AUDIT QUESTION - ONE

A. BACKGROUND

Choprite Stores Zambia Limited (CSZ) operates a chain of supermarkets in the major towns and provincial centres of Zambia.

B. STRATEGIC DEVELOPMENT AND MANAGEMENT

CSZ treats each province as a separate business segment, all operating as supermarket chains under the internally generated brand "chop-rite". However, CSZ has extended its business to include a distribution and warehousing division in each of its provincial centres. The first two divisions were expected to start operations on 1 January 2015.

CSZ aims to maximise its shareholder value based on three strategic objectives:

- Increase in market share of at least 4% each year
- Sustain return on capital employed at 25%
- Consistent improvement in the quality of products and related services

The opening of the two divisions was a huge drain on cash resources, as it involved significant capital expenditure, as well as an expensive promotional campaign to introduce the new products and services. This placed CSZ in a cash deficit position. The capital expenditure related to the construction of new sites and purchase of new distribution trucks. Some of the capital expenditure was raised by the issuance of a five year convertible bond. Bwacha Partners the current auditors of CSZ, played a key advisory role in designing this financial instrument. Bwacha Partners have several clients in the distribution and warehousing market and have extensive knowledge and experience in this business

Other funds were expected to be raised from the sale of non-performing distribution trucks, that were still being re-valued for this purpose.

The supermarkets constitute more than 80% of the revenue and are basically large stores located on the edge of towns and cities. The supermarkets sell a variety of items, including food and drink, clothing, household goods, and electrical appliances

C. BUSINESS ENVIRONMENT

Competition

Apart from existing competition, a number of foreign brand supermarkets continue to enter the Zambian market, taking advantage of the attractive investment conditions offered by the country. As a result of the increasing competition, CSZ has seen a 10% reduction in its sales, forcing it to operate at only 65% of its expected capacity.

Suppliers

CSZ buys 60% of its products locally and 40% of the products are imported, mainly from South Africa and Dubai. Although the exchange rate between the Kwacha and other convertible currencies has been depreciation over the recent past, CSZ does not find it necessary to enter into any hedging arrangements.

As most of the products sold by CZS need to stay fresh, all suppliers are required to provide assurance that their products meet the quality expected. CSZ is allowed to return all goods that fail the "24 hour fresh" test.

Customers

Following the continued depreciation of the kwacha, the purchasing power for many Zambians has further eroded. This has changed the demand patterns in a significant way, with many of the higher priced items staying on the shelves longer than before. It appears that CSZ is now holding these items longer by 15 days before they are sold. This is evident from the recent inventory count undertaken at the year-end. The profit margin on higher priced items is 20% higher than on those lower priced items.

Employees

As a response to increased competition and reduction in sales, it was rumoured that CSZ was planning to lay off some employees before the end of **the current financial year.** This rumour sparked off an expected strike towards the end of the year with some employees volunteering to be paid the redundancy package on offer. Many employees consider that the redundancy package is a much more attractive alternative. One of the employees is a good friend of Mwansa Mwansa, an auditor in Bwacha Partners and was hoping she would get more details from him about this package.

In attempt to retain key employees, CSZ decided to modify its employee benefit scheme in January 2015, resulting in enhanced benefits for both past and existing employees. This followed the departure of four key employees who secured alternative employment with competitor supermarkets. The CSZ employee benefit scheme is managed by Magson Insurance Co, on recommendation by Bwacha Partners.

In the same month of January 2015 CSZ also introduced a share appreciation scheme awarding eligible employees 500 shares if they remained with CSZ for the three years starting 1st February 2015. This scheme was only made available to senior employees occupying managerial positions

D. FINANCIAL STATEMENTS EXTRACTS

Year ended	31st March 2015 Draft (K'million)	31st March 2014 Audited (K'million)
Revenue	235,000	254,000
Profit before tax	43,500	39,800
Total Assets	568,900	487,000

E. RETENTION OF BWACHA PARTNERS AS AUDITORS

Bwacha Partners have been retained as auditors for the sixth year, to audit the financial statements of CSZ for the year ended 31st March 2015. Your name is Benson Shota and you are the partner responsible for the overall direction and reporting on this audit. You have been associated with the audit of CSZ as a junior audit, manager and now partner. Other members of the team, including their roles are as follows:

NAME	RESPONSBILITY
Christopher Bwembya	Audit Manager – Planning and overall review
Mary Mulilo	Audit Supervisor – Supervisor in charge of field work and also responsible to audit key risk areas of the audit
Mwansa Mwansa	Auditor responsible for the audit of non-current assets and other selected areas
Carlos Chintu, Catherine Zimba	Audit trainees responsible for other areas

F. MATERIALITY

Bwacha Partners have adopted a policy of determining planning materiality based on the financial statements as a whole, taking into account:

- The understanding of the entity and its business environment
- The understanding of accounting and internal control systems and procedures
- The assessment of risks

Performance materiality is set at around 75% of the planning materiality. Planning materiality depends on the results of the risk assessment:

- If the risk assessment is high, planning materiality is the average of the lower limits of the three indicative parameters based on revenue, profit before tax and total assets.
- If the risk assessment is low, planning materiality is the average of the upper limits of the three indicative parameters based on revenue, profit before tax and total assets
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REQUIREMENTS

1) In relation to the continued audit of CSZ financial statements for the year ended 31st March 2015
   a) Identify and explain the SIX ethical issues arising from the audit of CSZ **(15 marks)**
   b) For each issue in (a) above, recommend the action that CSZ should have taken **(9 marks)**

2) In relation to the planning of the audit of Choprite Stores Zambia Ltd for the year ended 31st March 2015, prepare a planning memorandum for CSZ Ltd in which you should:
   a) Identify and evaluate the business risks affecting CSZ **(15 marks)**
   b) State risks of potential material misstatement arising from business risks identified in (a), above and other information. You should support your answer with reference to relevant International Financial Reporting Standards. **(25 marks)**

c) Determine an appropriate level of planning and performance materiality using the firm policy of determining materiality **(6 marks)**

d) Recommend an overall audit approach that should be adopted in the audit of CSZ **(5 marks)**

Format, content and presentation **(4 marks)**

3) In relation to the construction of the new sites during the year, prepare a suitable audit program that describes the audit procedures to confirm the following assertions:

a) Valuation (**8 marks**)

b) Rights and obligations (**4marks**)

c) Completeness (**6 marks**)

d) Occurrence (**3 marks)**

Total marks for question one **(100 marks)**

AUDIT QUESTION TWO

MATA SHOE COMPANY LIMITED (MSCL)

1) GENERAL INFORMATION

Mata Shoe Company Limited (MSCL) is incorporated in Zambia under the Companies Act as a private limited company and is domiciled in Zambia. MSCL is a long-established supplier of safety footwear for mining and heavy industries. With a focus on using premium materials and components, MSCL develops footwear that not only complies with Zambian safety regulations, but which also provides comfort and support for the wearer.

MSCL's lead product line for the mining industry is the Champions collection. These boots are made with D30®, an impact-absorbing material designed to protect the metatarsal bones. Other safety-led features include:

- Penetration-resistant midsole made of composite material
- Sole with multi-directional slip-resistance
- Reinforced eyelets
- Full-grain leather uppers
- High-visibility reflective inserts
- Caustic-resistant stitching

Until recently, MSCL has been one of the largest manufacturers and vendor of industrial footwear, commanding more than 55% of this market segment. However the increase in the cost of production associated with increased electricity tariffs and a poorly performing kwacha against other convertible currencies has dealt a severe blow to this remarkable achievement. 40% of the input materials are imported.

Management is under extreme pressure to maintain the sales figures at previous levels.

2) SALES AND RECEIVABLES SYSTEM

a) 85% of the sales are made to credit customers. The credit period extended to customers is between 15 and 45 days depending on the perceived credit worthiness and reliability of the customer.

b) The sales system is computerised with application control procedures to meet the objectives of completeness, accuracy and validity. The extent of computerisation is such that much of the audit trail is lost. The control procedures include evaluating the credit worthiness of a customer by reference to credit reference information stored and updated on the master-file, automatic generation of goods delivered notes and invoices, including monthly statements.

c) Every month, the system automatically compares information on the receivables control account and the sales ledger and produces an exceptional report for any discrepancies. All discrepancies are fully investigated

d) Access to the master-file is restricted to designated personnel and amendments should be authorised by the sales director. This is achieved through passwords that are changed every quarter

e) The system also generates an age analysis of receivables between 15days, 25 days, 35 days 45 days and more than 45 days and generates automatic reminder letters for overdue amounts.

f) The system also generates an estimated bad debts provision based on the policy determined by management for each financial year. The policy involves setting a percentage to be applied to the total of receivables outstanding, depending on the number of days. For example a 10% provision has been made on all receivables outstanding for more than 45 days

3) FINANCIAL STATEMENTS – EXTRACTS

PROFIT AND LOSS – extracts – Year ended 31st March				
			2015 (K'000)	**2014 (K'000)**
Sales			224,389	311,470
Gross profit			55,117	85,135
Operating loss			(37,090)	(28,815)
STATEMENT OF FINANCIAL POSISITON – extracts – As at 31st March				
			2015 (K'000)	**2014 (K'000)**
Total non-current assets			32,444	40,788
Total current assets			49,614	35,531
			----------	----------
Total assets			**82,058**	**76,219**
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Total Equity			(122,073)	(97,843)
Total current liabilities			204,131	174,062

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			82,058	**76,219**
			----------	----------
There are no non-current liabilities				

4) GOING CONCERN

The directors maintain that MSCL is a going concern because they believe:

- The company will be able to meet its working capital requirements
- Negotiations to attract an equity partner have advanced with an injection of at least K150 million expected in the next twelve months
- The recent trading forecast for the next one year suggests significant operational improvements and further cost reductions

Accordingly, the directors have disclosed the uncertainty relating to the going concern in note 14 on page 17 of the financial statements

5) AUDITORS

MSCL is presently audited by NEXTUS & Associates. NEXTUS & Associates is a small firm comprising three partners with one office in Lusaka and another in Kitwe. Being a small firm, it has been difficult to achieve adequate policies and procedures relating to:

- Maintaining the objectivity of the reviewer – engagement partners are often involved in the selection of the engagement quality control reviewer, and often there is no quality control review
- Consultation – The expertise within the three partners is often limited to facilitate a wider scope of consultation
- Monitoring – Monitoring is performed by partners involved on the planning, performance and reporting of the engagement

Recently, the business environment has become very competitive forcing the partners to review their strategies. At the last strategic meeting of the partners (Which you did not attend), the partners invited a financial and management consultant to make recommendations on how the firm can sustain the profitability operations of the firm. At this meeting, the following proposals were made relating to:

- More focus on profitability
- Attitude towards clients
- Engagement performance
- Human Resources

a) More focus on profitability

This will require the firm to revisit its strategic, tactical as well as operational activities to make them refocused on maximising profitability. The firm's leadership and the examples it will now set will be the promotion of a profit oriented culture with clear, consistent and frequent actions and messages from all levels of the firm's management that emphasize this change in strategy. Particular emphasis will be placed on performing audit and other assignments in the most profitable manner. Accordingly, all promotions and rewards will now be based on this important profitability criterion.

In the meantime, all training and development will be suspended and the quality assurance manager will now be expected to evaluate audits based on profitability, as a priority.

b) Attitude towards clients

The firm will now evaluate the acceptability of assignments with preference given to the most profitable clients, with less emphasis placed on integrity and reputation of those clients. This implies that the allocation of staff and other resources to each client should be based on performing the assignment at the lowest cost possible. There should be no reason why any client should not be accepted and no consideration should be given to withdrawing from a client

c) Engagement performance

The firm will promote consistency in the profitability of engagements through the new policies and procedures. At the beginning of each engagement, teams will be briefed to obtain an understanding of the profitability objective of the assignment and the processes to follow to achieve this. Work will be reviewed with particular emphasis on the significant judgements made to achieve the profitability objective. Appropriate teamwork and supervision should be put in place to assist less experienced members of the engagement to clearly understand the profitability objective of the assignment.

d) Human Resources

Effective recruitment process and procedures will be put in place to help the firm select individuals who have the capacity to perform the firm's work and possess the drive and willingness to produce the most profitable results. The firm will endeavour to recruit already competent individuals as the training and development is now being suspended. The most important aspect of human resources management and development will be to help personnel to understand that advancement to position of greater responsibility will primarily depend upon profitability and adherence to the firm's strict control regime, and that failure to comply with these guidelines may result in disciplinary action.

6) AUDIT OF RECEIVABLES

Following the risk assessment process, NEXTUS determined that although the application controls in the sales and receivables system appeared adequate, there was a higher risk of material misstatement in receivables and sales, arising from the perceived pressure on management to maintain sales to previous levels.

The only information relating to the audit work and results on receivables done by the audit senior is as follows:

a) Obtained listing of receivables from management
b) Selected balances for confirmation at random. The sample of 40 customers represented 15% of the total population
c) Although all the responses were received, only 32 representing 80% of confirmations agreed with the balances.
d) No further procedures were considered necessary as the total balance of receivables not agreed was not material and a 100% response rate should be considered satisfactory

e) For the audit of bad debts provision:
- Enquired and obtained current policy on bad debt provision
- Performed the procedure in total by applying the policy on the age analysis
- As results agreed with the computer generated amount, no further work was considered necessary

Overall conclusion:
The receivable balance for the year ended 31st March 2015 is not materially misstated

REQUIREMENTS

4) In relation to the quality control policies and procedures at NEXTUS:

a) Evaluate the proposals made by the consultant under the following headings

i)	Leadership	**(4 marks)**
ii)	Client relations	**(6 marks)**
iii)	Engagement performance	**(4 marks)**
iv)	Human Resources	**(5 marks)**

(You should support your answer with reference to the requirements of the International Standard on Quality Control (ISQC) 1)

b) Recommend steps that NEXTUS, being a relatively small firm, could take to meet the requirements of the ISQC 1 in relation to:

i)	Maintaining the objectivity of the engagement quality control reviewer	**(4 marks)**
ii)	Consultation	**(4 marks)**
iii)	Monitoring	**(4 marks)**

5) In relation to the sales system:

a) Evaluate the impact of the computerised system on the planning and performance of the audit **(5 marks)**

b) For the control procedures in the sales and receivables system:

i) Explain the purpose of each control procedure included in the system **(5 marks)**

ii) For each procedure, describe an appropriate test of control **(5 marks)**

6) In relation to the audit of receivables

a) State other matters and information should have been considered in the sampling and evaluation of results obtain from the confirmation process:

i)	Determining the completeness and accuracy of the list of receivables	**(3 marks)**
ii)	Determining the sample size	**(3 marks)**
iii)	Selection of the sample	**(3 marks)**
iv)	Evaluation of the sample results	**(3 marks)**

b) Evaluate whether sufficient appropriate evidence was obtained in relation to the audit of the bad debt provision **(7 marks)**

c) Describe possible analytical procedures that could have been used in auditing the sales and receivable cycle. **(10 marks)**

7) In relation to the going concern doubt of MSCL:

a) Identify and describe the factors that suggest that MSCL may not be a going concern **(10 marks)**

b) Describe the additional audit procedures that should be carried out to assess and report whether MSCL is a going concern **(10 marks)**

c) Assuming that you are satisfied that the MSCL is a going concern and appropriate disclosure has been made by the directors in the financial statements, draft the opinion and other paragraph that should be included in the audit report for the year ended 31st March 2015. **(5 marks)**

Total marks **(100 marks)**