The Institute of Chartered Accountants of Zimbabwe

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QUALIFYING EXAMINATION

Part II
Paper 2

NOVEMBER 2010

TOTAL MARKS – 100
READING TIME – 20 minutes
WRITING TIME – 150 minutes

INSTRUCTIONS TO CANDIDATES

1 Enter your examination number on the front of the answer book. Your name must not appear anywhere.
2 You are reminded that answers may **NOT** be written in pencil.
3 The marks shown against the requirement(s) for each question should be taken as an indication of the expected length and the required depth of the answer.
- **Even if it is not explicitly required, you should show workings and cross-reference them to your answer.**
- Marks are awarded for appropriate arrangement and layout, clarity of explanation, logical argument and clear and concise language.

4 Working papers must be handed in with scripts.

Disclaimer clause: All names of persons, places and business entities mentioned in this examination paper are fictitious and any resemblance to real persons, living or dead, places and business entities are purely coincidental.

NOTE: The questions in this paper reflect currencies and comparative and historical figures in US dollars to make a meaningful comparison of financial performance possible, with no account being taken of the anomalies of converting previous Zimbabwean dollars to US dollars.

QUESTION 2 **100 marks**

Sassi Stores (Pvt) Ltd ('Sassi Stores') was founded 20 years ago by the current chairperson, Ms Zeta Sassoni, and the incumbent chief executive officer, Mr Roland Oliveira. The company has over 50 retail stores throughout Zimbabwe, which all sell clothing and accessories. Sassi Stores has positioned itself to sell quality high fashion apparel at exceptional prices, which are aimed predominantly at 18–30-year-old customers. International fashion trends are closely monitored to ensure that Sassi Stores is abreast of the latest trends.

The company has grown from humble beginnings to being a leader in its retail niche in Zimbabwe. Stores are located in large shopping centres and value centres situated close to major shopping malls.

Generally, consumer spending in Zimbabwe has been depressed over the past two years as a result of the knock-on effect of the global financial crisis. However, Sassi Stores has managed to increase revenue despite the prevailing economic conditions. Mr Oliveira attributes this to Sassi Stores's retention of loyal customers and its ability to attract new customers who do not want to spend exorbitant amounts on quality clothing. Apparel is sourced both locally and internationally from suppliers who manufacture 'Sassi' branded apparel.

Financial performance

Financial highlights of the 2009 and 2010 financial years and extracts from the latest forecast for the year ending 31 December 2011 are set out below:

SASSI STORES
YEARS ENDED/ENDING 31 DECEMBER

	2008	2009	2010
	Audited	Audited	Forecast
	$ million	$ million	$ million
Revenue	1 704	1 908	2 194
Gross profit	674	736	867
Earnings before interest, tax, depreciation and amortisation (EBITDA)	166	181	179
Profit after tax	97	106	98
Shareholders' equity	266	312	410
Cash and cash equivalents	75	80	170

The board of directors of Sassi Stores has set the following targets for the company over the next five years:

- Annual revenue growth of at least 12% per annum; and
- EBITDA/revenue margin of at least 10%.

Shareholders and distributions

The shareholders of Sassi Stores are The Sassoni Family Trust (50%), Mr Roland Oliveira (25%), Ms Gabriella Madiba (10%) (the chief financial officer of Sassi Stores), and The Sassi Stores Employee Share Trust (15%). The company consistently pays dividends on an annual basis to its shareholders, the most recent being $60 million paid to shareholders in December 2009.

Rolling forecasts

Ms Madiba recently attended a full-day workshop on the use of rolling forecasts as a budgeting tool. She attended the workshop in order to acquire continuing professional development points, and was impressed by the high quality of the content and the relevance of the workshop. The workshop presenters emphasised that –

- rolling forecasts are a far more effective management tool than traditional annual budgeting processes;
- rolling forecasts generally involve the preparation of quarterly forecasts for the next 18 months which are updated as frequently as required by the company, depending on the nature of its business;
- rolling forecasts alleviate the need for companies to prepare annual budgets;
- rolling forecasts encourage companies to realistically estimate what they should achieve over the next 18 months as opposed to unrealistic financial targets being forced down by top management;
- the future is impossible to predict and therefore variance analysis between actual results and budgeted results is flawed. Organisations should rather focus on improving their forecasting accuracy than spend countless hours on comparing actual results to annual budgets; and
- rolling forecasts are less detail orientated than traditional annual budgets, encouraging management to focus on the key value drivers in their business. Traditional budgets require far too much time to prepare and contain too much detail.

Utilisation of cash resources

Sassi Stores generates positive cash flows annually. The board of directors of the company has been exploring various options over time to utilise cash resources more effectively. Current deposit rates are low and Ms Sassoni is of the firm opinion that retaining cash on Sassi Stores's balance sheet destroys shareholder value. She believes that surplus cash should be paid out to shareholders and Sassi Stores should furthermore gear its balance sheet towards the enhancement of shareholder value.

Ms Madiba believes that Sassi Stores should always have a reasonable level of cash on its balance sheet as a buffer. She believes that retailers should never be in a net gearing position (in which interest-bearing debt exceeds cash resources) as retail companies generally have extended trade terms from trade creditors.

Credit division

Sassi Stores has for a number of years considered providing credit to customers. During 2010 this opportunity was investigated further and a detailed business plan has been formulated for consideration by the board of directors. It is proposed that a new division, a credit division, be established to take responsibility for the credit assessment of customers, advances, collections and monitoring of customer balances. The salient features of the business plan are as follows:

- Customers will have the opportunity of opening a Sassi Stores account from 1 January 2011. Potential account holders will be required to produce identity documentation as well as proof of permanent residency and monthly income. In addition, potential account holders will be required to submit a declaration of monthly income and expenditure, a personal statement of financial position and three credit references;
- The credit division will assess the credit-worthiness of each potential account holder based on a standardised credit scoring system. Credit limits per individual account holder will be set at 10% of their after-tax monthly income;
- Account holders will each be charged a monthly service fee and for the 2011 financial year this will amount to $10 per month. Account holders will each receive a Sassi Stores card

which will contain a five-digit pin code. They will be required to produce these cards and enter their pin code when making purchases on account at any Sassi Stores outlet;

- Account holders will be required to make minimum monthly payments of 15% of outstanding balances. Interest at 24% per annum, capitalised monthly, will be levied on customer balances; and
- Monthly statements will not be posted to customers. Instead, customers can elect to receive statements via e-mail or notification of account balances and minimum payments due by sms on their cellular phones. Account holders will also be able to request statement printouts at any Sassi Stores outlet.

The business plan includes detailed financial forecasts for the credit division and related assumptions which are summarised below:

SASSI STORES CREDIT DIVISION
FORECASTS AND ASSUMPTIONS FOR THE YEARS ENDING 31 DECEMBER

	Notes	2011	2012	2013	2014
Account holders					
New accounts opened	1	63 000	36 000	9 600	4 800
Total number of account holders at year end		63 000	99 000	108 600	113 400
Weighted average number of account holders during the financial year	2	41 500	82 500	103 800	111 000
Charges to account holders					
Finance charges (nominal annual, compounded monthly)		24%	24%	24%	24%
Monthly service fees		$10,00	$11,00	$11,50	$12,00
Pin card issue fee (once off)		$15,00	$15,75	$16,50	$17,50
		$'000	**$'000**	**$'000**	**$'000**
Forecast revenue and expenditure					
Finance charges earned		9 159	32 050	52 352	65 101
Monthly service fees		4 980	10 890	14 324	15 984
Pin card issue fees		945	567	158	84
Total revenue	3	15 084	43 507	66 834	81 169
Pin card expenses	4	(630)	(378)	(106)	(56)
Provision for bad debts	5	(6 986)	(8 926)	(5 825)	(3 992)
Depreciation	6	(8 000)	(8 000)	(8 000)	0
Other operating costs					
Variable operating costs	7	(5 188)	(10 808)	(14 324)	(16 095)
Fixed operating costs	8	(4 500)	(4 770)	(5 056)	(5 360)
Operating (loss)/profit		(10 220)	10 625	33 523	55 666
Taxation	9	–	(5 231)	(10 647)	(13 817)
(Loss)/profit after taxation		(10 220)	5 394	22 876	41 849
Gross trade receivables	10	69 863	159 125	217 372	257 294
Provision for bad debts	5	(6 986)	(15 912)	(21 737)	(25 729)
		62 877	143 213	195 635	231 565
Information technology (IT) equipment and system	6	16 000	8 000	–	–
Total assets		78 877	151 213	195 635	231 565

Notes

1 The projected number of account holders has been based on detailed industry research.

2 The weighted average number of account holders during the year is based on a forecast number of new accounts opened in each month.

3 The board of directors of Sassi Stores believes that the incremental gross profit arising from credit sales should not be taken into account in evaluating the feasibility of the credit division.

4 The estimated cost of each pin card in the 2011 financial year is $10, increasing to $11,60 in 2014.

5 The provision for bad debts throughout the planning period is estimated to be 10% of gross year-end trade receivables.

6 The initial investment required in the IT equipment and system is forecast to amount to $24 million and will be incurred and paid for at the end of December 2010. This expenditure will be amortised on a straight-line basis over three years. It has been assumed that Zimbabwe Revenue Authority (ZIMRA) will permit a special initial allowance (SIA) of 25% per annum.

7 Variable operating costs include amounts to be paid to an outsourced call centre. After investigating the cost of establishing and operating an internal call centre, it was decided that outsourcing this function would be far more cost effective. The selected external call centre operator will be responsible for following up on overdue amounts and contacting account holders when necessary.

8 Fixed operating costs comprise mainly employee costs.

9 Income tax has been provided for on the assumption that all income will be taxable on the same basis as recorded above and that all expenditure, apart from the provision for bad debts and depreciation, will be deductible for income tax purposes. It has been assumed that ZIMRA will not permit a deduction of the accounting provision for bad debts. A normal income tax rate of 25,75% (basic of 25% and 3% AIDS levy) has been assumed throughout the planning period. Taxable income has been estimated as follows:

Years ending 31 December	**2011**	**2012**	**2013**	**2014**
	$'000	**$'000**	**$'000**	**$'000**
(Loss)/profit before taxation	(10 220)	10 625	33 523	55 666
Add back: Net movement in provision for bad debts	6 986	8 926	5 825	3 992
Depreciation	8 000	8 000	8 000	–
Deduct: SIA on information technology systems	(6 000)	(6 000)	(6 000)	(6 000)
Tax loss brought forward	–	(1 234)	–	–
Taxable (loss)/income	(1 234)	20 317	41 348	53 658

10 The forecast annual movement in gross trade receivables is summarised below:

Years ending 31 December	**2011**	**2012**	**2013**	**2014**
	$'000	**$'000**	**$'000**	**$'000**
Opening balance	0	69 863	159 125	217 372
Credit sales to account holders	116 200	254 100	325 104	373 632
Monthly service fees	4 980	10 890	14 324	15 984
Pin card issue fees	945	567	158	84
	122 125	335 420	498 711	607 072
Finance charges	9 159	32 050	52 352	65 101
Repayments	(61 421)	(208 345)	(333 691)	(414 879)
Closing balance	69 863	159 125	217 372	257 294

11 You may assume that the mathematical calculations in the financial forecast and the assumptions included in the business plan are correct.

Evaluation of proposed credit division

The board of directors of Sassi Stores has stated that it will evaluate the feasibility of the proposed credit division using a capital budgeting approach, which is based on cash flow statements. The benchmark internal rate of return for the free cash flows of the credit division has been set at 20% and the division will need to exceed this return for the project to be approved. The board has requested that the capital budget cover the years ending December 2011 to December 2014 and that the terminal value at 31 December 2014 be based on the estimated net asset value of the division at that date.

The board of directors has agreed to extend an interest-free loan to fund the establishment of the credit division and its ongoing cash flow requirements. This loan can be repaid as and when the division generates surplus cash flow.

REQUIRED

		Marks
(a)	Indicate, with reasons, whether or not you agree with the workshop presenters' views on rolling forecasts.	10
(b)	Critically discuss Ms Sassoni's view that surplus cash should be paid out to shareholders and that Sassi Stores should introduce gearing onto its balance sheet.	8
(c)	Critically analyse and comment on the financial forecasts and related assumptions included in the business plan of the proposed credit division. Where appropriate, support your comments with relevant ratios and calculations.	27
(d)	Based on the assumptions set out in the business plan of the credit division, prepare the forecast cash flows for the period 2011 to 2014 and calculate the internal rate of return for the credit division.	12
(e)	Identify and describe – (i) the key business risks, including any key financial risks, to which the credit division will be exposed; and (ii) any other key issues the board of directors should consider in evaluating whether or not to approve the establishment and operation of the credit division.	 16 12
(f)	Identify and list the key internal controls that would be required in the credit division.	10
Presentation marks: Arrangement and layout, clarity of explanation, logical argument and language usage.		5

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QUESTION 1

REQUIRED

SECTION A

(Answer in the **YELLOW** answer book)

(a) Refer to the allegations made by Mr Irons at the AGM of Hully Steel Ltd, documented in WP A-550. Describe the steps/actions you would incorporate into the planning and performance of the 2012 statutory audit of Hully Steel Ltd as a result of the alleged:

		Mark guide
i.	poor compliance with safety regulations, and	(5)
ii.	excessive directors' emoluments.	(3)

Detailed audit procedures are not required. (8)

(b) With reference to the 'forecast of steel sales volumes' described under the heading 'Sales volumes' in WP A-300 (1/2):

1. Describe, using examples at the financial statement and account balance level, how this forecast could assist in planning and performing the 2012 audit of Hully Steel Ltd. (6)

2. Assuming you wish to place reliance on the forecast, describe the audit procedures that should be carried out to obtain sufficient appropriate audit evidence that the sales volumes reflected in the forecast are reliable. (13)

(c) Refer to the section headed 'Raw Material Imports' in WP A-300 (1/2): Describe the substantive procedures that should be performed to obtain sufficient appropriate audit evidence that the proposed designation of the forward exchange contracts as 'cash flow hedges' complies with the requirements of IFRS. (9)

(d) Discuss how the information documented in WP A-300 (2/2) will increase your assessment of the risks of material misstatement in the 2012 financial statements of Hully Steel Ltd (at both the financial statement and assertion levels). Exclude the presentation and disclosure assertions from your answer. (15)

TOTAL FOR SECTION A: (51)

SECTION B

(Answer in the **PINK** answer book)

(e) With reference to the working papers relating to the audit of salaries and wages:

1. State, with reasons, whether the decision documented in WP G-020 that certain salaries and wages-related internal controls need not be retested in the current year is appropriate. (6)

2. Consider the internal audit findings documented in WP G-025. Using a tabular format:

   - Describe the nature of the audit procedures that will have to be performed for the 2012 financial year in order to respond to each of these findings, and
   - Provide justification (reasons) for each of your audit responses.

   Note: Detailed audit steps are not required when the nature of the audit procedures is described. (8)

3. Having considered WP G-100, critically evaluate the key controls and the audit procedures that are documented in WP G-101. In answering this question, deal only with the key controls documented in WP G-101. (12)

4. Given that you have electronic access to all the payroll files (including the employee-data master file), describe the computer assisted audit techniques (CAATs) that should be performed to assist in:

	Mark guide
• identifying any unusual data that may impact on the audit of salaries and wages; and	(7)
• verifying the accuracy of the total salaries and wages cost reflected in the monthly payroll files.	(3)

   (10)

(f) Explain, with reasons, the effect that the uncorrected misstatements, documented in WP X-010, will have on the audit report to be issued on the 2012 annual financial statements of Hully Steel Ltd. In answering this question you are not required to write out any section of the audit report. (13)

TOTAL FOR SECTION B: (49)

TOTAL FOR QUESTION 1: (100)