Audit Risk: Assessment Of Bega Cheese Limited

The purpose of this report is to identify and highlight the most important/key audit areas in performing the audit of financial statements of Bega Cheese Limited (hereinafter “BCL”) for the year ended June 30, 2019. The report achieves its objectives by discussing the Company’s areas of operations, laws and regulations affecting its operations, recent major developments researched through publicly available sources and an analysis of the financial statements of the company. The report will assist the engagement partner and the tea in directing the audit efforts to the areas most expected to contain material misstatement/error.

1. Areas of operations

BCL is one of the major market players in Australian dairy industry that specializes in the production of natural and processed and cheese, butter and rich cream products. It was formed in 1899 and its manufacturing facilities are located in Bega, New South Wales and Strathmerton in Victoria (Australian Business Review, 2017). BCL is listed on the Australian Stock Exchange (Asx.com.au, 2019) and follows the acquisition model for the expansion of its operations across the globe, with major acquisitions of brands like Vegemite and Kraft in the past, and acquisition of companies like Tatura Milk in the past and Koroit production facility in the current year. By exporting its products to over 70 different countries across the globe, the Company claims to sell 1 million packets of cheese every day (Bega Cheese Ltd, 2016). These sales account for 40-50% of BCL’s revenue. Besides selling its products under various brand names, BCL also caters to the needs of other local manufacturers by supplying bulk quantities under contracts to be sold under other brand names (Bega Bionutrients, 2016).

BCL’s revenue from the two major products is depicted using the following pie chart (with data extracted from Segment reporting note in financial statements):

2. Laws and regulations affecting BCL’s operations

Besides being subject to reporting requirements under various local and international laws, BCL being engaged in operating various dairy farms and food processing facility has to comply with laws and regulation applicable on the dairy and farming industry. Some of these regulations are listed below:

- Australian Animal Welfare Standards and Guidelines having regulation relating to fair treatment of animals and land transportation of livestock, and cattle farmer
- The Foods Standards Code – FSANZ standards
- Export Control (Prescribed Goods - General) Order 2005
- Exports Control Act 1982
- FSANZ Product Recall Protocol under which company needs to have a working recall system complying the requirements
- Environment protection, occupational health and safety laws

3. Key Risk Areas

Adoption of the acquisition model of growth by BCL has resulted in purchase of several small and big brand names in the industry. The company also frequently undertake joint ventures within its industry. This has resulted accumulation of goodwill and intangible assets in its financial statements which might be overvalued. Further, the group operating in the food and agriculture industry has to account for its biological assets in accordance with IAS 41 and carry its inventory at fair value less cost to sell in accordance with that accounting standard. Since, these are subjective areas and often requires management of the entity to exercise judgment and are also subject to significant estimation uncertainty, the report identifies these two areas as highly risky and prone to misstatement due to the inherent degree of variability within their account balances.

Besides, the group has several transactions with related parties which are also inherently risky as transactions with related party could be undertaken on non-arm's length basis resulting in the entity being unable to realize full value of its resources. Besides these transactions re to be eliminated for the purpose of consolidation procedures under IFRS 10 Consolidated Financial Statements. These procedures and he resulting adjustments are often complex and require the entity to apply considerable judgment and skill, and therefore could be prone to error. The following paragraphs of the report discuss these identified issues in detail.

4. Goodwill and other acquired Intangible Assets

4.1 Explanation of the identified audit risk

Horizontal analysis of the breakup of intangible assets as disclosed in the available financial statements reveal the following:

Figures in AUD thousands

2019

2018

Difference

% change

Brands

140,405

140,405

-

0%

Water rights

5,601

5,601

-

0%

Headwork utilities rights

956

956

-

0%

Gene pool

1,467

1,467

100%

Software

51,185

35,055

16,130

46%

Goodwill

335,533

229,446

106,087

46%

Total Intangibles

535,147

411,463

123,684

30%

Overall intangibles have increased during the current year by 30% at $123,684,000. Total intangibles amount to $535 million which is 36% of the assets employed by the company and therefore highly material account balance.

Goodwill and indefinite useful life assets are to be tested for impairment at least annually, and the results could indicate that these assets cannot fetch an amount equal to their carrying amount, and therefore need to be written down. Additions to software also amount to $20.7 million and is individually material to financial statements. Considering the company has been making major investments in the new enterprise resource planning (ERP) software since 2017, the utility and benefit of these additions should be inquired and evaluated against the management's assertions. Intangibles therefore represent a major audit risk and would rightly deserve our major audit consideration.

Amount of $1.47 million recognized in the current year in respect of Gene Pool (as shown in table above) represents a seed research and development program of a subsidiary company – Peanut Company of Australia. It represents cost of R&D for the purpose of improving the desirable attributes of the peanut seeds varieties for optimum commercial production and grower's successful varieties. This needs to be evaluated as per paragraph 58 of IAS 38 Intangible Assets so that only those expenditures on research are capitalized for which future benefits and commercial viability can be practically demonstrated and proved.

4.2 Potential impact on the financial statements

The level of management judgement involved in the valuation models is high and requires forecasting of future cash flows, growth rate of the operations, and determining the appropriate discount to be used. The amounts recognized in financial statements in respect of intangible assets and particularly for goodwill could therefore be overstated (materially).

4.3 Audit procedures and the related assertions to address the identified risks

The addition to goodwill as discussed above pertains to Koroit facility that has been acquired by BCL during the year. Koroit facilities generates cash inflows for the Company independent of its other operations and segments, hence it is a cash generating unit (CGU) that is accountable for good of over $106 million. The management has tested the CGU for impairment by calculating the net present value of cash inflows and outflows that it expects to incur from Koroit CGU over the next many years. Management has made the following subjective judgments in concluding that the goodwill has not been impaired at the close of financial year:

- 1.5% growth rate for the products generated over the foreseeable future
- 6.5 discount rate can be achieved
- Sale of other products do not undermine the sale of Koroit products

- Supply of Lactoferrin (which is an essential ingredient in dairy products) can be obtained

The use of incorrect assumption could result in over-optimistic valuation of the CGU, which will lead to avoidance of impairment recognition and consequently overstated profits. Following audit procedures would address this risk.

1. Testing of management's assumptions in valuation of CGU in line with market conditions to concluding whether they are relevant and correct in accordance with our understanding of the Company and its environment. An expert valuer can be employed if required by us;
2. Performance of analytical procedures to predict the impact of acquisition of Koroit CGU on the company's key performance indicators (KPIs) to predict the change in revenue and then comparing it with actual revenue to ascertain whether the expected increase has materialized over the period as per draft unaudited accounts;
3. Comparing the forecasts used in the valuation with the budgets approved by the Company's Board of Directors;
4. Performing a sensitivity analysis of the calculations by varying key variables using a range of possible rates / outcomes, then determining which one is the most expected scenario (Jackson & Stent, 2015);
5. Checking the mathematical accuracy of the calculations given by management and consider whether any variable / event / possibility has been ignored in the present value of net cash inflows;
6. Reading the minutes of the BOD meeting to identify any fluctuations in the budgeted / expected cash inflows / outflows or deviations from initial expectations.

5. Inventories

4.1 Explanation of the identified audit risk

Biological assets that are livestock of the Company and the agricultural produce which is the result of harvest are recorded in financial statements in accordance with the 'fair value less costs to dispose' model. This assessment needs to be undertaken initially and at each reporting period.

Further there has been a volatility in prices of commodities throughout the period under audit owing to fluctuations in global commodity market as well as local Agri-produce markets. This further enhances the risk of BCL's inventory having been recorded at higher than its net realizable value (Australian Financial Review, 2018).

Moreover, the recording of provision against obsolete and slow-moving stocks is an inherently risky process involving use of judgments and prone to estimation uncertainty. There are a number of companies within he Group and the policy for determining and recording provisions may not be similar across the board which would give rise to further complexities in ascertaining the correct provision and auditing it.

4.2 Potential impact on the financial statements

Owing to the above risks, there is a possibility that provision for obsolescence is not adequately

recorded in the books, resulting in overstatement of inventories in the statement of financial position.

An analysis of the working capital ratio is done as follows:

2019

2018

Inventory

274,146

211,210

Revenue

1,419,952

1,252,041

Turnover (times)

5.18

5.93

Turnover (days)

70.469488

61.572784

The inventory turnover during the period has substantially reduced from about 6 times to 5 times. In terms of days, now BCL takes 70 days to sell the inventory to customers (on average) as compared to 61 days last year. This change could be because of the new type of inventory of the Koroit facility acquired during the year and needs to be investigated. This again suggest that inventory could be misstated in the financial statements.

4.3 Audit procedures and the related assertions to address the identified risks

The audit procedures particularly to verify the valuation assertion in inventory and completeness assertion in provision for obsolescence include the following:

1. Discuss with management of the entity any issue sin the quality and shelf life of the dairy products manufactured by BCL;
2. Identify form Board minutes and inquiries any quality control issues that may have arose

during the period and suggest that a particular kind of inventory may not be realizes at a price above its cost;
3. Analyze the credit notes received form customers and other sales adjustments post year-end to identify any issues in a particular kind of inventory / quality control issues;
4. Analyze for a type of inventory that appears to be subjectively valued, a sample of goods sold after the year-end to determine whether it is able to recover the costs and whether NRV computation is consistent with the actual sale prices.
5. In view of the risks identified through results of the audit procedures performed and after discussion with management of the Group, consider the adequacy of the provision recorded in the inventories (Jackson & Stent, 2015).

6. Acquisition of Koroit facility

4.1 Explanation of the identified audit risk

In August 2018 the Group acquired Koroit facility against a consideration of $251 million and in the financial statements for the period under audit the acquisition accounting has ben finalized. This appears to be one of the significant audit risks for the audit team because of the magnitude of the transaction and the inherent complexity of the consolidated procedures and accounting. The transaction is material being 17% of the total assets of the group (251,000 / 1,488,585) hence it needs special audit consideration.

In addition to above, the group has four subsidiaries including Bega Cheese Investments, Tatura Milk, Peanut Company, and 180 Nutrition, along with a joint venture and a joint operation. The complex group structure makes the consolidation procedures and accounting difficult and more prone to misstatements. Accordingly more attention would be required to ensure elimination of inter-company transactions during the year and balances at year end; calculation of net assets in subsidiary acquired during the year, any fair valuations thereof at the time of acquisition, intangibles acquired from subsidiaries, and their consequential impacts on the goodwill computed on acquisition, and resulting deferred tax assets / liabilities, if any.

4.2 Potential impact on the financial statements

As a result of error in any of the aforementioned procedures, the related account balances in the financial statement would be affected. Such as intangibles in case of incorrect computation of goodwill in Koroit CGU; whereas revenue would be overstated in case of not eliminating the intercompany sales within the Bega Group.

4.3 Audit procedures to address the identified risks

Accordingly, the following audit procedures are suggested to be performed at the planning and execution stage of the audit:

1. Obtain the sale agreement of Koroit facility to obtain an understanding of the terms and conditions of the purchase. Determine whether any additions to consider are necessary such as deferred or contingent consideration which may reduce the value of goodwill acquired;
2. Verify the amount of consideration paid with the banking records of BCL;

3. Recompute the goodwill base don the fair value of net assets acquired and consideration paid to seller;
4. Obtain a schedule of an intercompany transaction within the Group and reconcile;
5. Reperform the procedures required by AASB 3 Business Combinations in removing the effect of intra-group transactions and compare with the amount computed by the management.
6. The assets are normally acquired at their fair values, hence consider the adequacy of the fair valuations of property, plant and equipment acquired by the Group in the acquisition and decide whether to seek services of an expert valuer.

7. Conclusion

In view of the above, the three areas that are most susceptible to the material misstatement in financial statements are intangible assets, inventories and the adjustments relating to acquisition of Koroit facility and consolidation procedures required by AASB 3 and AASB 10. Planning and performing the audit with a view to minimize the audit risk in these three areas is essential as these are most prone to misstatement. This is important as devoting most efforts of the audit team in these areas would ensure that audit is performed in the timely and effective manner realizing that circumstances exist that may cause the amounts recognized in financial statements pertaining to these line items to be intentionally or unintentionally misstated. The procedures entailed in the foregoing paragraphs would help reduce the audit risk to an acceptably low level in accordance with ASA 210 and consequently result in a quality audit of BCL.

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