICA Code. The firm's policies and procedures should be reviewed to ensure they are adequate and they may need to be communicated again to members of staff.
3	**Employment in client company – Self-interest** As Laura was expected to join LCC, she may be more interested in protecting the interests of the prospective and may not as objective or as critical in dealing with potential misstatements arising with LLC	Any work that Laura Bowa may have recently performed on LLC should be subject to review, as there may have been a self-interest threat if Laura knew she was going to apply for the role at the same time as performing work for the client.
4	**Client expectations – quality management considerations** Bruuno Chez LLC has made some comments in relation to the audit fee which have ethical and other implications. First, he wants the audit fee to be low, and says that he is willing to pay more for other services. One of the problems of a low audit fee is that it can affect audit quality, as the audit firm could be tempted to cut corners and save time in order to minimise the costs of the audit.	Offering an unrealistically low audit fee which is below market rate in order to win or retain an audit client is known as lowballing, and while this practice is not prohibited, the client must not be misled about the amount of work which will be performed and the outputs of the audit. The issue for the client is that an unrealistically low audit fee is unlikely to be sustainable in the long run, leading to unwelcome fee increases in subsequent years.
5	**Contingency fees – self interest** The other issue is that Bruuno Chez LLC has suggested that the audit fee should be linked to the success of the company in expanding within the region, on which he wants the audit firm to provide advice. This would mean that the audit fee is being determined on a contingent fee basis. IESBA's Code of Ethics for Professional Accountants defines contingent fees as fees calculated on a predetermined basis relating to the outcome of a transaction or the result of the services performed by the firm. The Code states that a contingent fee charged by a firm in respect of an audit engagement creates a self-interest threat which is so significant that no safeguards could reduce the threat to an acceptable	Swan Assocaites should explain to Bruuno Chez the audit fee will be determined by the level of audit work which needs to be performed, and cannot be in any way linked to the success of LLC Co or advice which may be given to the firm by its auditors. The fee will be determined by the grade of staff who make up the audit team and the time spent by each of them on the audit.

	level. Accordingly, a firm shall not enter into any such fee arrangement.	
6	**ZEMA visit – breach of pollution regulation** This is an indicator of non-compliance with laws and regulations and may also lead to misstatement in the financial statements as potential fines and penalties may not have been accounted for in accordance with IAS 37, Provisions, Contingent Liabilities and Contingent Assets. This may question the integrity of LCC management if they deliberately breached ZEMA regulations	Swan Associates should discuss this issue with management to determine the extent of non-compliance if any, including reviewing any correspondence between LCC and ZEMA. If there are any integrity concerns, Swan Associates may have to consider withdrawing from the audit and also consider whether this is a public interest issue that should be reported to ZEMA
7	**Intimidation** Mr. Chez has expressed the view that he would not like the audit to be too disruptive and that the audit should be completed within four months of the year end. Although four months appear to be a long time, these comments may be construed to constitute intimidation.	Swan should discuss this issue with Mr. Chez to highlight that the timing of the audit is the responsibility of the auditor, obviously taking into account any reporting requirements from the client. If it is concluded that Mr. Chez's intentions are to intimidate, then the audit should be declined
8	**Strategic Advice – Self-Review threat** Provision of strategic advice may give rise to self-review threat as the information used in generating strategic advice is likely to be part of the information to be used in the audit of financial statements	Swan Associates should consider whether it has the competence and capability to provide this service. Should the firm consider that it is able to provide this service, a separate team should be comprised to perform this task
9	**Strategic Advice – Management threat** Provision of strategic advice may give rise to management threat as this may entail decision making. Decision making is a management responsibility and the auditor cannot assume management responsibility	Swan Associates should discuss this issue with management making it clear that Swan would provide information only and would not be involved in management functions. If LCC is not willing to accept this separation of responsibilities, then the strategic advice assignment should be declined

b) Evaluation of the audit strategy proposed by Laura Bowa

AUDIT STRATEGY

i) Overall Approach

A substantive approach is only appropriate in cases where there is no risk identified and it would be considered cost effective not test the effectiveness of internal controls. There are risk indicators that can be identified with the audit of LLC:

- The audit is new
- The company is relatively new and has never been audited before
- LCC is required to comply with ZEMA regulations and there are indicators of non-compliance
- LCC is owner managed and it is unlikely that they would be inadequate segregation of duties
- The valuation of lime requires specialized knowledge

Accordingly, a risk based approach would be more appropriate

ii) Sale of motor vehicle to Mr. Chez

The sale of motor vehicle to Bruuno is a related party transaction as Mr Chez has influence over LCC. The amount may not be material quantitatively but it is material as a matter of principle. Confirming that the balance is included in receivables only does not provide sufficient appropriate evidence

Other procedures should include:

- Reviewing board minutes to verify whether the sale was duly approved
- Discussion on the basis and reasonableness of the selling price
- Re - computing the gain or loss on disposal and verify correct treatment, including de-recognition of the asset from the records of LCC
- Ensuring that disclosures for related parties are made in accordance with IAS 24, Related Parties
    - Identification of related parties
    - Related party transaction
    - Balances included in the financial statements
- As the sale was made almost about ten months ago, a provision for bad debts should be considered

iii) Valuation of inventories – Lime

Reliance has been placed on the management expert without assessing whether the expert can provide sufficient appropriate evidence. Given that the expert is an employee of LCC, his objectivity may be questioned.

Swan should consider the following matters before placing reliance on the management expert:

- Qualification and competence

  Whether the expert has requisite qualification and experience to provide sufficient appropriate evidence relating to the valuation of lime

- Independence

  Whether the work of the expert can be duly influenced by LCC

- Scope of work

  Whether the work carried out by the expert is relevant to the audit of financial statements, i.e. physical inventory and valuation of lime

- Professionalism

  Whether the work undertaken by the management expert was conducted in a professional manner involving activities such as planning

iv) **Use of analytical reviews**

Analytical reviews are a requirement of International Statement of Auditing (ISA) 520. Not performing analytical reviews means that the audit is not carried out in accordance with international auditing standards. It is possible that this being a new audit, there may not be enough information to do a detailed trend analysis, but still the analytical procedures should be carried out to the extent possible

According to ISA 520, the primary purpose of substantive analytical procedures is to obtain assurance, in combination with other audit testing (such as tests of controls and substantive test of details, with respect to financial statement assertions for one or more audit areas. This is required to be carried out at:
- Planning stage as part of risk assessment
- Substantive testing
- Reporting as part of the final review

This is required on all audits, whether new or existing

2) In relation to the audit of Choc Chips Company (CCC)

a) Matters which cast doubt on the going concern status of Choc.

The information available in respect of CCC indicates many events or conditions which individually or collectively may cast doubt on the use of the going concern assumption in its financial statements.

Profitability
CCC's performance has deteriorated dramatically in the year, and despite being profitable in the previous year, it is reporting a loss of K1,500,000 for the year to 31 March 2023. It is likely that profitability will suffer even more in the next financial year due to the obsolescence of the Heavenly product which accounted for 45% of revenue.

Substantial operating losses are an indicator of going concern problems.

Current and quick ratios
These show that CCC's current liabilities exceed its current assets, meaning that the company is unlikely to be able to pay debts as they fall due. If suppliers go unpaid they may restrict supply, causing further working capital problems. There may be insufficient cash to pay wages or other overheads, or to pay finance charges.

Cash inflows
In addition, the company's cash inflows are likely to be very much reduced by the obsolescence of its major product, the Heavenly. The development of the replacement HealthyChoc product will have put severe strain on cash resources and given the company's cash position, there may be insufficient funds to complete the development. Hopefully there is enough cash to complete the development of HealthyChoc, and to keep the company afloat prior to its launch next year. Even then, it will take time for the new product to generate a cash inflow.

Loan covenant
Given the further deterioration in the company's liquidity since the year end, it is likely that the current ratio now breaches the terms of the loan covenant. If this is the case, the loan provider may recall the loan, which CCC does not seem to be in a position to repay. It may be forced to sell assets in order to raise cash for the loan repayment, which may not raise the amount required, and would put operations in jeopardy.

b) Audit evidence to find in respect of the cash flow forecast.

- Agreement of the opening cash position to the audited financial statements and general ledger or bank reconciliation, to ensure accuracy of extracted figures.
- Confirmation that casting of the cash flow forecast has been re-performed to check arithmetical accuracy.
- A review of the results of any market research which has been conducted on the HealthyChoc product, to ensure the assumption regarding its successful launch is appropriate.

- Discussion of the progress made on HealthyChoc's development with a technical expert or health expert, to gauge the likelihood of a successful launch in August 2023.
- A review of any correspondence with existing customers to gauge the level of interest in HealthyChoc and confirm if any orders have yet been placed.
- A review of any sales documentation relating to the planned sale of plant and equipment to confirm that K950,000 is achievable.
- Physical inspection of the plant and equipment to be sold, to gauge its condition and the likelihood of sale.
- A review of any announcement made regarding the redundancies, to confirm the number of employees affected and the timing of the planned redundancies.
- Sample testing of a selection of those being made redundant, agreeing the amount they are to be paid to human resource department records, to ensure accuracy of figures in the forecast.
- A review of the application made to the government to confirm the amount of the grant applied for.
- Confirmation to correspondence from the government department of the K800,000 grant to be received.
- Depending on the timing of audit procedures, the K800,000 may be received prior to completion of the audit, in which case it should be agreed to cash book and bank statement.
- Agreement that the cash flow forecast is consistent with profit and other financial forecasts which have been prepared by management.
- Confirmation that any other assumptions used in the cash flow forecast are consistent with auditor's knowledge of the business and with management's intentions regarding the future of the company.
- Comparison of the cash flow forecast for the period April 2023 – March 2024 with budgets and budgeted management accounts for the same period, to ensure accuracy of the forecast.
- Analytical review of the items included in the cash flow forecast, for example, categories of expenses, to look for items which may have been omitted.

c) In respect of the note on going concern to be included in Choc's financial statements.

i) The minimum contents of the note

The note should contain the following information:

- Acknowledgement by management that there is a doubt on the going concern status of the company
- Reasons for the doubt
- Plans put in place to deal with the doubt so as to still maintain the assertion that the company is a going concern. In this case the cash-flow forecast and other supporting information

ii) **Implications of the disclosure on your audit report**

- **Matter arising – potential material misstatements**

If the note contains adequate information on going concern issues, then there is no breach of financial reporting standards, and therefore no material misstatement has occurred. The audit opinion should not be modified and should state that the financial statements show a true and fair view, or are fairly presented.

- **Type of Report**

According to ISA 570 revised, If the auditor considers that the going concern basis is appropriate and that the disclosures are adequate, then the audit opinion will be unmodified and the auditor's report will include a section headed 'Material Uncertainty Related to Going Concern' which explains the uncertainty.

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

3) In relation to the possible litigation case against your firm

a) Litigation case and the concept of the "expectation gap"

Expectations gap is the difference between what the public believe that auditors do and what they actually do.

Elements
- Standards Gap (Standards expected)
- Performance Gap (level of performance re standards)
- Liability Gap (To whom is auditor liable)

The litigation case can therefore be related to the liability gap where there may be misunderstanding as to who can rely on the auditor's report and to what extent can that reliance be a basis for litigation against the auditor?

b) **Matters to assess possible chances of** liability

A duty of care exists when there is a special relationship between the parties, i.e. where the auditors knew, or ought to have known, that the audited accounts would be made available to, and would be relied upon by a particular person (or class of persons. In this regard, third parties could bring a case against the auditor in what is called third party liability under the law of tort

For this case to have any chance of success, Afri Finance Bank must therefore prove:

- That Swan Associates knew, or ought to have known, that the Afri Finance Bank was likely to rely on the audited financial statements
- That Afri Finance Bank had sufficient "proximity", i.e. belongs to a class likely to rely on the financial statements
- That Afri Finance Bank in fact relied, and
- That Afri Finance Bank would have acted differently if the audited financial statements had shown a different picture

4) In relation to the audit of CCP and the extract of the report to those charged with governance

a) Key Audit Matters and justification

Definition of Key Audit Matter (KAM) and objective of ISA 701

The term 'key audit matters' is defined in ISA 701 as:

'Those matters that, in the auditor's professional judgment, were of most significance in the audit of the financial statements of the current period. Key audit matters are selected from matters communicated with those charged with governance.'

The objectives of ISA 701 are for the auditor to:

- determine those matters which are to be regarded as KAM; and
- communicate those matters in the auditor's report.

Determination of Key Audit Matters (KAM)

The definition in paragraph 8 of ISA 701 states that KAM are selected from matters which are communicated with those charged with governance. Matters which are discussed with those charged with governance are then evaluated by the auditor who then determines those matters which required significant auditor attention during the course of the audit. There are three matters which the ISA requires the auditor to take into account when making this determination:

- Areas which were considered to be susceptible to higher risks of material misstatement or which were deemed to be 'significant risks' in accordance with ISA 315 (Revised), *Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment*.
- Significant auditor judgments in relation to areas of the financial statements that involved significant management judgment. This might include accounting estimates which have been identified by the auditor as having a high degree of estimation uncertainty.
- The effect on the audit of significant events or transactions that have taken place during the period.

In the context of CCP, the following matters can be identified and justified as Key Audit Matters

i) K574million Revenue recognized – Significant judgement

K574 million of revenue represents almost 55% of the total revenue and is about 15.5% of total assets. This amount was determined based on exercise of significant judgement of the cost or value completed. The process of determining interim stages of completion is complex

ii) Explosion – Significant subsequent event K329.5 million

The explosion that occurred on 20 May 2023 is a subsequent non-adjusting event that should be disclosed in the financial statements according to IAS 10 – Subsequent events. This event should be assessed to be significant given the resulting loss of assets valued at K329.5 million which is about 9% of total assets

iii) Lusaka District Council – Revenue Recognition – Significant risk

K50 million profit included in the financial statements for the year ended 31 March 2023. Given that only 6 months' work was completed between October 2022 and March 2023, only K25 million should have been reported as profit and K100 million reported as revenue. This results in overstatement of profit of K25 million which is material at 11.4% of profit before tax. The revenue overstatement is also material at 9.5% of total revenue. Accordingly, this should be justified as a significant risk of misstatement in the financial statements

iv) Ministry of Works – Legal case – Significant risk and significant event

The expected cost of litigation is K400 which is material at 9.25% of total assets. The K400 million would turn the profit of K220.5 million into a loss of K179.5 million. Additionally, given the cash position of CCP of only K30 million, this may question the going concern of the company should they fail to pay the litigation cost. Accordingly, this matter should be justified as a KAM on account of being both a significant event and significant risk

b) Evidence to find for each KAM and purpose of that evidence

i) K574 Revenue recognized – Significant judgement

- Construction contracts for details and validity
- Expert estimates to confirm stages of completion
- Re-computation of valuation of stage of completion to verify valuation
- Discussion with management to confirm consistence of accounting policy application for valuation purposes
- Management representation to confirm estimates
- Financial statements to verify amounts recorded

ii) Explosion – Significant subsequent event K329.5 million

- Press reports on explosion to confirm event and date
- Discussions with management for details of explosion
- Recent inventory records to estimate quantity of assets lost
- Carrying value of assets destroyed to confirm valuation of K329.5 million
- Financial statements to confirm appropriate disclosure in accordance with IAS 10
- Any insurance cover or claim on the assets
- Visit to the location for physical verification

iii) Lusaka District Council – Revenue Recognition – Significant risk

- Contract details for pricing and other details necessary for validity and valuation
- Discussion with management on the accounting treatment applied to confirm valuation
- Expert valuation of cost of value delivered at 31st march 2023
- Other contracts for consistency of accounting treatment
- Financial statements to verify profit and revenue recognised

1. Ministry of Works – Legal case – significant risk and significant event

- Correspondence between CCP and Ministry of Works
- Legal confirmations and assessment of probability of liability and value of K400 million
- Engineering reports on the cracks and damage
- Visit to the location for confirmation of damage and cracks
- Discussion with CCP management regarding the case
- Financial statements for disclosure of the K400 million
- Management representation to confirm management assessment of the legal position

c) **Perceived advantages and disadvantages of the requirements relating to Key Audit Matters**

As part of audit engagements, auditors may be engaged to report on Key Audit Matters (KAMs). The purpose of communicating KAMs is to provide greater transparency about the audit that was performed and to provide financial statement users with a basis to further engage with management and those charged with governance.

Advantages of KAMs

- KAMs encourage better conversations between the auditor and those charged with governance; this in turn contributes to better governance.

- KAMs help the auditor to focus on the areas of the audit requiring the most careful judgement; this in turn contributes to higher audit quality.
- KAMs give preparers incentives for revisiting financial reporting and disclosures in areas related to those KAMs. This in turn leads to better financial reporting.

Disadvantages of KAMs

However, others have contended that

- KAMs have resulted in increasing the length of the reports
- Too much discretion is given to the auditor to determine KAMs
- The auditor is required to exercise significant judgement in determining KAMs and this may give rise to inconsistencies between different audit firms