AUDIT QUESTION ONE – SUGGESTED SOLUTIONS

QUESTION 1

	(b) ETHICAL ISSUE	(c) RECOMMENDED ACTION
1	**Investment advice- conflict of interest** Offering of capital raising advice to CSZ is tantamount to underwriting the issue of the bond. This gives rise to a significant level of conflict in interest.	• Unless the implications of this advice is not considered material, otherwise the conflict of interest arising is too significant that it is unlikely that the risk involved can be reduced to an acceptable level. • Bwacha Partners should not have been involved in the issue of the bond whilst remaining as auditors of CSZ
2	**Auditing competitor companies – conflict of interest** Significant conflicts(objectivity and confidentiality) arise from the fact that Bwacha Partners audit two of the competitors of CSZ. It is not clear whether other clients have become aware that CSZ has now entered the distribution and warehousing market.	• Bwacha Partners (BP) should advise CSZ of the fact that the audit CSZ's competitors and also consult the other competing companies in the same way. • Assuming there is no objection to BP should consider : o Using separate teams with separate communication channels o Put in place procedures to prevent access to information – confidentiality between teams o Formally communicate instructions to prevent leakage of confidential information • BP should also institute independent reviews of the audit of CSZ and other competing companies, including the reporting
3	**Provision of other services- self interest- undue fees** The provision of other services will result in increased fees being received from CSZ. This may lead to a self interest of undue dependence on one client. ZICA guides that 15% or more fees receivable from one client constitutes a threat	• Bwacha Partners would be advised to keep this under review and take the necessary steps to reduce the perceived self interest threat once the fees from CSZ exceed 15%.
4	**Long association – familiarity threat** It appears that Benson Shota has been associated with CSZ for the last years. This potentially gives rise to significant familiarity threat	• Bwacha Partners should review the current and future involvement of Benson Shota on this client. ZICA guidelines provide that firms should consider rotating engagement partners and senior personnel on audits after seven years (five years for listed companies) • In addition, Benson Shota's work should be subjected to an independent partner/quality control reviews.
5	**Cross selling – self interest and**	• There is no threat that arises from cross

	management threat Bwacha Partners has recommended to CSZ to use the services of Magson Insurance Co. This gives rise to a possible management threat and self interest threat	selling provided BP has not received any remuneration from the "deal" • BP should ensure that it is not involved in the actual decision making process to avoid being considered as part of management
6	**Confidentiality** An employee of CSZ is expecting to receive payroll related information from one of the auditors of BP. This raises a threat relating to confidentiality.	Mwansa Mwansa of BP should be reminded that the ZICA ethical principle of confidentiality prohibits him from divulging any information obtained in relation to the audit of CSZ to a third party, without the explicit permission of CSZ.

QUESTION TWO

(a) PLANNING MEMORANDUM: Choprite Stores Zambia Ltd (CSZ) – Audit of financial statements for the year ended 31 March 2015

Introduction

Choprite Stores Zambia Limited (CSZ) operates a chain of supermarkets in the major towns and provincial centres of Zambia, with each province being treated as a separate business segment. CSZ has recently entered the warehousing and distribution market, which investment has resulted in a deficit cash position. Increase in competition has resulted in reduction in sales and has forced CSZ to consider cutting down on its workforce.

This planning memorandum is for the audit of CSZ's financial statements for the year ended 31st March 2015. The memorandum:

- Identifies and evaluates the business risks affecting CSZ
- Evaluates the risks of potential material misstatement arising from business risks
- Determines an appropriate level of planning and performance materiality
- Recommends an appropriate audit approach

a) Business Risks

✓ **Significant capital expenditure and marketing**

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. There is no guarantee that such expenditure will be recovered.

✓ **Cash burden and borrowing – going concern**

The requirement to fund the additional capital expenditure placed the financial position of CSZ in cash deficit position. The issuance of the bond on which further interest and principal payments will be required may begin to raise doubts on the ability of CSZ to continue as a going concern.

✓ **Competition – loss of market share**

The increase in competition has resulted in CSZ suffering a 10% reduction in revenue, making it difficult to meet the objective of meeting the increase in market share of at least 4% each year

- ✓ **Suppliers – Foreign Exchange risk**

CSZ has not initiated any strategy to protect itself against the continued depreciation of the kwacha against other convertible currencies. Expected exchange loss will impact negatively on its profitability and return on capital employed

- ✓ **Foreign Suppliers – possible delays**

CSZ gets 40% of its products from overseas, mainly from South Africa and Dubai. There is a bigger chance of delays resulting from unforeseen disruptions. This will increase the cost of these imports and possible stock-out. Increased costs will reduce profitability and return on capital employed.

- ✓ **Fresh products**

It is difficult to maintain fresh foods for a long time and given the change in the demand pattern, it is more likely that more and more products will stay on the shelves longer than is required. These goods may have to be thrown away for health reasons. Apart from ensuing losses expected to be incurred, this will negate the objective to consistently improve the quality of products.

- ✓ **Change in demand pattern**

The change in the demand pattern means that CSZ will now be posting lesser margins on the lower priced items. This will further negatively affect profitability and the objective to sustain the return on capital employed at 25%

- ✓ **Loss of key employees**

Loss of key personnel is likely to affect the operations of CSZ and replacing them will take time and at an extra cost, especially with the threat of completion. This will further impact on cost and profitability

- ✓ **Strike action**

Strike action will disrupt the operations and lead to loss of sales. This is likely to affect the customer's perceptions and will have an adverse impact on the objective relating to customer service

Conclusion

CSZ appear to be going through a difficult period with the expectation that results are going to get worse before they can get any better. The above risks would profile CSZ as a relative higher risk client.

b) Risk of material misstatement

- ✓ **Segment reporting – IFRS 8**

  CSZ operates each provincial centre as a segment. It is possible that the requirements of IFRS 8, *Segments* may not be fully complied with, especially with the opening of the new divisions.

- ✓ **Possible capitalisation of promotional expenditure**

  As marketing and promotional expenditure was incurred at the same time as other capital expenditure, there is a possibility that this expenditure may also be capitalised. According to IAS 38, *Intangible Assets*, promotional expenditure does not give rise to expected, controllable and measurable benefits flowing to CSZ and capitalising such expenditure would lead to potential material misstatement

- ✓ **Capitalisation of borrowing costs for the purchase of new trucks– IAS 23**
  The conditions of IAS 23, *Borrowing Costs* require that borrowing costs should be capitalised and included as part of the cost of qualifying assets. The standard prescribes strict requirements relating to the period and manner of capitalisation. The cost of issuing the bond may not be properly accounted in accordance with IAS 23. For example only the construction of sites would qualify under the standard.

- ✓ **Financial Instruments – IAS 32, *Financial Instruments* – five year bond**
  It is not clear the type of financial instrument this bond takes. It appears to be a business model where CSZ expects to receive interest and principal only with no expectation that the fair value option would be invoked. In the absence of clearer details about the financial instrument, it is possible that it may not be properly accounted for and full disclosures may not be provided, leading to potential material misstatement

- ✓ **Deferred tax – IAS 12- revaluation of trucks**
  According to IAS 12, *Income Tax,* the revaluation of trucks may result in a deferred tax liability or asset. In addition, the revised IAS 1 now requires results of such a revaluation to be presented in the "Other Comprehensive Income" component of the profit and loss. This may not be done properly, resulting in potential material misstatement

- ✓ **IFRS 5 – non-performing trucks held for sale**
  Some non-performing trucks have been set aside to be sold. IFRS 5, *Held For Sale and discontinued operations,* requires that certain conditions should be met before such assets can be accounted for under IFRS 5. These conditions include that the asset should be sold within one year and should be available for sale immediately. Since CSZ needs to revalue these assets before being sold, they are not available for sale immediately. It is possible that CSZ may have erroneously applied the accounting treatment under IFRS 5, leading to potential material misstatement.

- ✓ **IAS 36 – impairment of assets operating at 60% capacity**
  CSZ is now operating only at 60% capacity. Reduction in capacity and productivity is one of the indicators that the non-current assets may have suffered impairment. If impairment is not properly assessed and accounted for, this will to potential material misstatements.

- ✓ **IAS 37 - Contingent asset – the "24 hour fresh test"**
  CSZ is allowed to return fresh products that do not pass the "24 hour fresh test". This implies that CSZ has not taken over the risks and rewards until the test is passed. Accordingly, the returnable products should either be accounted for as assets if this can be determined with reasonable certainty or should be disclosed as contingent assets. Potential material misstatement is possible if this is not assessed properly.

- ✓ **Provision for redundancy payments – IAS 37**
  There is an expectation by employees that redundancy payments would be paid by the year end. It is not clear whether an obligating event has been created either contractually or as a constructive obligation as required by IAS 37, *Provisions, contingent liabilities and contingent assets.* This may lead to potential material misstatement

- ✓ **Fresh products and change in demand pattern– IAS 2, *Inventories***
  Fresh products beyond the expiry date would need to be re-priced or thrown away. In addition, the selling price of the higher value items may need to be reduced if they are to be sold. This implies that the net realisable of these inventory items is likely to be lower than cost. There is a greater chance that inventories may be materially overstated if this is not properly assessed and accounted for.

- ✓ **Employee benefits – IAS 19 – modification of benefits**
  CSZ has modified the benefits under its employee benefits resulting in enhanced benefits to be applied retrospectively. There is a possibility that this modification may not be properly accounted for as the revised IAS 19, *Employee Benefits* now requires that both past and present additional cost arising should be written off immediately.

- ✓ **Share based payments – IFRS 2 – introduction of share option scheme**
  CSZ has extended share appreciation rights to its employees on condition that they are still in employment for the next three years starting from 1 October 2014. This involves estimating the numbers of qualifying employees and may lead to potential material misstatement

Conclusion
There are too many cases of potential material misstatements affecting the financial statements of CSZ for the year ended 31s March 2015. This combined with higher degree of business risk places CSZ into a high risk category

c) Materiality

- ✓ **Indicative parameters**
  International guidelines provide the following indicative parameters for materiality

Revenue	0.5% - 1 %
Profit before tax	5% - 10%
Total assets	1% - 2%

- ✓ **Risk Assessment**
  Both the business risk and the risk of material misstatement profile the audit of CSZ for the year ended 31st March 2015 as high risk**, therefore the lower indicative parameters will be used**

- ✓ **Planning and performance material – indicators**

	K'million		
Revenue	235,000	@0.5%	1,175
Profit before tax	43,500	@5%	2,175
Total Assets	568,900	@1%	5,689

			9,039

	Planning materiality	Average /3	3,013
Therefore performance materiality is K2.260 million being 75% of K3.013 million.			

d) Audit approach

The overall audit approach is dependent on the risk profile of the client and the materiality parameters determined. If the inherent and control risks are assessed to be low, the auditor may consider using a systems-based approach where part of the reliance is to be derived from the effective operation of internal controls. This would imply a limited set of substantive procedures to be performed.

Where the risk assessment is considered high, a risk based appropriate is considered appropriate where audit procedures are targeted at the more risky areas of the audit, with increased use of analytical procedures

For CSZ, the assessment of both business risk and risk of material misstatement is concluded to be high. Accordingly a business risk approach is more appropriate with more attention paid to the audit of those transactions and balances with a higher risk of being materially misstated.

QUESTION THREE

AUDIT PROGRAMM – CONSTRUCTION OF NEW SITES

a) Valuation

- Inspect and verify material and labour costs and overheads to invoices, wage records etc
- Review and ensure expenditure has been analysed correctly and properly charged to construction sites
- Review capitalization of borrowing cost conditions have been satisfied
- Review to confirm that only directly attributable construction overheads have been included in the cost of the construction sites
- Re-compute borrowing costs and proper inclusion in the total cost only up to the time the sites were brought into use.
- Re-compute depreciation in accordance with depreciation policy of CSZ
- Review and discuss with management possible impairment, given difficulties in trading conditions

b) Rights and obligations

- Confirm construction sites being used for client's business
- Examine documents of title
- May need to obtain certificate from solicitors/bankers

c) **Completeness**

- Obtain or prepare summary of all new constructed sites showing gross, accumulated and net book values and reconcile to the starting position
- Reconcile schedule of new sites with general ledger and non-current asset register
- Check whether all the new constructed sites which physically exist are recorded in the non-current assets register

d) Occurrence

- Review general authorisation of capital expenditure to budget, board minutes as appropriate
- Verify cost to suppliers invoices, architect's certificates
- Check to confirm capitalisation is accordance with capitalisation policy
- Inspect and review to confirm that acquisition procedures in accordance with CSZ's policies
- Confirm recording of additions in the non-current assets register

AUDIT QUESTION TWO –SUGGESTED SOLUTIONS

1) Quality policies at NEXTUS:

a) Adequacy of policies and procedures

i) Leadership

ISQC 1 requires that the firm's leadership and the examples it sets should be aimed at significantly influencing the internal culture of the firm. This should be based on the promotion of a quality-oriented internal culture that depends on clear, consistent and frequent actions and messages from all levels of the firm's management that emphasize the firm's quality control policies and procedures.

In addition, incentive and promotional prospects should demonstrate the firm's overriding commitment to quality rather than commercial considerations

At NEXTUS,

- ***There is now more strategic focus on profitability***
- ***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 commercial/profitability criterion.***

ii) Client relations

With regard to acceptance and continuance of client relationships, ISQC 1requires that

a. Competence, capabilities, and resources

Consideration of whether the firm has the competence, capabilities, and resources to undertake and engagement should include whether:

- The firm personnel have adequate knowledge of the business and industry,
- The firm personnel have experience with the relevant or reporting requirements
- The firm has adequate resource, including adequate personnel

For NEXTUS, more consideration the ability of personnel to provide the service at the lowest cost rather based on knowledge and experience.

b. Integrity of client

The firm should consider the identify and business reputation of the client's principal owners, key management, and those charged with governance

For NEXTUS more emphasis is placed on acceptance of profitable clients with less emphasis placed on integrity and reputation issues

c. Continuance of client relationship and withdrawal

The firm should reassess its ability to continue a client relationship and should consider whether it is appropriate to discontinue a relationship with client.

For NEXTUS, there should be no reason why any client should not be accepted and no consideration is given to withdrawing from a client

iii) Engagement performance

ISQC 1 requires that the firms promote consistency in the quality of engagement performance through their policies and procedure. This should involve procedures relating to:

- How engagement teams are briefed on the engagement to obtain an understanding of the objectives of their work
- Process for complying with applicable engagement standards
- Processes of engagement supervision, staff training and coaching aimed at fostering high quality performance

At NEXTUS,

- ***The firm will promote consistency in the profitability of engagements through the new policies and procedures.***
- ***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.***

iv) Human Resources

ISQC 1 requires that effective recruitment processes and procedures should be put in place to help the firm select individuals of integrity who have the capacity to develop the competence and capabilities necessary to perform the firm's work and posses the appropriate characteristics to enable them perform competently. It also emphasizes the need for continuous training and development. Additionally, advancement to positions of greater responsibility should be based more on quality performance and adherence to ethical principles.

At NEXTUS,

- ***The only competence emphasized is the capacity to perform the firm's work and possess the drive and willingness to produce the most profitable results.***
- ***The training and development program has since been suspended***
- ***Advancement is based on profitability and adherence to the strict cost control regime***

b) Steps to meet the requirements of ISQC 1

i) Maintaining the objectivity of the engagement quality control reviewer

The firm is required to establish policies and procedures designed to maintain objectivity of the engagement quality control reviewer. Accordingly, such policies and procedures provide that the engagement quality control reviewer:

- Where practicable, is not selected by the engagement partner;
- Does not otherwise participate in the engagement during the period of review;
- Does not make decisions for the engagement team; and
- Is not subject to other considerations that would threaten the reviewer's objectivity.

For smaller firms such as NEXTUS, possible actions would include:

a) NEXTUS should consider contracting other suitably qualified external persons to undertake such reviews where considered necessary
b) NEXTUS may wish to use other firms to facilitate such engagement quality control reviews

However, before contracting for such services, consideration of the competence and capabilities of the external provider helps the firm to determine whether the external provider is suitably qualified for that purpose.

ii) Consultation

Consultation includes discussion at the appropriate professional level, with individuals within or outside the firm who have specialized expertise. Consultation uses appropriate research resources as well as the collective experience and technical expertise of the firm. Consultation helps to promote quality and improves the application of professional judgment.

Where NEXTSU considers it needs additional consultation, it may take advantage of advisory services provided by

- Other firms;
- Professional and regulatory bodies; or
- Commercial organizations that provide relevant quality control services.

However, before contracting for such services, consideration of the competence and capabilities of the external provider helps the firm to determine whether the external provider is suitably qualified for that purpose.

iii) Monitoring

In the case of NEXTUS, monitoring procedures are performed by individuals who are responsible for design and implementation of the firm's quality control policies and procedures, or who may be involved in performing the engagement quality control review.

To resolve this NESTSUS

- May choose to use a suitably qualified external person or another firm to carry out engagement inspections and other monitoring procedures.
- Alternatively, NEXTUS may establish arrangements to share resources with other appropriate organizations to facilitate monitoring activities.

However, before contracting for such services, consideration of the competence and capabilities of the external provider helps the firm to determine whether the external provider is suitably qualified for that purpose.

2) Sales system

a) Impact on planning and performance of the audit

i) With the computerised sales and received system, this means that

- The accounting system and internal controls are partly computerised. The sales system performs a range of application controls
- There is loss of audit trail, implying higher detection risk
- There is also the increased risk of loss of information and corruption of information which may affect the business and reliability and accuracy of financial statements

ii) Accordingly the auditor would need to consider

- Modifying understanding of the entity and systems to include the aspect of computerisation. This will require a requisite level of knowledge and experience of this type of computerisation
- There may need to consider the use of experts
- Given that the audit trail is lost, the audit will need to rely on CAATs (Computer Assisted Audit Techniques).
- Test data can be used to test application controls whereas audit software may be used to extract samples and perform some re-computations
- It may be necessary to plan the timing of the audit to include interim work so as to minimise disruption resulting from need to access the system

b) Purpose of control procedure and test of control

	i) CONTROL PROCEDURE and PURPOSE	**(ii) TEST OF CONTROL**
1	**Reconciliation between receivables control and sales ledger** **The system automatically performs reconciliation between the receivables control and the sales ledger. The purpose of the procedure is to detect and prevent fraud and error as an discrepancy is investigated**	• **Obtain monthly reconciliation reports and exceptional reports.** • **Re-perform a sample of these reconciliations- audit software could be used for this purpose** • **For a sample of exception reports, inspect results of investigations carried out**
2	**Evaluation of creditworthiness** **Credit orders checked against credit reference information updated on the master-file. The purpose is to ensure that credit sales are not made to customers that may not pay and lead to increased losses through bad debts**	• **By use of test data (Computer Assisted Audit Technique), you can attempt to input a customer order not allowed credit to confirm whether the system would reject** • **Obtain a sample of credit sales during the year and confirm against credit reference information**
3	**Access to master-file** **Access is restricted to designated personnel through the use of passwords. The master file contains integrity information that should be preserved by restricting access.**	• **Attempt access to the master-file without the password. The system should reject the attempted access**
4	**Amendments to master-file** **Amendments should be authorised by the sales director through the use of passwords. This is to ensure that changes in credit profiles of customers and credit policies are authorised at the highest level.**	• **Attempt to change information on the master file. The system should reject without the pass word authorisation from the sales director**
5	**Automatic reminders** **The system automatically generates reminders to follow up on overdue receivables. This is to ensure that timely action is taken on possible delinquent receivables.**	• **Review age analysis and select a sample of outstanding receivables and confirm to automatic reminder sent**

3) In relation to the audit of receivables

a) Matters and other information

i) Determining the completeness and accuracy of the list of receivables

The audit senior just obtains list of receivables from management without checking the accuracy of the list against the reconciliation between the receivables control and the sales ledger. The list may not be complete and the information may not be accurate.

The reconciliation at the end of the year should also be re-computed for accuracy and to confirm that any discrepancy was properly investigated

ii) Sample size

ISA 530, *Sampling* provides guidance on sampling. There is no evidence that there was any sample design. It is not clear the audit sampling being applied, whether it is statistical or non-statistical sampling. No consideration appear to have been given to the nature of evidence being sought and possible deviation expected to allow for a meaningful conclusion to be drawn. There is risk of material misstatement and it should be expected that the sample size would relatively bigger.

It is no clear how the sample size of 40 was determined. According to ISA 530, this should be affected the level of sampling risk the audit is willing to accept. The sample size can also be determined by the application of a statistically-based formula or by judgement

iii) Selection of the sample

The 40 items were selected at random. ISA 530 allows the use of random selection, systematic selection and haphazard selection methods, but which method is selected should be justified on the basis of the sample design

The use of the random method is not justified. Given the risk profile of the receivables it should be expected that judgement sampling would be used to identify balances more susceptible to material misstatement

iv) Evaluation of the sample

The audit senior concluded that no further work should be done as 80% of confirmations were received and the combined total of non-replies was not considered material. The evaluation of the sample results is not based on pre-determined deviation and reflects a misleading understanding of the concept of materiality.

An investigation of the causes of the differences may require additional audit work to done, or may lead to a reassessment of the risks involved.

b) Bad debts provision - evaluation of evidence obtained

Enquired and obtained current policy on bad debt provision

- The policy should be assessed for reasonableness in relation to the level of sales, credit period and experience of bad debts. Also comparison with industry average experience.
- Since a policies are amended each period, the reasons for the change should be discussed with management to confirm that it is valid

Performed the procedure in total by applying the policy on the age analysis

- Consideration should have been given to using audit software to perform the procedure

As results agreed with the computer generated amount, no further work was considered necessary

- Just because the amount is agreed does not imply that all the possible assertions have been satisfied. This does not test the assertion of completeness
- The operation of the application control that may need to be tested using an appropriate CAAT such as test data
- The age analysis should also be tested using audit software
- There may other factors other the age of the receivable that may require a provision to be considered, such as reviewing correspondence for disputes and examining post year end receipts.

c) Possible analytical procedures

i) Receivable days

The computation of receivables day and comparison with plan or expectation may indicate possible areas misstatement

ii) Sales turnover

The comparison of the sales turnover over a period should indicate whether the sales volume and value is within the expectations of management

iii) Inventory days/inventory turnover

Movement in inventory days may be used to assess expected movement in sales. If the inventory days reduce, it should be expected that the sales would be higher

iv) Trends in sales

An analysis of the rate increase/decrease in sales over the years would provide some evidence of possible misstatement if this is not in accordance with expectations. Information suggests that the sales should be reducing.

v) Trends in receivables

The movement in receivables should be consistent with the credit period, the credit sales as well as the state of the general economy.

vi) Trends in bad debts provision

The bad debts should be related to the credit sales as well as the credit periods extended

4) Going concern:

a) **Factors indicating doubt on going concern**

i. Deteriorating operating results

During the year, the sales have decreased about 27%, the gross margin percentage reducing from 27% to about 24%. The operating losses have increase by about 29%. This state of affairs casts serious doubts on the ability of the company to continue as a going.

ii. Working capital deficit

The current ratios for both years indicate that the company is not able to meet its current liabilities as they fall due. The current assets only represent 20% of the current liabilities in 2013 and only 24% of the current liabilities in 2014. Suppliers and other creditors may force the company into liquidation.

iii. Negative equity

The negative equity suggests lack of capitalisation and injection of capital into the company. This negative picture would not be attractive to other external lenders. A lack of investment suggests lack of confidence in the company, a further sign that the company may not be a going concern.

iv. Increased cost of production

The cost of production associated with increased electricity tariffs will also worsen the loss making position.

v. Poorly performing kwacha

40% of the input materials are imported. With increased deterioration of the kwacha against other currencies, the cost of importing these inputs will continue to rise. Unless the company is able to recover this through increased prices, this will give rise to further operating losses.

b) **Additional procedures**

The auditor's responsibility in respect of going is provided by ISA 570, *Going concern.* The auditor is responsible for obtaining sufficient appropriate evidence about the appropriateness of management's use of the going concern assumption in the financial statements. For MSCL, the following additional procedures should be carried out:

1) **Working capital requirements**
   - Re-compute current ratios and quick ratios based on the projected forecasts and to confirm that they show expected improvements
   - Review the credit periods for customers and suppliers and assess for reasonableness

2) **Negotiations to attract an equity partner in the next twelve months**
   - Inspect correspondence with equity partner to determine how advanced the discussions are
   - Review the planned utilisation of the K150 million to confirm expected improved operational results
   - With client permission, consider confirming this with equity partner

3) **Recent trading forecast for the next one year suggests significant operational improvements and further cost reductions**
   - Reviewing and evaluating the reliability of the underlying data and assumptions. In particular, the basis for expecting increases in revenue and further actions to reduce costs. Further cost reductions should be evaluated against most recent trend.

4) Consider facts and other information which may have become available since management assessment

5) Request written representations from management regarding their plans for future action and the feasibility of these plans

c) **Opinion and emphasis of matter paragraph**

Opinion

In our opinion, the financial statements give a true and fair view of the financial position of Mata Shoe Company Limited as at 31st March 2015, and of its financial performance and its cash flows for the year then ended in accordance with International Financial Reporting Standards

Emphasis of matter

We draw your attention to note 14 to the financial statements which describes the uncertainty related to the increased operational losses, the apparent company's inability to pay debts and the negative equity deficit position. Our opinion is not qualified in respect of this matter.

AUDIT QUESTION TWO –SUGGESTED SOLUTIONS

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In addition, incentive and promotional prospects should demonstrate the firm's overriding commitment to quality rather than commercial considerations

At NEXTUS,

- ***There is now more strategic focus on profitability***
- ***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 commercial/profitability criterion.***

ii) Client relations

With regard to acceptance and continuance of client relationships, ISQC 1requires that

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Consideration of whether the firm has the competence, capabilities, and resources to undertake and engagement should include whether:

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- The firm personnel have experience with the relevant or reporting requirements
- The firm has adequate resource, including adequate personnel

For NEXTUS, more consideration the ability of personnel to provide the service at the lowest cost rather based on knowledge and experience.

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ISQC 1 requires that effective recruitment processes and procedures should be put in place to help the firm select individuals of integrity who have the capacity to develop the competence and capabilities necessary to perform the firm's work and posses the appropriate characteristics to enable them perform competently. It also emphasizes the

need for continuous training and development. Additionally, advancement to positions of greater responsibility should be based more on quality performance and adherence to ethical principles.

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- ***The training and development program has since been suspended***
- ***Advancement is based on profitability and adherence to the strict cost control regime***

b) Steps to meet the requirements of ISQC 1

i) Maintaining the objectivity of the engagement quality control reviewer

The firm is required to establish policies and procedures designed to maintain objectivity of the engagement quality control reviewer. Accordingly, such policies and procedures provide that the engagement quality control reviewer:

- Where practicable, is not selected by the engagement partner;
- Does not otherwise participate in the engagement during the period of review;
- Does not make decisions for the engagement team; and
- Is not subject to other considerations that would threaten the reviewer's objectivity.

For smaller firms such as NEXTUS, possible actions would include:

c) NEXTUS should consider contracting other suitably qualified external persons to undertake such reviews where considered necessary

d) NEXTUS may wish to use other firms to facilitate such engagement quality control reviews

However, before contracting for such services, consideration of the competence and capabilities of the external provider helps the firm to determine whether the external provider is suitably qualified for that purpose.

ii) Consultation

Consultation includes discussion at the appropriate professional level, with individuals within or outside the firm who have specialized expertise. Consultation uses appropriate research resources as well as the collective experience and technical expertise of the firm. Consultation helps to promote quality and improves the application of professional judgment.

Where NEXTSU considers it needs additional consultation, it may take advantage of advisory services provided by

- Other firms;
- Professional and regulatory bodies; or
- Commercial organizations that provide relevant quality control services.

However, before contracting for such services, consideration of the competence and capabilities of the external provider helps the firm to determine whether the external provider is suitably qualified for that purpose.

iii) Monitoring

In the case of NEXTUS, monitoring procedures are performed by individuals who are responsible for design and implementation of the firm's quality control policies and procedures, or who may be involved in performing the engagement quality control review.

To resolve this NESTSUS

- May choose to use a suitably qualified external person or another firm to carry out engagement inspections and other monitoring procedures.
- Alternatively, NEXTUS may establish arrangements to share resources with other appropriate organizations to facilitate monitoring activities.

However, before contracting for such services, consideration of the competence and capabilities of the external provider helps the firm to determine whether the external provider is suitably qualified for that purpose.

6) Sales system

a) Impact on planning and performance of the audit

i) With the computerised sales and received system, this means that

- The accounting system and internal controls are partly computerised. The sales system performs a range of application controls
- There is loss of audit trail, implying higher detection risk
- There is also the increased risk of loss of information and corruption of information which may affect the business and reliability and accuracy of financial statements

ii) Accordingly the auditor would need to consider

- Modifying understanding of the entity and systems to include the aspect of computerisation. This will require a requisite level of knowledge and experience of this type of computerisation
- There may need to consider the use of experts
- Given that the audit trail is lost, the audit will need to rely on CAATs (Computer Assisted Audit Techniques).
- Test data can be used to test application controls whereas audit software may be used to extract samples and perform some re-computations
- It may be necessary to plan the timing of the audit to include interim work so as to minimise disruption resulting from need to access the system

b) Purpose of control procedure and test of control

	i) CONTROL PROCEDURE and PURPOSE	**(iii) TEST OF CONTROL**
1	**Reconciliation between receivables control and sales ledger** **The system automatically performs reconciliation between the receivables control and the sales ledger. The purpose of the procedure is to detect and prevent fraud and error as an discrepancy is investigated**	• **Obtain monthly reconciliation reports and exceptional reports.** • **Re-perform a sample of these reconciliations- audit software could be used for this purpose** • **For a sample of exception reports, inspect results of investigations carried out**
2	**Evaluation of creditworthiness** **Credit orders checked against credit reference information updated on the master-file. The purpose is to ensure that**	• **By use of test data (Computer Assisted Audit Technique), you can attempt to input a customer order not allowed credit to confirm**

	credit sales are not made to customers that may not pay and lead to increased losses through bad debts	**whether the system would reject** • **Obtain a sample of credit sales during the year and confirm against credit reference information**
3	**Access to master-file** **Access is restricted to designated personnel through the use of passwords. The master file contains integrity information that should be preserved by restricting access.**	• **Attempt access to the master-file without the password. The system should reject the attempted access**
4	**Amendments to master-file** **Amendments should be authorised by the sales director through the use of passwords. This is to ensure that changes in credit profiles of customers and credit policies are authorised at the highest level.**	• **Attempt to change information on the master file. The system should reject without the pass word authorisation from the sales director**
5	**Automatic reminders** **The system automatically generates reminders to follow up on overdue receivables. This is to ensure that timely action is taken on possible delinquent receivables.**	• **Review age analysis and select a sample of outstanding receivables and confirm to automatic reminder sent**

7) In relation to the audit of receivables

a) Matters and other information

i) Determining the completeness and accuracy of the list of receivables

The audit senior just obtains list of receivables from management without checking the accuracy of the list against the reconciliation between the receivables control and the sales ledger. The list may not be complete and the information may not be accurate.

The reconciliation at the end of the year should also be re-computed for accuracy and to confirm that any discrepancy was properly investigated

ii) Sample size

ISA 530, *Sampling* provides guidance on sampling. There is no evidence that there was any sample design. It is not clear the audit sampling being applied, whether it is statistical or non-statistical sampling. No consideration appear to have been given to the nature of evidence being sought and possible deviation expected to allow for a meaningful conclusion to be drawn. There is risk of material misstatement and it should be expected that the sample size would relatively bigger.

It is no clear how the sample size of 40 was determined. According to ISA 530, this should be affected the level of sampling risk the audit is willing to accept. The sample size can also be determined by the application of a statistically-based formula or by judgement

iii) Selection of the sample

The 40 items were selected at random. ISA 530 allows the use of random selection, systematic selection and haphazard selection methods, but which method is selected should be justified on the basis of the sample design

The use of the random method is not justified. Given the risk profile of the receivables it should be expected that judgement sampling would be used to identify balances more susceptible to material misstatement

iv) Evaluation of the sample

The audit senior concluded that no further work should be done as 80% of confirmations were received and the combined total of non-replies was not considered material. The evaluation of the sample results is not based on pre-determined deviation and reflects a misleading understanding of the concept of materiality.

An investigation of the causes of the differences may require additional audit work to done, or may lead to a reassessment of the risks involved.

b) Bad debts provision - evaluation of evidence obtained

Enquired and obtained current policy on bad debt provision

- The policy should be assessed for reasonableness in relation to the level of sales, credit period and experience of bad debts. Also comparison with industry average experience.
- Since a policies are amended each period, the reasons for the change should be discussed with management to confirm that it is valid

Performed the procedure in total by applying the policy on the age analysis

- Consideration should have been given to using audit software to perform the procedure

As results agreed with the computer generated amount, no further work was considered necessary

- Just because the amount is agreed does not imply that all the possible assertions have been satisfied. This does not test the assertion of completeness
- The operation of the application control that may need to be tested using an appropriate CAAT such as test data
- The age analysis should also be tested using audit software
- There may other factors other the age of the receivable that may require a provision to be considered, such as reviewing correspondence for disputes and examining post year end receipts.

c) Possible analytical procedures

i) Receivable days

The computation of receivables day and comparison with plan or expectation may indicate possible areas misstatement

ii) Sales turnover

The comparison of the sales turnover over a period should indicate whether the sales volume and value is within the expectations of management

iii) Inventory days/inventory turnover

Movement in inventory days may be used to assess expected movement in sales. If the inventory days reduce, it should be expected that the sales would be higher

iv) Trends in sales

An analysis of the rate increase/decrease in sales over the years would provide some evidence of possible misstatement if this is not in accordance with expectations. Information suggests that the sales should be reducing.

v) Trends in receivables

The movement in receivables should be consistent with the credit period, the credit sales as well as the state of the general economy.

vi) Trends in bad debts provision

The bad debts should be related to the credit sales as well as the credit periods extended

8) Going concern:

a) **Factors indicating doubt on going concern**

vi. Deteriorating operating results

During the year, the sales have decreased about 27%, the gross margin percentage reducing from 27% to about 24%. The operating losses have increase by about 29%. This state of affairs casts serious doubts on the ability of the company to continue as a going.

vii. Working capital deficit

The current ratios for both years indicate that the company is not able to meet its current liabilities as they fall due. The current assets only represent 20% of the current liabilities in 2013 and only 24% of the current liabilities in 2014. Suppliers and other creditors may force the company into liquidation.

viii. Negative equity

The negative equity suggests lack of capitalisation and injection of capital into the company. This negative picture would not be attractive to other external lenders. A lack of investment suggests lack of confidence in the company, a further sign that the company may not be a going concern.

ix. Increased cost of production

The cost of production associated with increased electricity tariffs will also worsen the loss making position.

x. Poorly performing kwacha

40% of the input materials are imported. With increased deterioration of the kwacha against other currencies, the cost of importing these inputs will continue to rise. Unless the company is able to recover this through increased prices, this will give rise to further operating losses.

b) **Additional procedures**

The auditor's responsibility in respect of going is provided by ISA 570, *Going concern.* The auditor is responsible for obtaining sufficient appropriate evidence about the appropriateness

of management's use of the going concern assumption in the financial statements. For MSCL, the following additional procedures should be carried out:

6) **Working capital requirements**
   - Re-compute current ratios and quick ratios based on the projected forecasts and to confirm that they show expected improvements
   - Review the credit periods for customers and suppliers and assess for reasonableness

7) **Negotiations to attract an equity partner in the next twelve months**
   - Inspect correspondence with equity partner to determine how advanced the discussions are
   - Review the planned utilisation of the K150 million to confirm expected improved operational results
   - With client permission, consider confirming this with equity partner

8) **Recent trading forecast for the next one year suggests significant operational improvements and further cost reductions**
   - Reviewing and evaluating the reliability of the underlying data and assumptions. In particular, the basis for expecting increases in revenue and further actions to reduce costs. Further cost reductions should be evaluated against most recent trend.

9) Consider facts and other information which may have become available since management assessment

10) Request written representations from management regarding their plans for future action and the feasibility of these plans

c) **Opinion and emphasis of matter paragraph**

Opinion

In our opinion, the financial statements give a true and fair view of the financial position of Mata Shoe Company Limited as at 31st March 2015, and of its financial performance and its cash flows for the year then ended in accordance with International Financial Reporting Standards

Emphasis of matter

We draw your attention to note 14 to the financial statements which describes the uncertainty related to the increased operational losses, the apparent company's inability to pay debts and the negative equity deficit position. Our opinion is not qualified in respect of this matter.