AUDIT – SUGGESTED SOLUTIONS

QUESTION ONE

PUTA & CO

1) IN relation to Golden Keys Limited

   a) Fraud through theft

      i) Comment on the assertion that your firm should be partly be blamed for the theft fraud

According to ISA 240 (Revised), *The Auditor's Responsibility to Consider Fraud and Error in an Audit of Financial Statements,* the primary responsibility for the prevention and detection of fraud rests with management and those charged with governance. Management's responsibilities include creating an environment where fraud is not tolerated, identifying risks of fraud, and taking appropriate actions to ensure that controls are in place to prevent and detect fraud. Those charged with governance are responsible for ensuring that management is carrying out the tasks assigned to them in relation to fraud risk and prevention, as well as understanding the environment to determine if management can override or influence the controls in place.

However, ISA 240

- Requires the auditor to maintain an attitude of professional skepticism recognizing the possibility that a material misstatement due to fraud could exist, notwithstanding the auditor's past experience with the entity about the honesty and integrity of management and those charged with governance;

- Requires members of the engagement team to discuss the susceptibility of the entity's financial statements to material misstatement due to fraud and requires the engagement partner to consider which matters are to be communicated to members of the engagement team not involved in the discussion;

- Requires the auditor to:
  - Perform procedures to obtain information that is used to identify the risks of material misstatement due to fraud;
  - Identify and assess the risks of material misstatement due to fraud at the financial statement level and the assertion level; and for those assessed risks that could result in a material misstatement due to fraud, to evaluate the design of the entity's related controls, including relevant control activities, and to determine whether they have been implemented;
  - Determine overall responses to address the risks of material misstatement due to fraud at the financial statement level and consider the assignment and supervision of personnel; consider the accounting policies used by the entity, and incorporate an element of unpredictability in the selection of the nature, timing and extent of the audit procedures to be performed;

In the context of GKC, the firm cannot be blamed for the incidence of fraud but can be blamed for any material misstatement caused by fraud as their planning and risk assessment should be expected to consider the incidence and impact of fraud, having been alerted to this fact by the client

ii) Discuss whether it was possible for your firm to have detected the incidences of theft through audit procedures

The purpose of an audit is to obtain reasonable assurance that accounting balances are comply with applicable assertions and that they are not materially misstated. The auditor is required to obtain sufficient and appropriate evidence to support their opinion. Sufficiency is determined by the level of risk and materiality assessed on each account balance and transaction. Additionally, the auditor does not necessary test every transaction or balance, but focuses on those balances and transaction that are assessed to be risky and material.

The focus of the auditor is to detect material misstatements, whether caused by fraud or error. Accordingly, fraud may be detected as part of the process of detecting material misstatements through a combination of control tests and procedures. Control tests are those tests performed for obtaining audit evidence about how the accounting and internal audit systems are designed and operated.

In conclusion, unless fraud incidences are brought to the attention of the auditor, the auditor may not detect fraud if there is no fraud risk assessed and there is no evidence of risk of material misstatement

In the context of GKC, the external audit firm has been alerted to the possible incidence of fraud through theft. Accordingly, Puta & Co should be expected to exercise due care and professional skepticism in performing appropriate procedures in inventories to detect material misstatement that may have been caused by fraud.

b) Ethical and other professional issues

i) Ethical and other professional issues arising

ii) Appropriate action that should be taken

	Ethical and Professional issue	**Action**
1	**Sale of furniture at a discounts –Self-interest** Whereas there is nothing wrong in exchanging gifts and pleasantries between auditors and clients, ethical guidelines recognize the potential existence of a self-interest threat depending on the size and intention of such gifts Ethical guidelines provide that such gifts should not be accepted if they are significant or intended to influence the auditor	It would appear that the furniture offered is expensive such that even the 50% discount would be considered significant. Accordingly, the offer should be declined. Further, it should be expected that Put & Co has put in place policies and procedure to provide further guidance on such gifts
2	**Bribe to Customs officials - Integrity**	The firm should carefully consider the wider integrity status of GKC and

	Involvement of GKC in paying bribes to customs officials should, though seemingly justified, raises integrity questions Ethical guidelines require firms not to associate with clients with negative publicity, especially where integrity is in question	consider whether the practice with Blaze Islands is an isolated case. If it is considered that the overall integrity of GKC is questionable, Puts & Co should consider discontinue this professional relationship
3	**Advice on the IT system – Self-review** The IT system is expected to be processing transactions and account balances and other information to be used in the production of financial statements. Being involved with IT system creates a significant self-review threat as the same information will be subjected to audit and the auditor may be less critical of such information because of their involvement.	Puta & Co should assess whether they have the expertise to provide this service. If the service can be provided, this assignment should be performed by a separate team for the audit team
4	A**dvice on the IT system – Management threat** Providing advice might include planning and decision making and this generates management threat. These are management functions and ethical guidelines prohibit audit firms from being part of management of clients they serve.	Puta & Co should discuss with GKC to ensure that there is a proper separation of responsibilities between providing information and performing management roles If GKC is not willing to accept this understanding, the assignment should be decline
5	**Theft – Fraud and error** According to ISA 240 (revised), the auditor is required to approach audits with a reasonable expectation to detect material misstatements caused by fraud or error Failing to detect material misstatements that may have been caused by this theft may result in audit risk and professional liability	Having been alerted to the possible incidence of fraud theft, Puta & Co should exercise due care and diligence and professional skepticism to obtain reasonable assurance that the theft has not caused material misstatement

2) In relation to Golden Keys Limited
   a) Evaluate SIX business risks

i) Governance capacity– possible overtrading

GKC has grown rapidly over the last three years with no proportional increase in the management's capability and capacity. The same family members assume key responsibilities with Mr. Chanza still assuming both the roles of chief executive officer and chairman of the company. Additionally, the internal audit has just been comprised and there are questions as to the capability of the audit team

Management and those charged with governance may fail to govern the affairs of the growing company leading to GKC failing to achieve some of its objectives. For example, incidences of theft of inventories may be an indictment to this fact

ii) Theft and fraud – controls

Reported incidences of theft of inventories may result in significant losses. In addition, this unfavourable and toxic conditions and disposition may extend to other areas of the business.

iii) Export - logistics

GKC is responsible for the transportation of goods the to the Blaze Island. This entails significant risks relating to transportation, handling and other logistics. Further delays may also be experienced for which the customer may hold GKC liable.

Although these risks can be insured against, their occurrence is likely to adversely affect the performance of this new venture in a significant way.

iv) Economic

On the local front, business has been slow because of the poor performance of the Zambian economy. If GKC continues to operate at such low capacity levels, it might start to fail to generate enough resources to support the enlarged operations – especially that some of the costs are likely to be fixed.

v) Liquidity risk

The terms of the Blaze Island contract are that and no payment will be made until an agreed volume of goods clears Blaze Island customs. This will put strain on the working capital required to support this venture.

vi) Reputation risk

GKC is required to pay a bribe to customs officials. The negative stigma associated with bribery and corruption may deter other more ethical business partners from conducting business with GKC if they consider that associating with GKC will result in some negative publicity

b) Risks of material misstatement.

i) Accounting system - out of date/ theft

The company's accounting and management system is out of date and this may have increased the incidence of fraud through theft and possible. Error and fraud both cause misstatement and in this case, inventories may be overstated.

Materiality

Given the attention that has been drawn to this issue, it is likely that the resulting misstatement may be material, especially that that reference is made to "high levels" of theft

ii) **Receivables – local contracts**

Receivables days have increased from 30 days to 60 days due to reduced purchasing power caused by high inflation. Prudence concept requires that the level of provision for bad debts should also be increased. If this is not done receivables are likely to be overstated.

Materiality

K1.2 million is included as receivables in the current year. This represents 6.7% 0f revenue, 2% of total assets and 60% of profit before tax. It is possible that the resulting increase in provision may be material

iii) Inventories - IAS 2 – Net realizable value – local contracts

On the local front, business has been slow, Golden Key has found itself accumulating a lot of products as the construction at both domestic and commercial levels have significantly reduced due to weak performance of the Zambian economy. In order to dispose of the higher levels of inventories, GKC may have to reduce the selling price. Further there is a risk of obsolescence through damage and change in fashion trends. This would suggest that the net realizable value of such inventories is likely to be lower than cost.

Materiality

The inventory days have increased to 120 days representing almost K6 million of the current turnover which stands at K18 million. This represents about 33% (6/18) and is material. It is also possible that the resulting write down may reduce the current profit of only K 2 million into a loss.

iv) Manufacturing plant - Impairment - IAS 36

Due to reduced business levels, the manufacturing plant has been operating at below 60% capacity. According to IAS 36 – Impairment, reduced capacity is an indicator of impairment and an impairment review should be undertaken. If this is not done, it is likely that the manufacturing plan may be overstated

Materiality

As 75% of the total assets are represent by manufacturing plant, and, given the level of reduction capacity, it is likely that the resulting impairment may also be material

v) Revenue recognition - IFRS 15

In order to exercise prudence, GKC has decided to recognize revenue when payment is received instead of when delivered and accepted. According to IFRS 15 – Revenue from contracts with customers, revenue should be recognized when obligations are fulfilled and the transaction prices is allocated to the performance obligation. Using cash basis of accounting would result in approximately 2/3 of the revenue – K1.2 million – not being accounted for until payment is received. This results in revenue and receivables being understated by the same amount

Materiality

If the amount is to be paid in three instalments after delivery, this implies that K1.2 million will not recognized as revenue representing 2/3 X 1.8 million outstanding. This 6.6% of revenue and 60% of profit before tax and is material

3) In relation to the attendance at the inventory count

a) Evaluate the matters that should be considered before relying on the work done by the internal auditor (10 marks)

According to ISA 610, Using the work of internal auditors, the external auditor should consider the activities of internal auditing and their effect, if any, on external audit procedures. While the external auditor has sole responsibility for the audit opinion and for determining the nature, timing and extent of audit procedures, certain parts of internal auditing work may be useful to the external auditor

During the course of planning the audit, the external auditor should perform a preliminary assessment of the internal audit function when it appears that the internal auditing is relevant to the external audit of the financial statements in specific areas.

When obtaining an understanding and performing a preliminary assessment of the internal audit function, the important criteria are:

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

Scope of function.
The nature and external of internal auditing functions performed and the relevance of that work to the financial statements and the work of the external auditor

Technical Competence.
Professional qualifications, technical training and competency

Due professional care.
Whether internal auditing is properly planned, supervised, reviewed and documented.

Adequacy and relevance.
When the auditor intends to use specific work of internal auditing, the external auditor should evaluate and test that work to confirm its adequacy for the external auditor's purposes

b) Extent of reliance on the work done by the internal auditors of GKC

In the context of GKC, the internal audit is not only new but is headed by an engineering graduate and although he has attended workshops on internal audit, this is not enough to constitute requisite qualifications and experience. Additionally, the internal audit team has been involved with inventory count on a regular basis, this creates a self-review threat and further questions their objectivity. Reporting to the Managing Director also dilutes their independence and objectivity

According to ISA 610, Using the work of internal auditors, the work of internal auditor should do not be relied upon if the work to be relied upon requires exercise of significant judgement and is also material or significant in terms of its impact on financial statements.

In the context of GKC, the inventory levels appear material to the financial statements and issues relating to the determination of net realizable can involve exercise of professional judgement.

In conclusion based on the above arguments, there is very little professional justification for Puta & Co to rely on the inventory work performed by the internal auditors of GKC.

c) **Comment on the adequacy of procedures performed by the junior auditor**

i) **Before the count**

The review of inventory count instructions is a very important procedure to carry out. However, this appears not to be enough given the findings during the inventory count. Further procedures at this stage should have included:

- Review previous year's working papers and discuss with management any significant changes from previous year. It was noticed during the count that the levels of inventory had increased significantly from previous levels
- Consider the location of inventories (e.g. at branches) and the problems thus caused for the client and the auditor. It was noticed during the count that GKC had used another new location during the year
- Establishing whether expert help may be needed (e.g. precious stones, antiques). It would appear that the counting of ornaments and figurines required expert assistance

ii) **During the Count**

- Observed the counting to confirm that it was being conducted in accordance with instructions
- Were surprised with the increased level of inventories and new warehouse located in another part of Livingstone
- On two occasions, the count team encountered a difference between the recorded quantities and the counted quantities. The record was adjusted to reflected the counted quantities

Audit practice now is for the auditor to attend the inventory take. The purpose of the attendance is not to take inventory or to supervise the inventory take but to observe (another word here might be witness} the client's internal control system in action.

The fact that increased levels of inventories and existence of a new location and new classes of inventories in terms of ornaments and figurines suggests poor planning. In addition to the observation procedure to establish whether the count was being conducted in accordance with instructions, the following additional procedures should have been performed

- Perform a two-way test count. First, selecting a few items from the inventory count sheets and physically inspect the items in the warehouse **(Existence, overstatement)**
- Second, selecting a few items from the warehouse and tracing them to the inventory count sheet to ensure that they are recorded accurately **(Completeness, understatement)**
- Details of items for cut-off purposes – Last deliveries to the year end. **(Cut-off)**
- Enquiry into, observe and discuss with store keeping staff the procedures for identifying damaged, obsolete and slow moving inventory. Obtain details of such defective, damaged, obsolete or slow moving items. **(Valuation)**

- Photocopies of rough inventory sheets should be taken. Details of the sequence of inventory sheets should be verified- This allows for the identification of any subsequent additions or omissions to the original count
- The difference encountered between the count and the recorded amount should have been reported to management and a full investigation carried out before adjusting the records. The discrepancy could have been as a result of reported theft.

iii) After the count

After inventory – follow up procedures

The review of the final stock sheets for any obvious additions and amendments is not enough if it is not combined with a record of stock sheets used during the count. Further, getting assurances from the warehouse manager is not sufficient and reliable as this internal and oral obvious. Other procedures should have included

- Test that the final inventory sheets have been properly prepared from the count records. In particular, the record of inventory take forms issued and returned must be checked.
- Follow up notes made at the attendance., especially on the results of the investigation of the difference between the count and the record
- Check final inventory sheets for pricing, extensions, casting, summarizing, and officials' signatures.
- Inform management of any problems encountered in the inventory take for action in subsequent counts.

4) In relation to the completion of the GKC audit
    a) In respect of each of the following matters documented on the completion of the audit of GKC
        i) **Court case** **(9 marks)**

- **Implications for the completion of the audit of GKC**

  According to IAS 37, Provisions, Contingent Liabilities and Contingent asses, a provision is a present obligation arising from a past event and which an entity cannot avoid. IAS 37 requires that if an obligation is assessed to be certain or probable, a provision should be made if the amount can be measured reliably. This leads to risk of material misstatement in the completion of the audit

  In the context of GKC, the obligation is assessed to be probable and the amount is estimated at K500,000. Therefore, a provision should be made. If the provision is not made liabilities will be understated and profit overstated by K500,000

- **Adjustments that may be necessary**

  The adjustment necessary is
  DR Legal costs (administration expenses) K500,000

CR Provisions (Liabilities) K500,000

Being recognition of legal costs probable

- **Further procedures that may be necessary**
  - Discuss with management of GKC on the need to make a provision in accordance with IAS 37 on account of the obligation being assessed probable
  - Request management to make an adjustment
  - Obtain written confirmation from the legal advisers of GKC on their assessment of the obligation, including discussions with them
  - Include the matter in the report to those charged with governance
  - Obtain written confirmation from the legal advisers of the ex-employee to ascertain their assessment of the case
  - Obtain written representation from management of GKC on their assessment of the case
  - Review any subsequent correspondence between the ex-employee and GKC
  - Review the financial statements to verify that no provision had been made

ii) Trade receivables (9 marks)

- **Assess the implications for the completion of the audit of GKC**

According to IAS 10, Subsequent events, a subsequent event is an event taking place between the year end and the date when the financial statements are approved in the annual general meeting.

The 1 May 2024, is a subsequent event adjusting event as the notice from the administrator has provided additional evidence on the recoverability of the receivable from FZL. As only K160,000 (being 10% of K1.6 million) will be received the balance of K1,440,000 should be written off as a bad debt

If this is not done, the assets are overstated and profit overstated by K1.440 million

- **Adjustments that may be necessary**

The adjustment necessary is
DR Bad debts (administration expenses) K1,440,000
CR Receivables K1,440,000

Being write off of debt from FZL, following its going into insolvency

- **Further procedures that may be necessary**
  - Discuss with management of the need to write of K1.440 million in accordance with IAS 10

- Request management to make the adjustment
- Review the notice from the administrator to confirm details, especially those relating to settlement of payables
- Review subsequent bank statements for receipt of the amount from the administrator
- Review other correspondence between GKC and the administrator for progress on the case
- Include the matter in the report to those charged with governance

iii) Chairman's report (6 marks)

- **Assess the implications for the completion of the audit of GKC**

  According to ISA 720 (Revised), The Auditor's Responsibilities Relating to Other Information, the auditor is required to read the other information and:

  - Consider whether there is a material inconsistency between the other information and the financial statements; and

  - Consider whether there is a material inconsistency between the other information and the auditor's knowledge obtained in the audit, in the context of audit evidence obtained and conclusions reached in the audit.

  As the basis the consideration of whether there is a material inconsistency between the other information and the financial statements, the auditor is required to compare selected amounts or other items in the other information with such amounts or other items in the financial statements.

  In the context of GKC, the chairman's report states that the revenue has increased by 20% from 2023. According the draft financial statements (which should be assumed to be correct) the revenue has increased by only 5.8% (1/17). There is therefore a material inconsistency between the chairman's report and the financial statements. This may be because the chairman's report was partly based on budgeted figures.

  Whereas this has no impact on the financial statements, it has implications for the duty of the auditor on other information in terms of reporting responsibilities

- **Adjustments that may be necessary**

  - Assuming that the financial statements are correct, management should be requested to amend the chairman's report so that it is consistent with the financial statements

- **Further procedures that may be necessary**
  - The inconsistence should be brought to the attention of management
  - Management should be advised of the responsibility of the auditor regarding other information
  - The management should be requested to amend the chairman's report so that it is consistent with the financial statements
  - The firm should consider to include this in the report to those charged with governance
  - The firm should include this fact in the paragraph – other information – in which the firm will state its responsibilities and findings from its review

b) Impact on the audit report if these adjustments are not made

The impact on the report depends on the matter unresolved, whether it is lack of sufficient appropriate evidence or potential misstatement, and whether the matter is considered material and pervasive

i) Court case

K500,000 is 25% of profit before tax and is material, it is 2,7% of revenue and is material and is less than 1% of total assets. This a misstatement that is material but not pervasive, therefore the impact on the report would be the issuance of a qualified / modified except for report for reason of material misstatement.

ii) Trade Receivables

K1,440,000 is 72% of profit before tax and is material, it is 6% of revenue and is material and is 2.4% of total assets and is material. However, it is unlikely that this may be regarded as pervasive. Accordingly, the impact on the report would be the issuance of a qualified / modified except for report for reason of material misstatement

Combined – Court case and Trade receivables

K1,940 is 97% of profit before tax and is material, it is 10.7% of revenue and is material and is 3.3% of total assets and is material. However, it is unlikely that this may be regarded as pervasive. Accordingly, the impact on the report would be the issuance of a qualified / modified except for report for reason of material misstatement

iii) Chairman's report

According to ISA 720, Using the heading "Other Information" or other appropriate heading, the auditor's report will include:

- A statement that management is responsible for the other information.
- Identification of the other information obtained and reviewed

- A statement that the auditor's opinion does not cover the other information and, accordingly, that the auditor does not express (or will not express) an audit opinion or any form of assurance conclusion thereon.
- A description of the auditor's responsibilities relating to reading, considering and reporting on other information as required by ISA 720 (Revised). A statement that the auditor has concluded that there is a material consistency between the chairman's report and the financial statements, a statement that describes the nature of uncorrected material inconsistency of the other information.

CPE AUDIT QUESTION TWO

SUGGESTED SOLUTIONS

5) In relation to EFL

a) Due diligence procedures

The objective of due diligence procedures is to ensure that accountants:

- Know who their clients are, and
- Do not unknowingly accept clients which are too high risk

The following detailed procedures will be carried out to establish (Most of this information is available in the public domain – PACRA)

- **Proper identity, owners and legality of business**
    - The shareholders and promoters of EFL
    - The location and address of EFL, however many they might be
    - Certificates of incorporation
    - Register of directors

- **For each shareholder and promoter – in this case Mr Washa and Mr Pambashe**
    - Names, location and addresses
    - Other shareholding and director positions held

b) **Indicators of money laundering suspicions**

1) Avoiding personal contact

If a client refuses to answer questions about themselves, firms should consider whether this is suspicious, especially if they have criminal associations. Mr. Washa has avoided contact with the auditors and also has links to a failed bank in the USA which was being investigated for money laundering suspicions.

2) Adverse media

Additional checks may also be needed if the cliient is a subject of negative news media in any part of the world, as this could increase money laundering risk. Mr. Washa was deported to Zambia after appearing in court for suspected involvement in money laundering in a case involving transfer of funds from Zambia to a number of missions abroad. The case attracted a lot of interest in the Zambian Media

3) Unusual transactions

Clients trying to launder funds may carry out unusual transactions. Firms should look out for activity that is inconsistent with their expected behavior, such as large cash payments, unexplained payments from a third party, or use of multiple or foreign accounts. EFL has invested in various derivatives, including crypto currency

4) Foreign exchange Accounts

Existence and frequent use of foreign exchange accounts with no justifiable business purpose should also raise suspicion of money laundering. EFL maintains numerous foreign exchange bank accounts both locally and abroad. Given that EFL is substantially a Zambian company, the frequent movements in these accounts may appear unjustified

5) Unusual source of funds

Transactions involving large amounts of cash or private funding could indicate money laundering, and if cash deposits or complex crypto assets are involved, identifying the source can be difficult. Between Mr Washa and Mr. Pambashe, an amount of K50 million was injected into EFL during the year. It is not clear the source of these funds

6) Politically exposed persons (PEPS)

Individuals – and their family and associates – in high positions are more vulnerable to corruption and could pose a higher risk of money laundering for quid-pro-quo favors or kickbacks. While no standardized global definition exists, **PEPs** typically include heads of state, senior politicians or government officials, judicial or military officials, senior executives of state-owned corporations, or important political party officials. Mr. Pambashe is a senior government official and his involvement with EFL and Mr. Washa in particular should raise some questions

c) Other policies and procedures and action

- The firm should maintain enhanced record keeping of due diligence activities and records
- The firm should put in place dedicated resources – Appointment of a Money Laundering Reporting Officer (MLRO)
- The firm should put in place formal policies and procedures to manage any potential risk
- The firm should establish internal procedures for reporting of suspicious transactions to the Financial Intelligence Centre (FIC)
- The firm should put in place appropriate policies and procedures dealing with communication and training of staff
- The firm should undertake regular reviews of such policies and procedure

Action to be taken

If EFL considers in good faith that the suspicions are well founded, the MLRO should make arrangements to report this matter to the Financial Intelligence Centre. EFL should seek legal advice including consultations with ZICA

EFL should also consider withdrawing from the audit

6) **In relation to EFL**
   a) **Evaluate**
      i) **EIGHT audit risks and**
      ii) **Materiality**

i) New Audit

This is a new audit for EFL with high risk of money laundering. Unless EFL is familiar with this industry, detection risk appears to be high

ii) Financial instruments – derivatives and crypto currencies – IFRS 9 and IFRS 7

EFL has invested in various financial instruments including derivatives and crypto currencies. Most of these are measured at fair value. Determination of fair value for unquoted instruments may be subjective. This may lead to misstatement. Additionally, extensive disclosures are required under IFRS 7, Disclosures. There is a risk that this is not complied with

Materiality

About K5 million has been invested in these instruments. This is about 1% of total assets and is material

iii) Laws and regulations – IAS 37

Failure to comply with Bank of Zambia regulations has led to a penalty fee of 2,000 points at K500 = K1 million. There is a risk that this is not provided for and provisions may be understated and profit overstated

Materiality

At 3% of Profit before tax, this is not material

iv) Technology – Impairment – IAS 36

In order to comply with Bank of Zambia regulations loans management, EFL, like all other banks are required to modify or replace their existing systems to incorporate forex management systems and new money laundering laws and regulations. New legislation requirements relating to assets is an indicator of impairment, in accordance with IAS 36. If impairment is not taken into account. This may lead to overstatement of assets and overstatement of profit

v) Research and Development – IAS 38

According to IAS 38, Intangible assets, development expenditure should only be capitalized once prescribed conditions are met, including assessing the intended benefits to be generated by the investment. As the systems are still in development stage, it is not possible to establish the technical viability of the systems. There is a risk that the capitalized intangible assets have not met this criteria, resulting in overstatement of assets

Materiality

About K4 million was spent on intangible assets, this is about 1.1% of total assets and is material

vi) Amortisation – IAS 38

All intangible assets are amortised over a 15-year life. However, it is likely that the useful lives of some of these assets are less than 15 years. Applying the 15 years would lead to reduced amortization and overstatement of assets and overstatement of profit

vii) Investment property – IAS 40, Fair valuation IFRS 13

During the year EFL moved to EFL House, a newly constructed complex of offices for rent, for which the valuation model has been adopted. According to IAS 40, when the fair valuation model is applied, the movement should be processed through the profit and loss and no depreciation should be charged. There is audit risk associated with the correct costs to be included as only construction overheads should be included and also that the movement in the revaluation may not have been accounted for correctly. Additionally, the determination of fair values is likely to be subjective, unless the investments are quoted

Materiality

The total construction cost of K6.5 million is material at 1.8% of total assets

viii) Revenue recognition – IFRS 15

For loans of less than six-month duration, EFL recognizes the total interest receivable as income regardless of when the loan is disbursed. EFL considers that this policy makes it less expensive and avoids the costly and tedious method of daily accruals of interest. This is not in accordance with IFRS 15 – Revenue from Contracts with Customers. Which requires that revenue should only be recognized once stated obligations are satisfied. This implies that revenue is likely to be overstated and profit overstated

b) Recommend and justify appropriate audit strategies for the following:

i) Level of planning and performance materiality to be set

A matter is material if its omission or misstatement is likely to affect the decision of a user. The materiality thresholds guided by the profession are:

Revenue	1/2 % - 1%
Profit before tax	5% - 10%
Total Assets	1% - 2%

For EFL

This would translate to (applying only the lower thresholds)

Revenue	1/2 % x 577 million	=	K2.885 million
Profit before tax	5% x K32.2 million	=	K1.610 million
Total Assets	1% x K349.2 million	=	K3.492 million

The level of materiality is also influenced by the level of risk. The higher the risk, the lower the materiality, and the lower the risk the higher the materiality. Effectively, the level of materiality is also an expression of the level of confidence that the auditor imputes on the figures in the financial statements

In the context of EFL, the risk should be considered as high. Accordingly, a lower materiality should be applied, which in this case would be K1.610 million based on 5% of profit before tax. This would be the planning materiality. A performance materiality would be reduced by say 5% to K1.53 million to result in slightly more work being done

ii) Overall approach to be adopted

The overall strategy or overall strategy to be selected should depend on the results of planning and risk assessment. If it is assessed that the risk profile of the client is low, then a substantive approach can be used where detailed testing is applied to each individual transaction and balance. Where internal controls are tested to be effective, a systems based approach can be adopted where part of the audit assurance is relied upon the effectiveness of internal controls.

Where the risk profile of the client is assessed to be high, then a risk based approach is adopted with focus on designing and implementing targeted audit responses to identified risks

Accordingly, in the context of EFL, a risk based approach should be adopted

c) Substantive procedures

i) Modification of the loan management system

- Inspect board minutes to verify authorization of the expenditure - **occurrence**
- Verify the K3.5 million to bank statements
- Verify details – amount and name to contract / agreement / invoices with suppliers – **Rights** and **valuation**
- Discuss with management and users on the utilization of the system and also inspect some of the reports to verify usefulness as an asset – **valuation** and **existence** as well **as right of use and control**
- Re-compute amortisation and verify with management calculations **- valuation**
- Trace the amounts to non-current asset register and financial statements

ii) Construction of EFL house

- Inspect board minutes for approval of capital project - **occurrence**
- Inspect and agree payments to bank statements
- Inspect and verify amounts to bills, labour and other charge records - **Valuation**
- Discuss and verify that only construction overheads were included in the cost and only costs incurred up to the date when the asset was ready for use should be included - **valuation**
- Assess the objectivity, capacity and capability of the external valuer - **Valuation**
- Inspect the valuation report and agree figures to financial statements – **valuation**
- Discuss the basis of the fair values used be reference to market values and other relevant information – Valuation
- Inspect the property to confirm that it **exists and being used for rental purposes**
- Inspect title deed and other ownership documentation to verify that the property is in the name of EFL – **Right of use and control**
- Re-compute the movement in revaluation and confirm processed in the profit and loss in accordance with IAS 40 - **valuation**

7) Completion of the audit of Delux Lux Limited plc – matters to consider and action

a) Financial Liability

Matters to consider

- According to IFRS 16 – Leases, a sale of a non-current asset which is immediately leased back will be accounted for depending on whether the right of use and control of the related asset has been transferred in accordance with IFRS 15 – Revenue from Contracts with Customers. DLL continues to use the asset and to incur insurance and maintenance costs. Effectively the asset has not been sold, rather DLL obtained a loan and provided the asset as security

- The treatment applied leads to risk of misstatement – other income overstated and liabilities understated

- The matter is 5.4% of profit before tax and is material, 2.8% of assets and 0.006% of revenue. The matter is material but cannot be considered as being pervasive

Further action to take

- Discuss with management
- Request management to make the necessary adjustment
  The correct entries are therefore to credit a financial liability and not revenue

Adjustment required

DR	Other income	K3.7 million	
CR	Financial Liability		K3.7 million

- Report to those charged with governance – the audit committee
- Consider impact on audit report. As the matter is material and not pervasive a modified, except for qualified opinion may need to be issued

b) Depreciation

Matters to consider

- The change in depreciation method does not constitute a change in accounting policy for which a prior year adjustment is required

- According to IAS 8, a change in depreciation method is regarded as a change in an accounting estimate and the accounting treatment is to effect the change prospectively from the year of change. In the case of DLL, the amount of K900,000 should be charged to cost of sales reducing profit for the year. The profit for year is overstated and equity understated

- K900,000 is only 1.3% of profit before tax and is not material on its own

Further action to take

- Discuss with management
- Request management to make the correct adjustment in accordance with IAS 8 as follows

Adjustment required

DR	Cost of sales – depreciation	K900,000	
CR	Retained profit brought forward		K900,000

- Consider discussing this with those in charge of governance – in this case the audit committee

- As the amount is not material, it will not affect the opinion on its own. However, it should be accumulated with other uncorrected misstatements

c) **Legal case**

Matters to consider

- The finance has not provided for a provision based on the argument that this obligation will be settled by the holding company

- According to IAS 37, a provision should be made if as a result of an obligating event, the outcome it certain or probable and the amount can be estimated reliably. Therefore, a provision of K73 million should be made and not merely disclosed. Accordingly, liabilities are understated by K73 million and profit is also overstated by K73 million

- The amount is 106% of profit before tax and would turn the profit into a loss of K4 million. K73 million is about 14% of revenue and 56% of total assets and would be regarded as being pervasive

- Given the pervasiveness nature of the matter, the going concern status of DLL should also be questioned

Further action to take

- Discuss with management
- Request for adjustment as below

Adjustment required

DR	Admin expenses – legal costs	K73 million	
CR	Provision		K73 million

- Given the significance of this matter, it should be discussed with the audit committee immediately

- If the amount is not adjusted for or dealt with correctly as a going concern matter, an adverse opinion would be issued

8) In relation to the draft report proposed by the audit senior

   a) Matters to consider regarding the letter of support

   (8 marks)

In certain circumstances, a letter of support **(letter of comfort)** from the directors of a group may be required. A situation may arise where a subsidiary may not be a going concern. If so, the subsidiaries accounts, which are consequently consolidated into the group accounts, should be prepared on a break-up basis.

However, the group may offer support to the subsidiary to enable it to continue trading in the foreseeable future. I f this is the case, the directors must give the principal auditor formal documentation, usually called a "comfort" or "support letter". This confirms their intention to support the ailing subsidiary

The auditor will normally accept such a letter as valid audit evidence of the going concern basis for the subsidiary's financial statements.

However, the audit firm should consider the following matters in determining whether the letter constitutes sufficient appropriate evidence

i) The letter must be signed/approved by the director/chairman with requisite authority to bind the holding company – Mpundu Holdings

ii) The letter should specifically cover all the support to be required by DLL

iii) Mpundu Holdings should have the capacity and capability to provide this support. In this regard, the auditor should assess the operating and financial position of Mpundu Holdings to provide this support, paying particular attention to liquidity and gearing ratios

They also be need to obtain a written representation from DLL management to this effect. The audit firm should then consider whether the letter of support, the management representation and any other evidence obtained constitute sufficient appropriate evidence to support DLL status as a going concern

b) Critically evaluation of audit report

According to ISA 700, Forming an Opinion and Reporting on Financial Statements, the report is in many respects standardized in terms of:

- Format
- Content
- Language
- Process

Using this criteria, the report is evaluated as follows:

iv) Addressee

The report is addressed to the directors instead of the shareholders

v) Format order

The order in which the paragraphs should appear is not correct. The correct order is opinion first, followed by basis of opinion and then other paragraphs

vi) Going concern paragraph

- This should now read "material uncertainty related to going concern – according to ISA 570

- It should refer to the page number and the note number

- It should refer to the fact that the report is not modified in that respect

vii)Basis of opinion

- This should read as basis for qualified opinion

- This should include an assessment and quantification of whether the provision is material and/or pervasive. In this case K3.7 million is 5.4% of profit before tax and is material. It is 2.8% of total assets and 0.06% of revenue. This would not be assessed as pervasive.

- Reference to by name to Mrs Jolly Lombe is not appropriate

- Reference to the finance director is not appropriate – it is management's responsibility to prepare financial statements and not one individual

- Expressing an opinion on Mrs Lombe as being misguided is not appropriate

- Reference to accounting standard should be in full in this case – International Financial Reporting Standard IFRS 16, Leases and 15 – Revenue from Contracts with Customers

viii) **Opinion**

- The opinion should be supported by the basis of opinion and should read "qualified opinion"

- As the unresolved matter is only material and not pervasive, an adverse opinion is not appropriate – it should be an except for, qualified opinion