

AUE3702

October/November 2016

SUBSTANTIVE PROCEDURES AND FINALISING AN AUDIT

Duration 3 Hours

100 Marks

EXAMINATION PANEL AS APPOINTED BY THE DEPARTMENT

Closed book examination

This examination question paper remains the property of the University of South Africa and may not be removed from the examination venue

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THIS PAPER CONSISTS OF **SIX (6)** PAGES

This paper consists of **SIX** questions that deals with the following main topics

MAIN TOPIC	MARKS
Going concern	6
Substantive procedures - trade and other payables	24
Audit sampling and external confirmations	12
Substantive procedures - inventory	27
Provisions and contingent liabilities, and audit reporting	16
Subsequent events	<u>15</u>
	<u>100</u>

NOTE:

The main objective of the examination is to test a candidate's knowledge of and ability to apply the study material, although the examiners will also take into account the candidate's ability to organise and to present that knowledge in writing and according to an acceptable standard

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CASE STUDY

100 marks

Background information

You are an audit senior at XYZ Incorporated. You are a member of the audit team performing the audit of Bikes are Best Ltd (BrB) for the year ended 30 April 2016. The company wholesales motorbike accessories (i.e. helmets, safety jackets and safety boots) to motorbike dealers. The company's administration offices and warehouse are situated in Durban.

READ THE REQUIRED PART OF THIS PAPER ON PAGES 5 AND 6 BEFORE CONTINUING.

WORKING PAPER RELATING TO GOING CONCERN (Required part 1)

Client: BrB	Year end: 30 April 2016	B1
Prepared by: W Shiraz	Preparation date: 17 May 2016	
Reviewed by: J Ross	Review date: 23 May 2016	
Subject: Going concern		
<p>BrB is currently experiencing going-concern problems. Management is however of the opinion that the going concern assumption is still appropriate, and has implemented the following measures to improve the company's situation:</p> <ol style="list-style-type: none"> 1. Long-term loans obtained from private companies that amount to R2 million have been converted into share capital. 2. Management is also of the opinion that the continuous increase in fuel prices will boost the company's sales, as motorbikes' fuel consumption is low in comparison with that of motor vehicles. According to management, this expected increase in motorbikes' sales will place the company back on the road to profitability. <p>BrB's management is prepared to disclose, in a note to the balance sheet, that the company is experiencing going-concern problems and how it proposes to address those problems.</p>		

TRADE AND OTHER PAYABLES (Required part 2)

As part of the verification procedures for purchases you decided to satisfy yourself as to the validity of the reconciling items appearing on a sample of trade payables reconciliations of BrB at 30 April 2016. BrB's policies require that all purchases must be accompanied by an authorised order and goods-received note.

One of the creditor reconciliations that was included in the audit sample is detailed below:

Creditor reconciliation of Chang Enterprises Ltd: 30 April 2016

Description	Amount (R)
Balance as per creditor statement translated to a rand value using the spot rate as at 22 April 2016	1 950 000
Add Invoice 18700 dated 01 April 2016 (Note 1)	311 700
Less Receipt 20069 dated 25 April 2016	(400 000)
Balance as per creditors ledger at 30 April 2016	1 861 700

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Note 1

BrB ordered 100 motorbike helmets at a cost of US \$300 per helmet from its foreign supplier in China, Chang Enterprises Ltd, on 1 March 2016 BrB was issued with invoice number 18700 on 1 April 2016 The goods were shipped free on board (FOB) on 5 April 2016 The goods were received at the Durban Harbour on 15 April 2016 The goods were personally collected by the warehouse manager on 26 April 2016 and received at BrB's warehouse on the same day The invoice was not included in the creditor statement as at 22 April 2016

The following spot rates are available to you

- 01 April 2016 \$10 41
- 05 April 2016 \$10 39
- 15 April 2016 \$10 43
- 26 April 2016 \$10 45
- 30 April 2016 \$10 55

AUDIT SAMPLING AND CONFIRMATION REQUESTS (Required part 3)

Your audit plan for the year-end audit will include meaningful subsequent receipts testing for the existence of the accounts receivable (debtors) balance (i.e. motorbike dealers to whom BrB wholesales motorbike accessories) You also plan to perform a debtors circularisation (confirmation) on a sample of BrB's debtors (motorbike dealers) However, BrB's clients have a poor track record of responding to confirmation requests You assessed the risk of material misstatement of the existence assertion relating to the accounts receivable balance as high

WORKING PAPER RELATING TO INVENTORY (Required part 4)

Client: BrB	Year end: 30 April 2016	A1
Prepared by: W Shiraz	Preparation date: 16 May 2016	
Reviewed by: J Ross	Review date: 18 May 2016	
Subject: Inventory		
<ol style="list-style-type: none"> 1. An automated perpetual inventory system is utilised All inventories are issued directly to customers from the warehouse in Durban 2 All the motorbike accessories are imported from China Imported goods arrive in containers at the harbour, where Clearwater (Pty) Ltd (a company used by BrB) arranges for the successful clearing of BrB's imports 3 All inventory imported is entered in the system using a goods-received note (GRN) Sales invoices are used to record the sales of inventory on the system 4 You and other team members attended the inventory count and concluded that an accurate and efficient inventory count took place on 30 April 2016 The warehouse was closed and no inventory was received or despatched on the day of the count Count teams recorded count quantities on pre-printed inventory sheets The discrepancies between the theoretical and the actual quantities were resolved and damaged (unsaleable) inventory was identified All the necessary amendments were made to the inventory masterfile after being authorised on an inventory adjustment form 		
<i>(Working paper continues on the following page)</i>		

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5. BrB measures inventory at the lower of cost or net realisable value. The cost of inventory is determined on a first-in first-out (FIFO) basis.
6. The final automated inventory master file is available for audit purposes and contains the following fields:
 - Inventory code (every item of inventory has its own alpha-numeric item code, e.g. BA 0332)
 - Description of the motorbike accessory
 - Costing report number*
 - Date of last purchase
 - Date of last sale
 - Quantity on hand at the beginning of the financial year
 - Quantity sold year to date
 - Quantity purchased year to date
 - Quantity on hand at the end of the financial year
 - Unit selling price at year end
 - Unit purchase price in rand at year end (calculated on a FIFO basis) (cost)
 - Value of inventory at the end of the financial year (quantity x cost)

**The costing report number applies to the hard-copy file that contains the various costing reports (including the invoices from Clearwater (Pty) Ltd) of all imported motorbike accessories*
7. You are satisfied that the value of inventory as per the inventory masterfile at year end should not be reduced by a write-down for slow-moving or obsolete inventory.
8. During the 2015/2016 financial year, Better Bikes Ltd, a competitor of BrB that also sells motorbike accessories, enquired from BrB's management if it could store a number of inventory items in BrB's warehouse. BrB's management decided to decline the request. As a result, at year end, no inventory held on behalf of a third party was stored in BrB's warehouse.

FINALISING THE AUDIT (Required part 5)

On completion of the audit the following items were still outstanding on the working papers and management was not prepared to make adjustments to the financial statements:

1. During discussions with the warehouse manager you became aware of a lawsuit that had been filed against BrB in May 2016. A major customer of BrB, Head-Safe Ltd (Head-Safe), had purchased specialised helmets to the value of R3 000 000 during the 2016 financial year. BrB had sourced these helmets from a supplier in China and sold them to Head-Safe. These helmets were found to be defective and of an inferior quality, as customers of Head-Safe Ltd had sustained head injuries while wearing the helmet. Head-Safe consequently withdrew the entire class of helmet from the market. BrB does not have any of these defective helmets in inventory at year-end.
2. Legal counsel indicated that the possibility that Head-Safe will succeed with the litigation is very good. The value of the claim is R6 000 000 to compensate Head-Safe for the loss in sales as well as injuries suffered by its customers.
3. BrB's insurance does not cover the legal claim.
4. Final materiality was set at R5 000 000.

SUBSEQUENT EVENTS (Required part 6)

Despite of the discussions with management and staff members, you have not performed further procedures to identify possible subsequent events that relate to BrB.

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REQUIRED	Marks
PART	
1. With reference to working paper B1 entitled “ Going concern ” on page 2 Describe the audit procedures that you will have to perform in order to be satisfied with the preparation of the annual financial statements on a going-concern basis , taking into account the issues raised in the working paper	(6)
2. With reference to the information contained under the heading TRADE AND OTHER PAYABLES on pages 2 and 3 Describe the substantive audit procedures you will perform on the creditor reconciliation of Chang Enterprises Ltd as at 30 April 2016 Communication skills - proper formulation of substantive audit procedures	(22) (2)
3. With reference to the information contained under the heading AUDIT SAMPLING AND CONFIRMATION REQUESTS on page 3 (i) Describe what effect successful subsequent receipts testing will have on the sample size of the debtors circulation (confirmation) if the auditor intends to obtain sufficient, appropriate audit evidence regarding the existence of trade receivables (ii) Define the terms “positive confirmation” and “negative confirmation” and indicate the type of confirmation that should be used during the audit at BrB. Provide reasons for your selection	(3) (9)
4. With reference to working paper A1 entitled “ Inventory ” on pages 3 and 4 (i) Formulate the substantive audit procedures that you will perform, including those that you will perform with the assistance of computer assisted audit techniques (CAATs) , to ensure that inventory is correctly valued at year end Your answer should exclude substantive audit procedures relating to the attendance of the year-end inventory count Communication skills - proper formulation of substantive audit procedures (ii) Assume that BrB granted permission to Better Bikes Ltd to store its inventory in BrB’s warehouse Explain why it will be necessary to conduct audit procedures on inventory held for a third party (i.e. Better Bikes Ltd)	(22) (2) (3)

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REQUIRED PART		Marks
5	With reference to the information contained under the heading FINALISING THE AUDIT on page 4:	
	(i) Describe how the litigation should be treated in the financial statements at 30 April 2016	(6)
	(ii) Discuss the effect of management's refusal to adjust the financial statements on the audit report of BrB for the year ended 30 April 2016. You do not need to write down the opinion and basis of opinion paragraphs	(9)
	Communication skills – clarity of expression and logical flow of arguments	(1)
6.	With reference to the information contained under the heading SUBSEQUENT EVENTS on page 4	
	Formulate the audit procedures to identify possible significant subsequent events in terms of <i>ISA 560 – Subsequent events</i>	(15)