**BAC313 – Audit Theory & Assurance**

**Business Report**

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# Executive Summary

Maxi com Ltd is a computer hardware manufacturer. It sells its products all over Australia and exports to other countries. However, in recent years it has been observed that there is a significant decrease in profits over the period of the last 3 years. To reduce the cost, the company has outsourced its manufacturing process in China, but this step is creating a lot of difficulties as the products manufactured are faulty, and customers have returned a large amount of volumes. There is a risk that due to such faulty supplies, the company may have to face fines and a decline in sales as it may lose customer loyalty. Maxi had also signed a contract with one of its clients in Korea two years ago; however, due to current circumstances, there may be a risk that the major portion of sales being exported to Korea is discontinued.

Moreover, Maxi Com has upgraded its current technology and has acquired new machinery by financing loans. The old machinery is still with Maxi, and it is bearing all its depreciation expenses. We have given the following recommendations based on our knowledge and experience. Maxi should prepare an appropriate business plan for its future operations. In addition, it should consider changing its supplier from China to another trustworthy supplier who can supply quality products with fewer rejection rates to gain more customer loyalty.

Further, Maxi should prepare a variance analysis between actual and forecasted financial and non – financial information. Appropriate policies and procedures should be devised to check the quality of inventory before the sale of inventory to customers. The Maxi’s management should assess the ability to continue its operations with respect to going concern requirements.

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**Business Report**

To the Board of Directors of Maxi com Ltd,

# Introduction

We D&K(firm) are a firm of professional auditors and accountants providing our services all around the world. Our staff is equipped with all the relevant skills and expertise necessary to audit an entity. We have undertaken the assignment of an audit of Maxi com Ltd for the current year ended. We are professionals equipped with all the technical and legal skills as required by the rules in the State. We have also ensured that our team has complied with all relevant ethical requirements relating to independence. We have obtained an understanding of the entity's internal control and mechanisms relating to operations and audit of the entity.

Maxi com Ltd is a computer hardware manufacturer. It sells its products all over Australia and exports to other countries. However, in recent years it has been observed that there is a significant decrease in profits over the period of the last 3 years. To reduce the cost, the company has outsourced its manufacturing process in China, but this step is creating a lot of difficulties as the products manufactured are faulty, and customers have returned a large amount of volumes. There is a risk that due to such faulty supplies, the company may have to face fines and a decline in sales as it may lose customer loyalty. Maxi had also signed a contract with one of its clients in Korea two years ago; however, owing to current circumstances, there may be a risk that the major portion of sale being exported to Korea is discontinued. Moreover, Maxi Com has upgraded its current technology and has acquired new machinery by way of financing of loans. The old machinery is still with Maxi, and it is bearing all its depreciation expenses.

# Discussion

We have considered the above scenario, and our report is expressed in four (4) different sections as below:

## **Section 1 - Account Balances**

In this section, we have considered three different account balances and the risks associated with each of the balance and its possible effect in a misstatement of financial statements:

* Inventory

As Maxi is operating in a highly dynamic industry, there is a risk that its inventory is not being measured at lower of cost and net realizable value. Moreover, the unsold inventory may also become obsolete in the future. The inventory received from the seller in China also needs to be checked properly as there are many cases of defects and complaints in that inventory, and damaged inventory should not be accounted in good inventory as this may alter the true amount of inventory to be presented in accounts. Currently, there is no mechanism in Maxi to check the quality of inventory received by a Chinese supplier. An internal inspection should be carried out of the inventory before the sale if such inventory.

We also know that amount of inventory is material; therefore, all risks should be accounted for while presenting inventory amounts in the financial statement.

* Receivables

Maxi offers a 30-day credit payment period to its customers; however, it has been observed that many of its customers are unable to pay their liabilities in the defined period, and most of them pay in 60 days. This depicts that there is a lack of a strong mechanism to collect the receivables in a specified time. Maxi should also introduce the terms of penalties in late payments of sales. Moreover, a reminder should be issued every 15th day of sales to remind the debtor of the exact date of payment.

The number of debtors needs to be adjusted by considering the correct amount of provision for bad debts. If a customer is delaying payments, there is an increase in risk that the provision for bad debts should also be increased.

* Property plant and equipment

Maxi has currently outsourced its manufacturing facility to a Chinese company in China. As a result, the manufacturing plants of Maxi are now nit being used for any purpose. However, the company is still bearing the depreciation expenses of such plants. The outsourcing of manufacturing indicates that current plant and machinery being used to manufacture also need to be disposed of. However, the entity has not yet taken any steps for its disposal. The carrying value of such a plant also needs to be assessed as there is a risk that the entity has not calculated the amount of impairment, and as a result, the accurate value of plant and equipment could not be reflected.

## **Section 2 - Going Concern Impact**

Maxi Com is operating in an IT business that is rapidly changing IT business. In recent years it has been observed that there is a significant decrease in profits over the period of the last 3 years. To reduce the cost, the company has outsourced its manufacturing process in China, but this step is creating a lot of difficulties as the products manufactured are faulty, and customers have returned a large amount of volumes. From the above data, we have precluded following information that creates a threat to Going Concern Assumption of the entity:

* Significant Decrease in Profits

Maxi has disclosed that its major sales are to the client in Korea, and it has resulted in profits, and at the same time, the Maxi's profit is decreasing from the last three years, which indicate that there might be an issue with Maxi's products. It indicates that there is a risk that an entity may not be able to continue in the future unless other strategies are applied. Moreover, Maxi has also obtained a loan from the bank; we should also check whether any asset is pledged or charged for obtaining this loan.

* Liquidity Problems

The entity’s current mechanism of collecting seems to be lacking in various perspectives as there is no stubborn mechanism to collect receivables on time, and as a result, the entity might face liquidity crunch in the future.

* Outsourcing of Manufacturing of Products

The entity has currently outsourced its manufacturing process to China, and there have been many manufacturing defects in the products, which shows that the entity's operation may suffer in the future because the quality of outsourced products is not up to mark and entity may lose customers. Further, the entity has bought a new plant to produce a different product. This shows that there is a risk that the entity might not be able to continue its operations in the future. Therefore, the above scenario creates a significant doubt that the entity's operations will continue in the future.

* Loan from Bank

Maxi has obtained a loan from bank for financing of new plant and machinery. However, the currently Maxi’s is also facing liquidity issues therefore it is possible that Maxi may be unable to pay its loan installments on time and collateral asset against which loan has been obtained may be claimed by bank.

## **Section - 3 Introduction of Sale Bonus System**

From the above scenario, it is quite evident that sale of Maxi is decreasing year by year so to boost up the sale and increase the profit values, Maxi has introduced the new system of payment to employees that include lower fixed salaries but a greater amount of variable salary in the form of 5% commission on sales.

Risks Related to the Commission:
This new system has created some of the risks related to sales which are as under:

* Overstatement of sales

Most of the employees will try to increase sales value to increase their commission. As a result, the employees may also not decide appropriate credit terms with the customer to return their payables.

* Increased amount of sale returns

To achieve a higher amount of sales, there may be an increased risk of bogus sales. I.e., the customers return a large amount of volumes after the sale has been recorded or a period has ended.

The following internal controls should be established to reduce the above risks related to the sale

* Revision of Commission terms

Maxi should consider revision of its commission terms with employees and try to integrate the clauses of the specified recovery period and no sale return for eligibility of commission.

* Threshold Limit for Maximum Commission in a period

The maximum amount of commission that one employee can earn in a year should be defined, and other compensation policies should be devised to compensate the employees for achieving maximum sales.

## **Section 4 - Assertions and Substantive Procedures related to inventory**

* Existence

It means that assets and liabilities really do exist and there has been no overstatement – for example, by the inclusion of fictitious receivables or inventory. This assertion is very closely related to the occurrence assertion for transactions.

* Relevant tests – physical verification of non–current assets, circularisation of receivables, payables and the bank letter..
* Accuracy, valuation and allocation

It means that amounts at which assets, liabilities and equity interests are valued, recorded and disclosed are all appropriate. The reference to allocation refers to matters such as the inclusion of appropriate overhead amounts into inventory valuation.

* Relevant tests – Vouching the cost of assets to purchase invoices and checking depreciation rates and calculations.

# **Conclusion and recommendation**

 In the above discussion, we have discussed multiple issues that need to be addressed during the audit of Maxi co LTD. We have highlighted the possible misstatements that need the attention of the management and board of directors. On this basis, our recommendations are as follows:

* Maxi should prepare an appropriate business plan for its future operations. In addition, it should consider changing its supplier from China to another trustworthy supplier who can supply quality products with less rejection rates so that more customer loyalty can be gained. Further, Maxi should prepare a variance analysis between actual and forecasted financial and non – financial information.
* Appropriate policies and procedures should be devised to check the quality of inventory before the sale of inventory to customers.
* The Maxi’s management should assess the ability to continue its operations with respect to going concern requirements.
* Surplus plant and machinery should be disposed of to avoid depreciation expenses on such surplus plants. Moreover, the disposal of surplus plant and machinery will also solve the problem of liquidity crunch for Maxi com Ltd.
* Maxi should introduce a new mechanism to collect its revenue within the credit limits of 30 days by making new policies of fines for late-payments and discounted credit sales for a time limit of 30 days or lower. This will help in the timely collection of receivables.

In the end, we preclude that our recommendations will allow the entity to present its true and fair presentation of its accounts and help improve Maxi's operational abilities in the future. We have given such recommendations on our experience of the IT industry, and we believe that these are all based on professional standards.

Senior Manager,
D&K