



AUE303R

October/November 2012

ADVANCED THEORY OF AUDITING AND THE PERFORMING OF THE AUDIT PROCESS

Duration 2 Hours

100 Marks

EXAMINERS :

FIRST

SECOND .

EXTERNAL .

MS L FERREIRA

MR K JOUBERT

MRS C STEYN

Use of a non-programmable pocket calculator is permissible.

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.

THIS PAPER CONSISTS OF SIX (6) PAGES.

This paper consists of the following questions and main topics:

QUESTION	MAIN TOPIC	MARKS
1	Review an audit engagement letter	18
2	Substantive procedures to audit sales	22
3	Audit the valuation of allowance for credit losses	22
4	Issues to consider with related-party transactions	14
5	Considering misstatements identified during the audit	<u>24</u>
		<u>100</u>

NOTE

The primary purpose of the examination is to test a candidate's knowledge and application of the subject matter. However, the examiner will also consider the candidate's ability to organise and present such knowledge in acceptable written language.

[TURN OVER]

Petersons (Pty) Limited is a manufacturer and distributor of fashionable fine pipe smoking products (pipes and tobacco). The business started as a small family business 15 years ago and has grown into a well-established business. Tobacco sales make up about 75% of the total turnover.

The company's financial year ends on 31 August 2012. During July 2011 the audit committee appointed Una Auditors to act as the newly appointed auditors for the 2012 financial year. Una Auditors accepted the appointment and you are the audit manager assigned to supervise the audit

PART A

All of the necessary ethical issues were considered and there was no indication of any suspicious reason for the change of auditors. You requested a second-year trainee accountant to draft an engagement letter and he provided you with the following draft letter to review.

Letterhead (Una Auditors)

Mr Zippo Lighter
The Financial Director of Petersons (Pty) Limited
Petersons (Pty) Limited
P O Box 4477
MODIMOLLE
0510

Dear Sir

We are pleased to announce our acceptance of Petersons (Pty) Limited as a client and hope to add value to your business. This letter, once undersigned by you and returned to us, serves as a formal letter of appointment.

Our appointment is based on the following terms and conditions:

1. Petersons (Pty) Limited's MOI requires an audit to be performed.
2. We will conduct the audit for the year ended 31 August.
3. On 15 October we will sign off the financial statements comprising the statement of financial position, statement of comprehensive income, statement of changes in equity, statement of cash flows, as well as a summary of significant accounting policies and explanatory notes.
4. Our role is to certify the fair presentation of the financial statements presented to us by your chief financial officer.
5. We will perform the audit in accordance with the International Standards on Auditing (ISAs) and we will comply with all the relevant ethical requirements. We will plan and perform the audit to obtain reasonable assurance that the financial statements are free from material misstatements. The audit procedures that we will select will depend on our judgment and include the assessment of the risks of material misstatements.

[TURN OVER]

6. You should provide us with the draft financial statements prepared in accordance with the International Financial Reporting Standards by 15 September, and allow us to access all the financial information and persons within the entity whom we determine necessary to perform our duties.
7. You are also responsible for the internal controls necessary to enable the preparation of financial statements that are free from material misstatements.
8. Our fees will be based on the previous year's invoice adjusted for inflation
9. The form and content of our report will depend upon our audit findings.

Kindly undersign the letter and return it to us.

Kind regards

Mike Blimey
Senior Audit Manager

Signed.
Zippo Lighter
Financial Director of Petersons (Pty) Limited

REQUIRED

Marks

- 1 In terms of ISA 210, *Agreeing the terms of audit engagements*, identify the weaknesses of the proposed audit engagement letter. You are **not** required to redraft the letter.

(18)

PART B

Petersons (Pty) Limited buys tobacco directly from Zimbabwean and South African farmers and blends the Virginia, Burley and Cavendish tobaccos into its popular and smooth aromatic pipe tobaccos. Pipes and tobacco are sold on credit to selected tobacconists in South Africa. The company does not sell directly to the public and therefore no cash sales take place. Petersons (Pty) Limited's revenue and receipts cycle is fully computerised. Your risk assessment did not indicate that a specific assertion attracts a higher risk of material misstatement than any of the others. You therefore plan to perform audit procedures that will cover all the assertions for sales. Due to effective cost reduction measures and driven by a highly competitive market, Petersons (Pty) Limited did not raise their selling prices during the 2012 financial year. Petersons (Pty) Limited is registered as a VAT vendor.

[TURN OVER]

Customers place their orders via e-mail. As soon as an order is approved, a *tax invoice* is generated in conjunction with a *picking slip* and a *despatch note* based on the prices and discounts on the pre-approved price lists. The transaction is recorded in the sales journal Petersons (Pty) Limited's credit policy stipulates that an account must be settled within 30 days of the statement date. Credit limits are approved by the credit controller for each debtor prior to any sales being made to that debtor. Receipts from debtors are recorded on *remittance advices* which serve as a receipt which is then captured in the cash receipts journal.

The following schedule was prepared by Petersons (Pty) Limited:

Audit File Preparation Documentation: 31/08/2012

Trade receivable

Line Manager: Peter Dunno (Contact: pdunno@petersons.com x 4664)

	2012	2011
	R	R
Revenue	<u>654 916 267</u>	<u>549 131 627</u>
Trade receivables	54 576 110	45 760 916
Allowance for credit losses	Note 1 <u>-2 183 045</u>	<u>-2 678 140</u>
	<u>52 393 065</u>	<u>43 082 776</u>
Bad debts written off for the year to date	<u>650 186</u>	<u>588 121</u>

Age analysis: 31/08/12					
Total	Current	30 days	60 days	90 days	120 days+
54 576 110	33 291 427	13 098 266	5 457 611	1 637 283	1 091 523

Note 1

Allowance for credit losses:

Total 90 days	1 637 283
Total 120 days	<u>1 091 523</u>
	2 728 806
* Per policy document	<u>80%</u>
	<u>2 183 045</u>

* Approved policy for calculating allowance for credit losses, calculated at 80% of outstanding debtors - 90 days and older

[TURN OVER]

REQUIRED	Marks
2 Describe the substantive procedures that you will carry out to audit sales. (Your solution should exclude the use of audit software.)	(22)
3 Describe the substantive procedures that you will carry out to audit the valuation and allocation of the allowance for credit losses. (Your solution should include the use of audit software.)	(22)

PART C

During the financial year under review a trainee accountant in your team identified a sales transaction where Petersons (Pty) Limited sold the remainder of their 2011 Special Reserve tobacco (inventory), with a cost price of R3,3 million and a sales value of R7,2 million to the distributor company, SA Fortune (Pty) Limited, for R2,2 million. The 2011 Special Reserve tobacco is a popular choice amongst refined pipe smokers. Petersons (Pty) Limited is a profitable company while SA Fortune (Pty) Limited is a young company with an accumulated assessed tax loss of R10,2 million. SA Fortune (Pty) Limited is a wholly owned subsidiary of Petersons (Pty) Limited. The directors of Petersons (Pty) Limited view the transaction as a measure to reduce tax.

REQUIRED	Marks
4 Describe in detail the auditor's considerations in relation to the stated transaction.	(14)

PART D

Your team of trainee accountants has just completed the final audit field work of Petersons (Pty) Limited for the year ended 31 August 2012. They handed you the audit file to perform an overall review of the financial information, to evaluate the audit evidence, and to conclude on fair presentation. The transaction described in Part C (qualitative audit difference) is included in the file due to the lack of disclosure thereof in the notes to the financial statements. You need to aggregate the schedule of quantitative audit differences and discuss the findings with management. The trainee accountants have already performed a subsequent events review and audited management's going concern assessment. They concluded that all subsequent events have been correctly treated and the company will continue to operate as a going concern in the foreseeable future.

You may assume that statistical sampling was used in all instances.

[TURN OVER]

REQUIRED

Marks

- 5** Describe the steps and procedures that the auditor should perform when considering the audit misstatements identified during the audit. **(24)**

Your answer should address the following aspects:

- Qualitative audit differences
- Quantitative audit differences (individual as well as in aggregate)