COMPETENCE PRACTICE EXAMINATION

FULL AUDIT

JUNE 2010

SUGGESTED SOLUTIONS

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QUESTIONS 1

SECTION A

1) **Professional Etiquette:**

a) Ethical and professional matters raised
b) Action and conclusion

(a) Ethical and professional matters raised	(b)Action
(i) Communication with outgoing auditors It is a professional requirement for us to contact the outgoing auditor to determine whether there are any other reasons that preclude us from taking on this engagement. Reluctance on the part of Mr Lou should be viewed with suspicion as this may be an indication that Mr Lou has something to hide	We should have explained the purpose of this communication to Mr. Lou that it is necessary for two reasons: • As a matter of courtesy to the outgoing auditors • To decide if there are any ethical and other issues that should be taken into account in accepting the appointment. We should also emphasise that not being able to proceed with this communication is enough professional grounds for us not to take up the appointment
(ii) Poor Controls – qualified report Internal controls have in the past been assessed to be poor. In addition, KEG was not able to substantiate certain transfers made to a Chinese company. This attitude demonstrates a very weak control environment and brings the integrity of management into question.	We should be careful not to be associated with negative publicity. If it is assessed that KEG are not willing to improve their state of controls and are not willing to properly disclose reasons and documentation relating to the transfers, we should not have taken up the appointment
(iii)Possible money laundering The existence of significant transfers to a Chinese a company for which no clear documentation or justification may indicated possible money laundering. Accordingly, the Money laundering is a serious criminal offence. Under current confidentiality guidelines, we have a duty to report such activities to a	This is a serious matter and exposes us to significant negative publicity. A full explanation relating to these transfers should have been obtained with adequate supporting documentation and justification. Failure to this, we should not have taken up the appointment as doing so would require

regulatory authority, in this case, the Drug Enforcement Commission	that we report KEG to the relevant authorities
(iv) Outstanding audit fees The existence of significant undue fees from an audit client may constitute a self-interest threat or appear to be a threat to objectivity akin to that of a loan. The outgoing auditor is owed fees from 1998 and we may also be in the same position	We should have explained the implications of undue fees to Mr Lou and recommend that fees due to Tayonse & Co be settled immediately. It may be a good idea to have addressed this issue in the letter of engagement.
(v) Audit evidence The outgoing auditors are expected to ensure that all books and papers belonging to KEG are properly transferred to us. However, professional accountants are obliged to hold on to such documents where they are claiming a lien over them in respect of unpaid fees. This evidence may constitute a limitation of scope on our audit	This matter should have been discussed with KEG with recommendation that the fees should be settled as soon as possible. Otherwise this should be evaluated and its impact on the audit report determined. If material, it may lead to a modified, "except" for opinion.
(vi) Provision of other services The assumption by Mr Lou that we should provide any service that KEG may require may threaten the provision of our audit services on account of: i) Such work can generate significant levels of income which may overly influence our decisions and conclusions reached during the statutory audit process ii) Provision of other services may create a self-review threat as such work may have an impact on the financial statements under audit.	The provision of other services should only be considered if we able to: • Put in place separate engagement teams • Increase quality control reviews • Avoid involvement in making management decisions • Avoid undue dependence on the KEG, in terms of total income generated

Conclusion:

The ethical and professional matters raised seem to question the integrity of management and the illegality of some of the activities being undertaken. Possible conflicts are also likely to arise resulting in a possible acrimonious relationship with KEG. It is therefore recommended that we should not continue to act as auditor and professional advisors to KEG

2) **Audit of the KEG Glass division,**

a) **Professional skepticism**

The auditor is required to '**maintain an attitude of professional scepticism'** throughout the audit. The auditor should recognize that a material misstatement as a result of fraud could exist regardless of the auditor's previous experience of the client and its management and those charged with governance. This attitude is important when considering fraud, due to the concealed nature of fraud. It is possible that things might not be as they seem. This is particularly so for the audit of KEG, given the state of controls and the fact that this is the first year audit.

In other words, it is necessary to keep an open mind of the commercial reality of the possibility of fraud while carrying out an audit and to ensure that all audit evidence gathered is critically assessed. An auditor should not be persuaded by less-than-persuasive audit evidence as a result of the fact that in the past the management and staff of the company have appeared to be honest and trustworthy.

However, the auditor is entitled to take documents of face value unless he has reason to believe otherwise. In other words, auditors are not required routinely to check whether documents presented to them as audit evidence are authentic. If their suspicions are roused, then they would be required to make further enquiry, for example, they should attempt to obtain evidence from a third party.

b) **Audit and Business Risks**

i) **Detection risk**

- It is the first year audit and the auditor is unlikely to have comprehensive understanding of the entity and related systems. This is compounded by anticipated problems in dealing with Mr Lou, following delays in making the appointment

ii) **Control risks**

- The controls in the business have always been assessed previously as poor.
- There is likely to be **little segregation of duties**, although management have a 'hands on' authoritarian style.

iii) **Operational risks**

- The issue noted above in inherent risk of the business supplying one customer who is significantly bigger than them. This means in effect that the **customer controls operations** and holds significantly more power over the company than would be good for the company.

iv) **Financial risks**

- The company is dominated by one man (Mr Lou) and **raising capital** if required might be restricted beyond him. He is likely to have to give personal guarantees to the bank for lending. The business is likely to have undue dependence on him in this regard.
- Lack of segregation of duties leads to higher opportunities for **fraud** and **misappropriation of cash.**

- The company deals in **portable, saleable items** at high risk of being stolen

v) **Compliance risks**
- There are **a number of employees** so the risk arising from the need to comply with the **employment laws** is significant, as the company is unlikely to employ an expert in this area.
- **Glass** is a dangerous product to work with and this will have **health and safety implications.**

c) **Audit Strategy and justification**

The first stage of the audit will be to understand the entity. This will include documenting and confirming the systems and internal control. However, it appears likely that the controls will be assessed as ineffective, or at best, strongly reliant on the control of the key manager. Therefore, it is extremely unlikely that **a systems and control approach** will be taken to the audit. It is far more likely that **a substantive approach** will be taken..

Risk

Audit and business risks have been discussed above. Auditors often take a risk approach to an audit in connection with a substantive approach. This can be a business risk approach or an audit risk approach. Usually it involves an assessment of both as the two issues are related. (ISA 315 requires the auditor to assess the risks faced by the business as means of identifying risks of material misstatement in the financial statements.)

The **business risk approach** is often taken for large companies, who have strong controls who are accustomed to the concepts of risk management and awareness. In a smaller firm, such as the KEG division, it is likely that the auditor will be able to rely on the business's own ability to manage risk effectively. Concerns over the controls of the business indicate that a detailed substantive approach would be more appropriate.

There are clear audit risks in this client. It is therefore sensible to take an **audit risk approach** and focus the detailed audit tests in the areas of the business where problems are most likely to arise.

Substantive approach

The fact that a detailed substantive approach is required has been mentioned several times already. This would suggest that an **analytical approach** would be appropriate. This is compounded by the fact that it is a first year audit and with a lack of knowledge of the business to apply to the financial information, an analytical approach would be less effective.

In terms of detailed testing then, two approaches could be taken. The audit could be conducted around the statement of financial position or the transactions (the transactions, or **cycle approach)**. In my opinion, the cycles approach is the more sensible approach for the following reasons:

- Controls are believed to be poor, two approaches could be taken. The audit could be conducted around the statement of financial position or the transactions being misstated.
- Last year's statement of financial position was not audited by our firm.
- Testing the transactions will give us a significant insight into how the business operates and increase our knowledge of the business.

Conclusion

The appropriate approach is an audit risk approach, combined with a detailed substantive cycles approach.

3) **Procedures on the profit forecast**

a) **General**

(i) Discuss with management the way in which the profit forecast is prepared
(ii) Compare the actual results of previous restructuring with forecasts to determine overall level of accuracy of the profit forecast.
(iii) Determine who specifically is responsible for the preparation of the profit forecast and assess their experience and expertise.
(iv) Assess the control procedures exercised over the preparation of profit forecast.
(v) Check the accounting policies normally adopted by the company. These should have been consistently applied in the preparation of the profit forecast.
(vi) Obtain written representations from management regarding the intended use of the cash flow forecast, the completeness of significant management assumptions and management's acceptance of its responsibility for the profit forecast.

b) **Specific procedures on the profit forecast**

(i) Discuss with management the means by which they have predicted expected revenues/profits. For example extrapolation of historical data may be inappropriate due to the restructuring.
(ii) Check that any assumptions made are consistent with one another. For example if revenue is expected to grow, certain costs would also be expected to increase (although not necessarily in direct correlation). Assess the assertion by the business that the restructuring will result in a lower cost base.
(iii) Compare assumptions made for forecasts purpose with other internal information produced by the business. For example expected sales growth can be compared to sales and marketing plans.
(iv) Compare budgeted expenditure on R&D with budgets and final costings on completed products. (This is particularly important as the aim of increasing market share is dependent on innovative products. R&D is likely to be a major cost).
(v) Compare assumptions made with general industry data and trends particularly in respect of building systems market.
(vi) Check the arithmetical accuracy of the profit forecast by making clerical clerks such as re-computation. Internal consistency should also be assessed through the use of analytical procedures.
(vii) Compare predicted costs against actual costs incurred. Clarify the rationale behind any significant cost savings.

SECTION B

4) **Inventory procedures**

a) **Inventory attendance and reporting**

Professional provisions require that the auditor should attend the inventory count to observe and confirm that instructions are being adhered to. This should be supported by appropriate follow up procedures to compare quantities counted with the inventory records. The reasons why auditors are required to attend inventories include:

(i) Inventories often represent a significant asset in the financial statements

(ii) The value of inventories has a direct impact on profit

(iii) The valuation of inventories is often a subjective process as the decisions to the stage of completion and allocation of overheads is often subjective

(iv) The physical controls of inventories are often difficult because of multiple locations, including inventories held by third parties

(v) The provision for slow moving and obsolete inventories is another subjective area.

However, there are practical reasons why the auditor may not be able to attend the inventory count. For example, when auditors are appointed after the inventory count has already been undertaken

The mere fact that we are not able to attend the inventory count is not grounds for qualification. There are alternative procedures that can be carried out to obtain sufficient and appropriate evidence relating to inventories. Audit qualification or modification should only be considered where sufficient and appropriate evidence cannot be obtained from other alternative procedures.

b) **Alternative procedures**

i) **Physical Count at 30 April**

- Request for a physical count to be undertaken for selected material items
- The sample of items should cover all locations
- The auditor should attend all these counts as the counts will be used to roll back to the year end
- The count should be traced back to inventory records as at 30th April.
- All differences should be properly investigated and resolved

ii) **Analytical procedures**

Given the apparent disparity between sales and purchases during this period, it is necessary to carry out appropriate analytical procedures. Important ratios are those of gross profit margin and inventory turnover

- An unexpectedly high inventory turnover ratio, or unexpected low gross profit ratio, might be caused by overstatement of cost of goods sold and a corresponding understatement of inventories
- Conversely conformity of these ratios with expectations provides assurance that inventory figures are more likely to show a true and fair view

iii) **Movements between January and April – For selected items in the inventory count**

- Review and enquire to ensure that goods received notes are prepared for goods received
- Confirm that the inventory accounts are debited for all goods received.
- Review and enquire to ensure that goods issued out are properly authorized and documented on delivery documents
- All sales should be charged to cost of sales – crediting inventories and debiting cost of sales at appropriate cost

iv) **Write offs**

For items written off as broken or of poor manufacturing quality:

- Discuss with management how these were identified as being of poor manufacturing quality
- A physical inspection should be carried out to confirm existence
- Inquire and discuss cost of write off by reference to costing records and invoices as appropriate
- Enquire and review possible existence of other similar items that should be written off

v) **Inventories at other locations and with third parties**

When inventories are stored at other locations and with third parties, the auditor should obtain evidence as to the existence of the inventories by direct communication with the custodian. This type of evidence will be deemed sufficient except when the amounts involved represent a significant proportion of current assets. In this case, the following addition procedures should have been carried out:

- Consider the integrity and independence of the third party
- May consider visiting the third party to conduct a physical inventory and other alternative procedures
- May consider obtaining confirmation from the auditor's of the third party

vi) **Valuation**

- For items at cost, examination of suppliers invoices
- For work in progress, verify costs by comparing with costing records
- All inventory items should be tested for net realizable value and written down to net realizable value if this is below cost. Given the inherent risk associated

with this aspect, the following additional procedures should have been undertaken:

(a) Reviewing all the sales after the balance sheet date
(b) During the inventory count conducted in April, observing signs of deterioration or obsolescence, including slow moving inventories
(c) Making inquiry of management and of sales and production personnel
(d) Reviewing the minutes of the board of directors and management.

vii) **Evaluation of audit evidence – materiality**

- All the evidence obtained should then be evaluated. Any matters outstanding, including the refusal by Mr. Chew to make any adjustments should be evaluated in the context of materiality.

viii) **Management representations**

- It will be necessary for management to include confirmation assertions relating to inventory in the letter or representation to be provided to us at the end of the audit

5) **Reporting**

a) **Matters to consider**

i) **Nature of matters arising**

It should determined whether the matter is one of disagreement with the reporting framework or whether it is a matter of limitation in scope where the auditor not being able to obtain sufficient appropriate evidence. In this case, it is limitation in scope as the auditor has not been able to obtain sufficient and appropriate evidence

ii) **Materiality**

If the matter is material but not pervasive, an "except for" opinion would be issued, if it is considered material and fundamental, a "disclaimer" opinion would be issued. If it is not material, no adjustments would be necessary and no modifications would be necessary in this regard

iii) **Basis of the opinion**

The matter should be clearly explained and quantified in terms of materiality as a basis for the opinion

b)

i) **Extract of the report – Assuming inventory material but not pervasive**

We did not observe the counting of physical inventory as at 31 December 2009, since that date was prior to the time we were initially engaged as auditors of KEG, Glass Division. Owing to the nature of the company's records and our inability to undertake satisfactory procedures, we were unable to satisfy ourselves as to the inventory quantities. The amount attributed to inventories is K23 billion and is considered material

In our opinion, except for the effects of such adjustments, if any, as might have been determined to be necessary had we been able to satisfy ourselves as to physical inventory quantities, the financial statements give a true and fair view…….

ii) **Extract of the report - Inventory material and pervasive**

We did not observe the counting of physical inventory as at 31 December 2009, since that date was prior to the time we were initially engaged as auditors of KEG, Glass Division. Owing to the nature of the company's records and our inability to undertake satisfactory procedures, we were unable to satisfy ourselves as to the inventory quantities

Because of the significance of the matters discussed in the preceding paragraph, we do not express an opinion on the financial statements.

QUESTION 2

SECTION A

1) **PROVISION OF OTHER SERVICES**

a) Benefits of providing other services

i) The auditor will enjoy addition income arising from the provision of addition services
ii) The client will probably benefit from a saving in using the same professional for all these type of work, because information gained on one assignment can be used on others and the Choprite will not be paying for the learning time of a new advisor
iii) Choprite's staff and management should also save time, as they should not need to explain the business repeatedly to different people
iv) Provision of other services such as accounts preparation and taxation gives the auditor a very good opportunity to keep in touch with the company's performance during the year and take note of any possible audit problems as soon as they arise
v) Choprite stands to gain from the breadth and depth of experience gained by the auditor over time

b) Independence implications and action to take

i) Taxation

It is customary for the company's taxation liability to be at least checked, and often computed, as part of routine audit work. It is unlikely that independence would be impaired by this, or by routine correspondence with the Zambia Revenue Authority. It is normal for an auditor to deal with director's affairs. A problem would, however, arise if there were any dispute between the Choprite and its directors, as the auditor would suffer a conflict of interest.

Choprite would probably be best advised to relinquish either the audit or the tax advisory role

ii) Accounts preparation

This clearly gives the auditor a very good opportunity to identify likely problems affecting the financial statements. However, there is a risk that the auditor will not be as detached in carrying out the audit of accounts they have prepared as would be the case if the client had produced the accounts

The best option is not to be involved in the accounts preparation. The next alternative is to ensure that different personnel are involved in the preparation of financial statements

iii) **Advise to the directors**

Clearly the auditor will be able to draw on knowledge of the company in giving advice. There is a significant risk however, that independence will be compromised particularly if the advice turns out to have been mistaken. If the auditor has prepared a profit forecast for submission to the bank which subsequently proves over-optimistic, he or she may find it difficult to require the client to reflect the actual result in the year-end accounts

This provides a serious advocacy threat and the Auditor is advised not to put themselves in such a conflict of interest situation

iv) **Board Meetings**

There is a risk here that the auditor may completely forfeit independence by becoming too closely involved in the running of the company. The Companies Act regards as a director anyone who carries out the functions of a director, and an auditor would be exposed to the presumption if he or she attended meetings regularly.

It would therefore be advisable for Danzi & Partners to attend only board meetings at which the annual accounts are approved by the board.

2) Going concern

a) Factors indicating going concern problems and calculations

GOING CONCERN

Guidance note: The first part of this question demonstrate what can be deduced from the calculations for example short-term funds used to purchased fixed assets and delayed payments to creditors. It is vital when you approach questions like this that you do not spend so long calculating ratios that you fail to make comments and draw conclusions from your work. Equally, having been asked in the question to undertake some calculations, it would be wrong not to do so. You must apply judgment in the balance between calculations and analysis in your answer, remembering that you will score better marks for analysis. Of course, to get those marks, you must have something to analyze.

Workings

The following significant accounting ratios are based on the accounts provided:

	2006	2007	2008	2009
Gross profit (%)	10.90	14.20	20.20	19.70
Other expenses: sales (%)	10.90	14.40	14.40	15.30
Interest: sales (%)	1.10	5.20	5.20	6.20
Net profit (%)	(1.10)	(5.40)	0.30	(1.80)
Current ratio	0.91	0.73	0.73	0.76
Quick ratio	0.59	0.46	0.37	0.34
Gearing	0.75	9.52	9.58	20.69
Inventory (months)	2.28	2.26	2.77	3.57
Receivables (months)	3.66	3.24	2.26	2.32
Payables (months)	4.83	3.80	3.54	4.09

Notes

$$\text{Inventory age} = \frac{\text{year end inventory}}{\text{Cost of sales}} \times 12 \text{ months}$$

$$\text{Receivables age} = \frac{\text{year end Receivable}}{\text{Sales}} \times 12 \text{ months}$$

$$\text{Payables age} = \frac{\text{year end payable}}{\text{Cost of Sales}} \times 12 \text{ months}$$

$$\text{Gearing} = \frac{\text{Long-term loans + Bank overdraft + Hire purchase}}{\text{Shareholders funds}}$$

The various factors in the accounts which may be indicative of going concern problems are as follows:

i. Only losses or low profits are being made; the company is not generating sufficient funds to finance the expansion required.
ii. There has been a dramatic increase in the level of overdraft over the last year, there seems little prospect of the borrowing being reduced and the security is threatened
iii. There are signs of overtrading as the expansion has been financed by borrowings and the increase in current assets is being financed by payables.
iv. The gearing is high and increasing, with very little security being available for the loans.
v. There is a low current ratio; short term funds are being used to finance long term assets.
vi. The quick ratio is low and decreasing and the company's ability to meet its liabilities on demand must be very questionable.
vii. Inventory levels are increasing, suggesting that one or more of the following problems may exist: deteriorating sales, poor inventory control, obsolete or slow moving inventories.

viii. The value and age of payables is increasing: some creditors must be having to wait a considerable time before being paid and it can only be a matter of time before pressure is put on the company by one or more of its creditors

ix. High and increasing interest charges make the company very vulnerable, especially in a period of recession and high interest rates.

x. The fluctuating gross profit would suggest that the company's profit margins are under pressure. The present level of gross profit does not seem sufficient given the company's high level of expenses.

b) Further investigations

The other steps to be taken by the auditors in determining whether or not the company may be properly regarded as a going concern at the year end would include:

i. Review carefully the cash and profit forecasts for the next year to see if they suggested any improvement in the company's position; consider the basis of preparation of these forecasts and whether they appear comprehensive.

ii. Seek some evidence that the company's bank is prepared to continue supporting the company.

iii. Review the level of post balance sheet trading to see if this supports the forecasts and show any signs of improvement in the company's position.

iv. Examine correspondence files for any evidence that creditors might be putting pressure on the company for repayment of monies owing.

v. Consider how the company's position compares with similar companies in the same business.

vi. Discuss generally the situation with management and review any recovery plans which they may have in mind.

SECTION B

3) **Other matters arising from the audit – Letter to the directors**

1 March 2010

Mr. Norman Chilufya
Finance Director
Choprite Ltd
P.O. Box 35622
L U S A K A

Dear Mr. Chilufya:

RE: FINANCIAL STATEMENTS: YEAR ENDED 31 DECEMBER 2009

Thank you for your letter dated 21 February and copy of the minutes of your board meeting at which the above financial statements were approved. We note also that it was resolved that no amendments should be made to the statements approved.

We must nevertheless point out that there are certain matters which we have noted during our review of the financial statements and, subject to further discussion, these may well required suitable reference in our audit report when this is finalised in due course. These matters accordingly are listed below:

a) Free hold property

In past years, this property has been shown in the statement at its original cost, whereas it is now restated at K25 billion as professionally valued during the year. We are satisfied as to the basis of the valuation, adjustment to and disclosure within the financial statements. As a result no further reference to this property revaluation will be required in our audit report

b) Doubtful debt provision

It is our belief that no part of the debt of K23.7 billion due from certain customers will be recovered by the company. Since the financial statements which the directors have approved include no provisions against this debt, it will be necessary for us to state that

- No provision has been made against an amount of K23.7 billion owing by certain customers
- We believe such amount to be irrecoverable
- This amount is material
- Except for the failure to make such provision, in our opinion a true and fair view of the state of the company's affairs and its results is given by the financial statements.

c) **Loan to director**

Since the director's indebtedness of K220 million which subsisted during a six week period, has not been disclosed in the financial statements in accordance with the provisions of the companies Act 1985, we are obliged under the Act to include in our report a statement giving the required particulars.

The particulars include:

a) The name of the director
b) The fact of his indebtedness
c) The amount due (including any interest) i.e. K220,000,000

This is also in breach of International Accounting Standard 24, *Related Party Transactions*, which requires that similar disclosures are made

d) **Alleged breach of contract.**

Because of the potential materiality of the uncertainty concerning the amount of compensation (possibly including costs) which it appears will be payable following the major breach of your contract with Landa Construction, we feel it will be necessary for our report to refer to the explanatory note in the financial statements in which this contingent liability is disclosed under a fundamental uncertainty paragraph.

This paragraph simply draws closer attention to this matter. It is not a modification of our opinion.

e) **Fine for pollution**

An intangible asset is a resource control by the company as a result of past events and from which future economic benefits are expected to flow. You seem to be trying to argue that the fine is unavoidable cost of operating the manufacturing facility and that economic benefits result from it. But the fine is avoidable and therefore it is an expense and not an asset. The fine should be recognised in the statement of income for the year, and if material disclosed separately.

Should you and your co-directors wish to discuss these matters further, please do not hesitate to contact us. If it is believed that, in the light of the above comments, amendments to the accounts should be made, it will, of course, be necessary for the board to re-approve the amended financial statements.

However, should the board still consider that no amendments are to be made, it will be necessary for us to draft our audit report incorporating the various matters referred to in this letter. A copy of the proposed report will be forwarded for your information.

Yours sincerely

Chomba Mutale
For Danzi & Partners

4) **Going concern reporting**

a) Possible reasons why Choprite is not willing to provide note

The possible reasons why the directors are not willing to provide this note include:

- Accountability
- Trigger further financial distress
- Operational problems – customer and suppliers
- Operational problems – loss of staff
- Directors do not think going concern is impacted

i) Accountability

The directors of Choprite may not want to highlight the difficulties the company is experiencing as they will be held directly responsible by shareholders and other stakeholders. Even if the problems are as a result of an external force, such as a new competitor, the directors could still be held accountable and will want to protect their interest

ii) Trigger further financial distress

Choprite is currently trying to raise finance to cover its operating cash flows. The likelihood of being able to raise this finance is reduced by including the note to the financial statements as potential lenders will be concerned about non-repayment. Additionally, it could cause existing lenders to recall their funds early as they are worried about the company's ability to pay in the future. The directors may therefore be concerned that the note may only exacerbate any financial difficulties Choprite is suffering.

iii) Operational problems – customer and suppliers

The directors could be concerned that including the note in the financial statements would lead to operating problems, worsening the current situation. Suppliers may choose to withdraw business if they are concerned about Choprite's ability to pay. Customers may be worried that the company will close leaving them without supplies at short notice and so choose to go elsewhere

iv) Operational problems – loss of staff

Employees of Choprite may decide to find alternative employment rather than risk redundancy. The directors may fear that the inclusion of the note will cause valued employees to leave and have a negative impact on business

v) Directors do not think going concern is impacted

The directors could genuinely believe the going concern status of the company is not impacted by the problems it faces. The directors may believe that they are likely to secure the finance they require to cover their cash flow difficulties and so the future of the company is secure.

b) Implications for the audit report

i) Directors refuse to disclose

According to IAS 1, management must disclose any material uncertainties related to events or conditions that may cast significant doubt upon the entity's ability to continue as a going concern. Working papers from the audit of Choprite indicate there is a significant doubt over the going concern status of the company. If the directors refuse to include the note, IAS 1 has not been adhred to.

As auditors, we will need to modify the audit report to express a qualified or adverse opinion depending on how significant we believe the omission of the note to be. As we believe that the non-inclusion of the note is so material and pervasive that a qualification would be not be adequate to disclose the misleading nature of the financial statements, we should express an adverse opinion.

ii) Directors agree to disclose

If the directors include the note and we believe that the use of going concern assumption is appropriate but that a material uncertainty exists, then certain provisions of the IAS 570 *Going Concern* will apply. We will need to review the note ensure that it adequately describes the cash flow difficulties which have cast significant doubt on Choprite's ability to continue as a going concern and how management intends to deal with these. We will also to ensure that the not clearly discloses that there is a material uncertainty casting significant doubt on Choprite's ability to continue as a going concern.

If we conclude that the disclosure is adequate, we should express an unqualified opinion and include emphasis of matter paragraph in our report. This paragraph will highlight the cash flow difficulties Choprite is experiencing and these and will draw the reader's attention to the disclosure note in the financial statements.

If we find that the note does not provide adequate disclosure in line with IAS 1, then we will express a qualified or adverse opinion.

END OF SOLUTIONS