GRADED QUESTIONS ON AUDITING

2017

GOWAR AND JACKSON

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ISBN softcover 978 0 409 12461 3
e-book 978 0 409 12479 8

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CHAPTER 1

AN INTRODUCTION TO AUDITING

AND

SUNDRY AUDITING TOPICS

1.1 **(35 marks 42 minutes)**

1. Give three reasons (with brief explanations) as to why auditors are needed in society.(9)

2. Explain the following terms
   * internal auditor
   * forensic auditor
   * postulates of auditing
   * professional scepticism
   * applicable financial reporting framework (10)

3. Identify and briefly discuss the inherent limitations of an audit of the set of annual financial statements of a company. (10)

4. Explain the difference between
   * an assurance engagement and a non-assurance engagement. (4)
   * a statutory and a non-statutory engagement. (2)

1.2 **(16 marks 19 minutes)**

The Companies Act 2008 and its accompanying Regulations 2011 require that every company and close corporation calculates what is termed its "public interest score".

YOU ARE REQUIRED TO:

a) explain the term public interest score and how it is calculated. (8)

b) explain fully, the link between the public interest score of a ***private*** company and the type of assurance engagement (if any) to which the company must subject its annual financial statements. (8)

1.3 **(15 marks 18 minutes)**

Professional accountants, lawyers and doctors are all considered to be members of a profession. It is also generally accepted that all professions require their members to have certain attributes such as honesty and integrity. However, the auditing profession differs from the other professions in that it places great importance on its members not only being independent but also being seen to be independent.

YOU ARE REQUIRED TO:

a) discuss the attributes which any profession, including the accounting profession must retain if it is to justify its status as a profession. (6)

b) explain the term "independent" in relation to members of the ***auditing*** profession. (3)

c) explain the phrase "an auditor should not only ***be*** independent, but should ***be seen to be*** independent". (3)

d) comment on whether independence is a more important attribute for auditors than for doctors and lawyers. (3)

1.4 **(24 marks 28 minutes)**

PART A **(14 marks 16 minutes)**

Television shows seem to like having an auditor on the show! "So you think you can dance?" is a show in which contestants are eliminated week by week until a winner is left. Contestants are eliminated on the strength of votes cast by the judges and the general public with the contestant obtaining the lowest combined vote leaving the show. The show presenter makes a point of referring to the fact that "the vote has been verified by our auditors", at the end of the show.

YOU ARE REQUIRED TO:

a) explain why shows like "So you think you can dance?" make use of the auditing profession in this manner. (6)

b) comment on whether this kind of exposure is good for the auditing profession. (2)

c) indicate the matters about which the auditors should be satisfied before taking on this type of engagement. (6)

PART B **(10 marks 12 minutes)**

Each year the "Sunday Times" and other newspapers publish statistics indicating, amongst other things, the number of people who read the various Sunday newspapers, the race of their readers and the geographic location of their readers. For example, the Sunday Times may state that they have a readership of 4.1 million. The newspapers who publish statistics always make a point of stating that they are publishing ***audited*** figures.

YOU ARE REQUIRED TO:

a) explain why the newspapers make reference to the fact that the published statistics are audited. (5)

b) state whether the fact that the figures are ***audited*** means that the audit body is ***certifying*** that the Sunday Times readership is 4.1 million. Give reasons to support your answer. (5)

1.5 **(15 marks 18 minutes)**

Performing an audit is, in reality, about providing assurance to another party or parties. An assurance engagement is one where a ***professional accountant*** evaluates or measures a ***subject matter*** that is the ***responsibility of another party*** against ***identified criteria***, and

expresses a conclusion that provides the ***intended user*** with a level of assurance about that subject matter.

YOU ARE REQUIRED TO explain each of the terms or phrases given in bold above in the context of

- * a statutory (external) audit of a company's annual financial statements (5)
- * an internal audit of a public company's internal control systems (5)
- * a VAT audit of a taxpayer (company) conducted by professional accountants employed by SARS (5)

1.6 **(10 marks 12 minutes)**

Appearing below is a list of different types of auditor and other individuals associated with the financial world. Also listed is a broad description of some of the activities carried out by the individuals.

1. Individuals

1.1 forensic auditor
1.2 a registered auditor
1.3 internal auditor
1.4 independent accounting professional
1.5 a financial director
1.6 government auditor
1.7 special purpose auditor
1.8 management accountant.

2. Activities

1.1 takes responsibility at board level for the adoption and implementation of the accounting policies adopted by a company
1.2 investigates and gathers evidence where there has been alleged financial mismanagement/fraud
1.3 analyses cost and variance reports
1.4 expresses an independent opinion on whether the financial statements of a company are fairly presented
1.5 expresses an opinion on whether the financial information presented by the Eastern Cape provincial health department to the government is fairly presented in terms of the government's reporting guidelines
1.6 performs, on behalf of the board, an independent evaluation of whether a company is appropriately addressing the risks faced by the company
1.7 conducts procedures to determine whether a mining company is complying with environmental regulations
1.8 independently compiles the annual financial statements of a private company.

YOU ARE REQUIRED TO:

a) identify which of the individuals listed above will be ***employees*** of the entity for which they are carrying out the activity. (2)

b) match each ***activity*** to the ***individual*** most likely to carry out the activity. (8)

1.7 **(10 marks 12 minutes)**

YOU ARE REQUIRED TO indicate whether each of the following statements is true or false.

1. The Board of Directors of a company appoints the external auditor. (1)

2. If the external auditor finds only immaterial errors in the audit of a company's annual financial statements, he or she may certify the AFS as correct. (1)

3. To be classified as a "chartered accountant in public practice" a person must be a member of SAICA ***or*** registered with the Independent Regulatory Board for Auditors.(1)

4. Assurance engagements performed by a registered auditor are intended to enhance the credibility of the information which is the subject of the engagement. (1)

5. Provided an external auditor is properly qualified and technically proficient, his or her independence becomes less important when performing an assurance engagement. (1)

6. Engagements in which a registered auditor compiles financial information for a client, or provides management consultancy services, are not assurance engagements. (1)

7. Assertions are the representations by management contained in the Directors Report as well as the Chairman's Report. (1)

8. Audits provide positive assurance, reviews provide negative assurance. (1)

9. The audit plan refers to the nature, timing and extent of audit procedures deemed necessary in the circumstances to achieve the objective of the audit. (1)

10. The external auditor and the internal auditors are, in a public company, collectively responsible for the preparation and presentation of fair financial statements. (1)

1.8 **(25 marks 30 minutes)**

YOU ARE REQUIRED TO state whether each of the statements below is true or false. Justify your choice.

1. The directors of a public company may replace the external audit of the company's annual financial statements with an audit conducted by its internal audit department provided the company has a correctly constituted audit committee. (2)

2. It is not the specific objective of the auditor, when conducting the annual audit of a company's financial statements, to discover or prevent fraud. (4)

3. An auditor can only express an opinion on the fair presentation of financial information if there are suitable criteria against which the financial information can be reliably measured. (3)

4. All auditors, whether they are internal auditors, external auditors, environmental auditors or forensic auditors, must be registered with the Independent Regulatory Board for Auditors (IRBA). (4)

5. Access given to the auditor to the accounting records, books and documentation of an audit client is a privilege and not a right. (2)

6. One of the important objectives of the external audit of a company is for the auditor to express an opinion on the company's compliance with the King IV Report on corporate governance. (3)

7. The external auditor must comply with the International Standards on Auditing (ISAs) regardless of whether he is conducting the annual audit of a public or private company. (3)

8. The major reason that registered auditors cannot certify the annual financial statements as being 100 percent correct is that the cost of the audit would be too high. (4)

1.9 **(10 marks 12 minutes)**

1. Whether or not a public company must have its annual financial statements audited depends upon:
   1.1 the company's public interest score only.
   1.2 the company's public interest score ***and*** whether its financial statements are compiled by an independent financial accountant.
   1.3 the requirements of the industry in which the company operates.
   1.4 none of 1.1 to 1.3.

2. Which of the following is ***not*** a factor in the calculation of a company's public interest score:
   2.1 turnover.
   2.2 the number of independent non-executive directors on the company's board.
   2.3 the average number of employees during the financial year.
   2.4 the company's third party liability at year-end.

3. A registered auditor can carry out two broad types of assurance engagement, namely:
   3.1 independent audits and compilation engagements.
   3.2 independent reviews and "agreed upon procedures engagements".
   3.3 independent audits and independent reviews.
   3.4 independent reviews and compilation engagements.

4. A successfully completed external audit of a company's financial statements provides the user with:
   4.1 absolute assurance.
   4.2 acceptable but limited assurance.
   4.3 reasonable assurance.
   4.4 moderate assurance.

5. Besides the obvious element of a subject matter, e.g. a set of financial statements, for an engagement carried out by a registered auditor to be classified as an assurance engagement, it must contain the following additional elements:
   5.1 a three party relationship.
   5.2 the availability of sufficient appropriate evidence.
   5.3 suitable criteria on which assurance can be judged.
   5.4 all of the above.

6. Which of the following is ***not*** generally regarded as being an inherent limitation of an audit:
   6.1 the use of testing (test checking) by the auditor.
   6.2 the inherent limitations of internal control systems.
   6.3 the complexity of the International Standards on Auditing.
   6.4 the fact that many account balances in the financial statements being audited are subjective.

7. Which of the following statements best describes what the auditor's opinion on a set of annual financial statements provides:
   7.1 the presence or absence of fraud.
   7.2 the future viability of the company.
   7.3 the efficiency with which management has conducted the affairs of the entity for the financial year.
   7.4 the fair presentation of the financial statements in terms of a relevant reporting framework.

8. When conducting an assurance engagement on a set of financial statements which is intended to provide the user with reasonable assurance, the most important requirement which the audit team must comply with, is:
   8.1 cost control and budget awareness.
   8.2 confidentiality pertaining to client information.
   8.3 independence of mind and in appearance.
   8.4 efficiency and effectiveness.

9. On the external audit of a public company, the designated auditor is:
   9.1 the most senior partner/director of the audit firm which holds the appointment of auditor.
   9.2 the individual who is responsible for the audit in terms of Sec 44(1) of the Auditing Profession Act 2005.
   9.3 the member of the audit team who is appointed to the company's audit committee.
   9.4 the individual identified by the company's audit committee to take responsibility for the audit engagement.

10. Which of the following types of auditor must be registered with the IRBA before they can conduct audits of financial information:
   10.1 internal auditors.
   10.2 external auditors.
   10.3 government auditors.
   10.4 all of the above.

1.10 **(24 marks 29 minutes)**

It is obvious that registered auditors must have the knowledge and skills to perform their function and that they should be totally honest. However, there are a number of other attributes or fundamental principles of ethical behaviour, which all auditors should have/comply with and these are identified in various international pronouncements as follows; the auditor should:

(i) act with ***integrity***
(ii) act ***objectively***
(iii) act with ***professional competence and due care***
(iv) respect the principle of ***confidentiality***
(v) embrace ***professional behaviour***.

The following actions taken by registered auditors are examples of ***non-compliance*** with one or more of the principles listed above:

1. Peter Boston the registered auditor in charge of the Milkmaid (Pty) Ltd audit, made racist comments concerning the client's staff during an audit planning session. (2)

2. Preggy Pillay the registered auditor in charge of the audit of Rosebeds (Pty) Ltd, charged the client a fee for audit procedures which he knew had not actually been carried out. (2)

3. Fred Feathers the registered auditor in charge of the audit of Impendle (Pty) Ltd, failed to identify the misapplication by the client of an important accounting policy. The misapplication resulted in a material overstatement of the company's profit. (2)

4. Julius Zuma a registered auditor, arranged with some of his clients to pay the fees which he charged for his services, in cash. Any client agreeing to do so, was not charged VAT and was given a discount. (5)

5. During the planning stage of the audit of Marketvest (Pty) Ltd, a company which invests money on behalf of its clients, Rocky Ranchod the registered auditor in charge of the audit, was given access to the investment strategy which the company intended to adopt. Rocky Ranchod noted the listed shares which Marketvest (Pty) Ltd intended to purchase and instructed his own stockbroker to immediately purchase a number of these shares for Rocky Ranchod's family trust. (3)

6. As the budget for the audit of Redbands Ltd would be exceeded and because he felt he had a competent audit team, Axel Mkize the registered auditor in charge of the audit, decided not to spend the necessary time on reviewing the workpapers of the audit team.(3)

YOU ARE REQUIRED TO:

a) briefly explain each of the attributes or fundamental principles of ethical behaviour listed above (i) to (v). (7)

b) identify with a brief explanation, which of the fundamental principles have not been complied with in each of the situations described in 1 to 6 above. (17)

Note: A single action may amount to non-compliance with more than one principle.

1.11 **(22 marks 26 minutes)**

Each of the following statements ***may*** or ***may not*** be regarded as a postulate of auditing:

1. The auditor must adopt an attitude of professional scepticism.

2. The professional status of the independent auditor imposes commensurate professional obligations on the auditor.

3. When conducting an audit of annual financial statements, the auditor must plan and carry out procedures specifically designed to detect fraud.

4. Internal controls reduce the probability of errors and irregularities.

5. Professional competence outweighs independence (objectivity) when conducting an audit.

6. Fair presentation of the financial statements must be evaluated in terms of sound principles of corporate governance.

7. An auditor must act exclusively as auditor in order to be able to offer an independent and objective opinion on the fair presentation of financial information.

8. With regard to achieving fair presentation of the financial statements, there is no conflict of interest between the auditor and the company's management.

YOU ARE REQUIRED TO:

a) explain the term "postulate" in the context of auditing. (2)

b) identify which of the above statements may be regarded as postulates of auditing and explain briefly each of the postulates you have identified. (12)

c) for each of the above statements which you have not identified as a postulate, state whether the statement is true or false. Justify your choice. (8)

1.12 **(15 marks 18 minutes)**

The key element of the external audit and the internal audit is the independence of the individual or firm holding the audit appointment or, in the case of internal audit, the status of the internal auditing department in the organisation. However if the auditor is to carry out his function he must be granted access to the information he requires.

YOU ARE REQUIRED TO:

a) explain briefly why the auditor, internal or external, must have the right of access to all information he requires. (3)

b) discuss whether the external auditor's right of access is sufficiently entrenched in the legislation. (6)

c) explain briefly how the internal auditor's right of access is entrenched. (3)

d) discuss whether the right of access granted to the internal or external auditor creates any duties/obligations for the auditor. (3)

1.13 **(26 marks 31 minutes)**

The annual financial statements of a company can be viewed as a collection of assertions made by the directors. These assertions can be categorized as:

* assertions about ***classes of transactions and events*** and related disclosures for the period under audit e.g. sales, purchases, interest received
* assertions about ***account balances*** and related disclosures at year-end e.g. accounts receivable, property plant and equipment, accounts payable

The intention of the auditor is to obtain sufficient appropriate evidence pertaining to the assertions so as to be in a position to express an opinion on the fair presentation of the financial statements.

YOU ARE REQUIRED TO:

a) explain the term financial statement assertion. (2)

b) identify the assertions pertaining to each of the above two categories and provide a brief explanation for each. (12)

c) explain the term sufficient appropriate evidence. (5)

d) explain the term "the auditor's right of access". (4)

e) explain the link between the assertions and the auditor's right of access. (3)

1.14 **(10 marks 12 minutes)**

List A below consists of the first parts of ten sentences. List B below consists of the second part of each sentence. When the parts (A and B) are combined, a complete and correct statement is made.

LIST A

A1 The essential characteristic common to all types of audit (assurance) engagement is …

A2 The International Framework for Assurance Engagements defines an assurance engagement as one "in which a practitioner expresses a conclusion designed to …

A3 A professional accountant in public practice must be registered with …

A4 Whether a private company is required to be externally audited will depend primarily on its …

A5 One of the auditing postulates is that the application of a recognized accounting framework in the preparation of the financial statements will …

A6 The audits of provincial departments are usually undertaken by …

A7 An audit does not certify that the financial statements are correct, but it does provide …

A8 Another of the auditing postulates states that the status of the independent auditor in society …

A9 A review of financial statements will provide …

A10 The assertions contained in the financial statements can be described as the …

LIST B

B1 … the IRBA but does not have to register with SAICA.

B2 … the office of the Auditor General.

B3 … result in fair presentation.

B4 … the independence of the auditor from the "entity" (e.g. company/division/dept) being audited.

B5 … imposes an obligation on the auditor to place service before personal interest.

B6 … representations of the directors/management to the shareholders.

B7 … enhance the degree of confidence of the intended user.

B8 … limited assurance as to the fair presentation of the financial statements.

B9 … public interest score.

B10 …reasonable assurance as to the fair presentation of the financial statements.

YOU ARE REQUIRED TO select the part of the sentence from ***LIST B*** which, when matched to a part of the sentence from ***LIST A*** forms a complete and correct sentence.

1.15 **(15 marks 18 minutes)**

During an auditing workshop held for first year trainee accountants, participants were required to complete a "true/false" test on the topic "An introduction to auditing". Whilst most trainees did very well on the test, Patrick Panday surprised everyone by getting every answer ***incorrect*** due mainly to the fact that during the lecture on the topic he had been playing a game on his smart phone.

For each of the following statements Patrick Panday had selected the ***"false" option***:

1. It is not necessary for an individual who is employed as an internal auditor to register with either SAICA or IRBA.

2. The attitude which is common to, and essential for all categories of auditor, is independence.

3. If an auditor is not seen to be independent of his client, he will not be seen to be objective even if he has acted objectively.

4. An audit assurance engagement is typically a three party relationship, the three parties being the registered auditor, the board of directors, and the shareholders.

For each of the following statements Patrick Panday had selected the ***"true" option***:

5. An individual who intends to offer (audit) services to audit company financial statements, must be registered with SAICA.

6. A forensic auditor specialises in the audit of compliance by a company with environmental regulations pertaining to the industry in which the company operates.

7. The fact that an external auditor is independent of his client, enables the auditor to certify the client's financial statements as being correct.

8. A review assurance engagement typically consists of only two parties, for example the registered auditor and the shareholders.

9. An unmodified external audit opinion provides a user with absolute assurance that the financial statements on which the opinion is given, are in all material respects, fairly presented.

10. The auditor's opinion given for a review engagement provides the user with limited assurance that the financial statements are correct.

YOU ARE REQUIRED TO briefly explain why each of the answers selected by Patrick Panday is ***incorrect.***

CHAPTER 2

CORPORATE GOVERNANCE, INTERNAL AUDITING AND AUDIT COMMITTEES

2.1 **(32 marks 38 minutes)**

1. Contrast the "comply or else" and "apply and explain" bases of approach to corporate governance. (3)

2. King IV adopts the "apply and explain" basis for its Code on Corporate Governance for South Africa. True or false? (1)

3. Explain the stakeholder - ***inclusive*** approach to corporate governance. (2)

4. Explain the following terms
   * integrated reporting (integrated report) (2)
   * the triple context (2)
   * value creation (2)

5. King IV proposes that companies make sustainable development a top priority. There are a number of key aspects which companies must recognize if they are to achieve sustainability. Identify and discuss these key aspects. (5)

6. Explain the term alternative dispute resolution (ADR) and comment on whether considering ADR is a sound corporate governance practice. (4)

7. In terms of the stakeholder inclusive approach to corporate governance, would the following be regarded as stakeholders in the company?
   7.1 the directors themselves
   7.2 suppliers of goods to the company
   7.3 the commissioner for inland revenue
   7.4 the community in which the company is situated
   7.5 hourly paid employees
   7.6 the company's major competitor (3)

8. Why do listed companies report on their strategies to combat HIV/AIDS, and on whether they have a broad based black economic empowerment strategy? (3)

9. What is a company's Code of Ethics and to whom does it apply? (2)

10. List the six ethical values which, in terms of King IV, are embodied in ethical leadership. (3)

2.2 **(25 marks 30 minutes)**

1. Three of the underpinning philosophies of King IV are, stakeholder inclusivity, profit maximisation and corporate citizenship. True or false. Justify. (1.5)

2. Reporting in the triple context requires that companies report on historical profits, future profits and dividend distributions. True or false. Justify. (1.5)

3. In terms of King IV a company board's role includes four overreaching responsibilities. Two of those are (i) steering and setting strategic direction, and (ii) approving policy and planning. What are the other two? (1)

4. List the four beneficial governance outcomes for a company which, in terms of King IV, may arise through good governance. (2)

5. Distinguish, in your own words, between practices, principles and governance outcomes with reference to King IV. (3)

6. The King IV Report makes frequent reference to the "six capitals" to which a company has access and, in terms of which the value created by the company should be "measured". List the six capitals. (3)

7. Briefly explain the phrase "corporate citizen" in the context of King IV. (2)

8 Compliance with King IV requires that, the chairperson and chief executive officer of a listed company must be different people. True or false. Justify. (1.5)

9. The senior partner of the company's firm of legal advisers should not be the chairperson of the company. True or false. Justify. (1.5)

10. All directors, both executive and non-executive, must be financially literate. True or false. Justify. (1.5)

11. Give two committees of the board on which the chair should not be the chairperson of the company. (1)

12. The company secretary's duties include reporting to the board on failure on the part of the company or a director to comply with the Companies Act 2008. True or false. Justify. (1.5)

13. The role of a compliance officer is to ensure that company personnel comply with the internal control procedures laid down by the company. (1)

14. An internal audit department's primary role is independent evaluation as opposed to operational involvement. (1.5)

15. Internal audit and external audit should co-operate in evaluating the company's financial systems. (1.5)

2.3 **(14 marks 16 minutes)**

The following groupings or individuals play an important role in corporate governance:

1. Chairperson of the board
2. The board of directors
3. Chief executive officer
4. Company secretary

5. Internal audit
6. Audit committee
7. Management.

In terms of the King IV Code specific responsibilities should be assigned to the individuals or groupings listed above.

For each of the questions (1 to 14) below, select your answer from the groupings or individuals listed under 1 to 7. Note: some of the questions the responsible grouping or individual may not be included in the list (1 to 7). If so, indicate this in your answer.

1. Who is responsible for setting the company's short, medium and long term strategy? (1)

2. Who is responsible for designing, implementing and monitoring the process of risk governance? (1)

3. Who should inform and guide the directors as to how their responsibilities as directors, should be met? (1)

4. Who should be responsible for appointing or dismissing the head of internal audit? (1)

5. Who should be responsible for introducing new directors to the manner in which the company "governs"? (1)

6. Who is responsible for providing assurance that management processes to identify and monitor significant risks and opportunities are adequate? (1)

7. Who should appoint the chief executive officer? (1)

8. Who is responsible for appointing new directors? (1)

9. Who should be the chairperson of the remuneration committee? (1)

10. Who should lead the annual performance evaluation of the chairperson? (1)

11. Who should conduct the annual performance evaluation of the chief executive officer? (1)

12. Who should serve as the link between management and the board of directors? (1)

13. Who should ensure disclosure and reporting that enables stakeholders to make an informed assessment of the company's performance? (1)

14. Who should provide independent oversight of the independence of the auditor and other assurance providers? (1)

2.4 **(22 marks 26 minutes)**

1. Principle 1 of the King IV Code states that "the board should lead ethically and effectively". Identify the characteristics which members of the board should cultivate and exhibit in their conduct to achieve this principle. (3)

2. Responsible corporate citizenship is simply about the company obeying the laws and regulations which relate to it, and paying its taxes. Discuss. (4)

3. Give four examples of activities which could be undertaken by a company within the community in which it operates which would reflect responsible corporate citizenship, and explain how these activities in general relate to corporate governance. (5)

4. Principle 2 of the King IV Code states that "the board should govern the ethics of the company in a way that supports the establishment of an ethical culture". Briefly describe the practices recommended by the King IV report to achieve this principle. (5)

5. To fulfil their role as stewards of the company, directors must exercise five moral duties. Identify and explain five moral duties all beginning with the letter "c" which a director should exercise in his actions. Note: the answer to this question is not directly related to the King IV report. (5)

2.5 **(29 marks 35 minutes)**

The Board of Directors is the most important factor in corporate governance, and King IV like its predecessors, places great importance on the role of the board and its directors.

1. Identify the factors which the board should consider in determining the number of directors which should be appointed to the board. (5)

2. Should the Chairperson of the board be an executive director, a non-executive director or an independent non-executive director? Justify. (2)

3. Outline the considerations and procedures to be followed in appointing a director to the Board. (7)

4. The chairperson should appoint the chief executive officer. True or false? (1)

5. If the company secretary has the requisite knowledge of labour law and executive remuneration he or she should be appointed to the remuneration committee. Agree or disagree? Justify. (2)

6. What requirements must a non-executive director satisfy to be classified as an ***independent*** non-executive director? (5)

7. The chief executive officer should be the chairperson of the remuneration committee. True or false? (1)

8. The performance of the chairperson should be evaluated

8.1 annually
8.2 at least every two years
8.3 at the request of the company secretary. (1)

9. Principle 9 requires that performance evaluations of the board, its committees and various individuals should be carried out. Indicate whether each of the following statements is correct or incorrect. Justify.
   9.1 The audit committee should evaluate the chairman of the board.
   9.2 The chairperson of the board may evaluate board members.
   9.3 Only executive directors need to be evaluated.
   9.4 The company secretary should be evaluated at least once a year.
   9.5 The results of the performance evaluations should not be disclosed other than to the board. (5)

2.6 **(21 marks 25 minutes)**

1. Distinguish between executive and non-executive directors. (2)

2. Would the following individuals qualify for appointment as *independent* non-executive directors in terms of the King IV Code? Justify your answer.
   2.1 a partner of the law firm that acts as legal advisors to the company
   2.2 the company's auditor
   2.3 the company's recently retired chief executive officer
   2.4 a shareholder who holds 3% of the company's shares. (4)

3. What is a board committee? (1)

4. What requirements should be satisfied in any board committee to make it successful? (5)

5. Does the Companies Act 2008 distinguish between executive directors and non-executive directors? (1)

6. May a board committee include a person who is not a director? Explain. (3)

7. What functions should a lead independent non-executive director (LID) fulfil? (2)

8. State whether the following are true or false in terms of the King IV Code:
   8.1 The chairperson of the audit committee should be the chairperson of the board? (1)
   8.2 The CEO must chair the remuneration committee. (1)
   8.3 The nominations committee should consist of only non-executive directors. (1)

2.7 **(12 marks 14 minutes)**

1. For the purposes of King IV corporate governance is about
   a. strict compliance with the Companies Act 2008
   b. the process whereby companies are directed and controlled
   c. compliance with government and industry regulations
   d. the exercise of ethical and effective leadership.

2. Which term best describes the basis (application regime) on which the King IV Code is built?
   a. Comply or else
   b. Comply or explain
   c. Apply and explain
   d. Apply and comply

3. Which of the following is ***not*** specifically regarded by King IV as one of the characteristics of ethical leadership?
   a. Responsibility
   b. Accountability
   c. Fairness
   d. Efficiency
   e. Transparency

4. Which of the following is ***not*** a principle of leadership ethics and corporate citizenship?
   a. The board should lead ethically and effectively
   b. The board should ensure that the company is, and is seen to be, a responsible corporate citizen
   c. The board should ensure the company is efficiently and effectively managed to maximize shareholder's wealth
   d. The board should govern the ethics of the company in a way that supports the establishment of an ethical culture.

5. Which of the following is/are ***not*** a recommended practice(s) in the King IV Code?
   a. The chairperson of the board's appointment should be confirmed every two years
   b. The chairperson should be an independent non-executive director
   c. The chairperson should have served as the lead independent non-executive director prior to being appointed as the chairperson
   d. A retiring CEO should not be eligible for appointment as chairperson until a period of 5 years since his retirement has elapsed.

6. Which of the following is true? In terms of the King IV Code the chairperson of the board:
   a. should not be a member of the audit committee
   b. should chair the remuneration committee
   c. must chair the risk committee
   d. should not be a member of the nominations committee

7. Which of the following is true? In terms of King IV the CEO
   a. is not prohibited from being a non-executive director of another company
   b. should be a member of the audit committee
   c. should be accountable, and report to the chairperson of the board
   d. should be the chairperson of the remuneration committee.

8. The balance of power on the board is best attained from which of the following combinations?
   a. A majority of executive directors, with the other directors being non-executive directors, the majority of whom should be independent

b. A majority of non-executive directors, the majority of whom should be independent
c. A majority of non-executive directors, the minority of them being independent
d. A clear majority of executive directors with a non-executive chairman

9. Which of the following is ***not*** a committee specifically recommended by the King IV Code?
   a. Audit Committee
   b. Risk Committee
   c. Sustainability Committee
   d. Nomination Committee
   e. Remuneration Committee

10. Which of the following statements is ***not*** correct in terms of King IV?
   a. A company should disclose the remuneration of each individual director and certain senior executives, provided it has the individual's consent to do so
   b. Shareholders should exercise a non-binding advisory vote on the board's remuneration policy every two years or when other specified conditions exist
   c. Companies should remunerate fairly, responsibly and transparently
   d. The names of the directors who are appointed to the remuneration committee should remain confidential other than to members of the board.

11. Which of the following does ***not*** form part of the oversight responsibilities of the audit committee?
   a. Audit and assurance requirements
   b. The company secretary function
   c. The integrity (reliability and usefulness) of reports
   d. External audit quality.

12. Companies should report in the triple context. Which of the following is ***not*** part of this kind of reporting?
   a. Social performance
   b. Economic performance
   c. Comparative performance
   d. Environmental performance

2.8 **(30 marks 36 minutes)**

Recently, while perusing the annual report of JSE listed company Mullins Inc, you came across the company's disclosure of board and board committee composition. Mullins Inc manufactures agricultural machinery and was founded by Rob Mullins 30 years ago. He listed the company 10 years ago, and did not retain any shares in the company. From the extensive disclosures, commentaries and reports in the annual report, you were able to extract the following information pertaining to the board:

Rob Mullins (Executive Chairman) B.Sc (Engineering)
Tammy Quinn (CEO) B Comm MBA
Beth Foley (Finance Director) (CA) SA
Themba Dlamini (Operations Director) M. Sc (Agriculture)
John Naidoo (Human Resources Director) B.A. (Sociology)

Thembi Mbethe (Marketing Director) MBA
Perry Majola (non-executive Director) CA (SA))
Pete Copley (non-executive Director) CA (SA)

Note 1. Rob Mullins stepped down as CEO a year ago after 30 years of service as the CEO, immediately assuming the newly created role of Executive Chairman.

Note 2. Perry Majola was for a number of years Mullins Inc's Finance Director, but retired 2 years ago. Rob Mullins, an engineer, was not interested in the financial function at all, and relied heavily on Perry Majola for financial information and financial decisions. He rejoined the board at Rob Mullins' request when Rob Mullins became the chairman. Rob Mullins has always taken responsibility for recommending and having directors appointed by the shareholders or appointing them himself.

Note 3. Pete Copley is the CEO of Astro Invest, a large JSE listed company within the financial services sector. Neither Pete Copley nor Astro Invest have any financial interest in or business relationship with Mullins Inc.

The company has two board committees, an audit committee and a remuneration committee each consisting of three members. Both are chaired by Rob Mullins and generally meet a few weeks after the financial year-end to discuss the recently completed audit and consider the remuneration of company personnel for the upcoming year. Perry Majola serves on both committees, as does Thembi Mbethe. The position of company secretary has been vacant for six months. Rob Mullins will make an appointment during the course of the upcoming financial year.

The board of directors meets every quarter, but Thembi Mbethe is often forced to tender her apologies due to her demanding travel schedule and the fact that she holds the appointment of non-executive director in a number of other companies.

YOU ARE REQUIRED TO comment on the information provided above in the context of the recommended practices provided by the King IV Code and the requirements of the Companies Act 2008 pertaining to the composition of the board and the composition, sufficiency, and role of the board committees.

2.9 **(40 marks 48 minutes)**

You are the auditor of EePio (Pty) Ltd, a large chemical manufacturer. Due mainly to the size of the workforce and its turnover, the company has a public interest score of nearly 1200. Evan Cadel, the chief executive of the company, has called you to a meeting to clarify certain issues relating to corporate governance.

At the meeting Evan Cadel informed you that the company was coming under increasing pressure from a number of sources, including one of the company's shareholders, a listed company, to adhere to the principles of corporate governance contained in the King IV Code on Corporate Governance. He concluded by saying, "I personally think these corporate governance codes are a load of rubbish, we didn't have them 30 years ago and we don't need them now. But if there are superficial changes I can make to keep everyone happy, I'll think about it. Our responsibility is to maximize profits for shareholders and not to spend them on charity and do good causes."

EePio (Pty) Ltd has always been a tightly run company. Evan Cadel and his sons Hugo and Oscar, together have held 45% of the shares in the company since its inception in 1985. In addition to being shareholders, Evan Cadel is the chairperson of the Board, and Hugo and Oscar fill the roles of financial director and production director respectively.

The Cadel's influence has always ensured the appointment of executive directors of their choice to fill the remaining two positions on the company's Board, which are held by Jack Jones and Gordon Smith. Evan Cadel insists on the Board of Directors being totally committed to and involved in the company. He demands that the directors work as a team to get the job done themselves, without "engaging outsiders and forming committees."

The company's basic operational and reporting philosophy is one of secrecy and minimum disclosure. Evan Cadel's reasons for adopting this philosophy are that in the highly competitive chemical industry, EePio (Pty) Ltd has a record of being more successful and profitable than any of its competitors. In his opinion, "the less information available to competitors and other parties, the better the company is able to protect this competitive advantage and limit exposure to groundless lawsuits and strikes by workers. As far as financial reporting goes our policy has been to follow the requirements of IFRS to the extent necessary to satisfy the auditors. We are not interested in integrated reporting because our shareholders are simply not interested in masses of other useless information."

YOU ARE REQUIRED TO:

a) briefly discuss the points you would raise to explain to Evan Cadel why codes of corporate governance should not be regarded as a "load of rubbish". (9)

b) comment on Evan Cadel's statement that "if there are superficial changes I can make to keep everyone happy, I'll think about it". (3)

c) list the instances of non-compliance with the recommended practices in the King IV Code pertaining to the existing of board of directors at EePio (Pty) Ltd. (8)

d) identify the board committees, other than a remuneration committee, which EePio (Pty) Ltd should appoint to satisfy the recommendations of King IV. Provide reasons as to why the appointment of each committee would be beneficial to EePio (Pty) Ltd. (12)

e) comment on Evan Cadel's attitude to reporting in the context of the requirements of King IV. (8)

2.10 **(30 marks 36 minutes)**

Principle II of King IV states that "the board should govern risk in a way that supports the company in setting and achieving its strategic objectives".

1. The King IV definition of risk consists of three parts. Identify the three parts. (2)

2. Risk governance is not really important in small or medium sized businesses, it's only important in listed companies which have a large number of shareholders. True or false? Justify. (3)

3. Who in a large listed company should be responsible for:
   3.1 implementing the risk governance process? (.5)
   3.2 determining the levels of the company's risk appetite? (.5)
   3.3 overseeing risk governance? (.5)
   3.4 providing the board with independent assurance on risk governance? (.5)

4. What is a company's risk philosophy? (2)

5. Identify four key risks facing the modern company. (2)

6. Explain briefly how risk and opportunity are linked in the context of a company's strategy. (2)

7. Identify five (general) outcomes which should result from a company's risk management process. (5)

8. Identify eight objectives which should be achieved by effective technology and information management in a large company. (4)

9. Describe four possible risk response options which a company may adopt. (4)

10. Identify four matters which should be disclosed in relation to technology and information. (4)

2.11 **(38 marks 46 minutes)**

The sustainability of any company can be threatened by any number of risks. Obviously not all companies face the same risks.

The risks identified below have all been taken from the annual reports of companies listed on the JSE. The annual reports were selected from different types of companies, e.g. banking, mining, farming, etc. All of the risks listed below threaten the sustainability of companies of more than one type:

1. climate change

2. HIV/AIDS

3. proliferation of fake branded goods on the market

4. impact of the company's operations on the environment

5. withdrawal of licence to operate

6. internet downloads

7. fire

8. decline in government infrastructure spending

9. rising costs of private medical care.

Virtually every single company listed on the JSE will face technology and information risk frequently referred to as IT risk. The responsibility for governance of this risk appropriately is, in terms of King IV Principle 12, a duty of the board. The board's overall responsibility is to formulate an IT governance framework. IT management should be delegated the responsibility for the implementation of the IT framework, which will include what is termed the information security management system (ISMS) .

YOU ARE REQUIRED TO:

a) identify for each of the risks listed above (1 to 9), two types of company which are likely to regard the risk as being a material and specific risk to the company's sustainability. You must justify your selection. (27)

   Note: many of the risks listed in the question (1 to 9) affect all large companies to some degree. This question requires you to identify risks which are "material and specific" threats to the company. For example HIV/AIDS affects most large companies to some degree, but some types of company are materially and specifically threatened.

b) identify three high level information security principles which the information security management system (ISMS) for any listed company should include and explain why the implementation of these principles is particularly important for the sustainability of a listed company which operates private hospitals. (11)

2.12 (44 marks 53 minutes)

Treelines Ltd is a large forestry company which grows and harvests trees and transports them to its mills where the timber is pulped, (an operation which uses a great deal of water and produces an unusable waste) for the manufacture of pulp based products. Demand for pulp based products is declining worldwide, but demand for other timber products is stable.

The company's forests are spread over numerous regions of the country and the majority are in remote areas. A key element of the location of forests for both re-planting (once trees have been harvested) and new forests is the level of local rainfall as forests are not irrigated.

Treelines Ltd employs a reasonably large work force at its forest locations ranging from unskilled (e.g. planters) to skilled logging machine operators all of whom are vital to the operation. It also has a large administration, financial, marketing and support staff of mixed gender and race at its head office.

The board of Treelines Ltd adopts sound corporate governance in how it conducts its business and in how it reports to its stakeholders. Integrated sustainability reporting and disclosure is regarded as an important part of keeping stakeholders informed, building and maintaining relationships and promoting respect between the company and the stakeholders.

YOU ARE REQUIRED TO:

a) explain in your own words the term integrated reporting. (4)

b) comment on whether integrated thinking and the integrated report are connected. (3)

c) briefly describe the characteristics of effective integrated reporting. (10)

d) identify the capitals on which the "six capitals" model is based. (3)

e) discuss how frequently a company like Treelines Ltd should report to its stakeholders on sustainability and other issues. (2)

f) identify the stakeholders, other than the shareholders, with whom Treelines Ltd should be building relationships and indicate briefly for each why you consider them to be stakeholders. (10)

g) identify and briefly discuss, ***based on the information about Treelines Ltd given in the question***, the sustainability issues which you would expect the company to report on in its integrated report/annual report. (12)

2.13 **(27 marks 32 minutes)**

Paintmaker Ltd is a large paint and related product manufacturer. The company's products are aimed exclusively at the expensive end of the market and the company has built up a reputation for quality. The market for this type of product is very demanding and it is extremely important for manufacturers in this sector to maintain product quality. The directors are considering whether to introduce a cheap range of paint into the local market directly aimed at the mass housing sector. This market is very competitive and specialized in its own way but the production director has suggested that the company's existing manufacturing equipment could be adapted to produce the low quality paint.

The company has a diverse operational staff ranging from a large number of semi-skilled wage earners to scientifically trained product researchers. All the product researchers are trained in Germany.

Paintmaker Ltd's manufacturing process for its major product (paint) is complex. Innovation and development in manufacturing technology is aimed at producing better quality paint is rapid and equipment is expensive. Paintmaker Ltd's preferred method of funding equipment is by financial lease. All the major equipment and machinery must be imported from Germany. German technicians fly out twice a year to service the equipment.

All of the company's information systems e.g. financial, marketing, inventory control as well as the manufacturing process are computerized, the latter being a very sophisticated system. Most of the raw materials for manufacture are imported.

The paint manufacturing process produces fairly extensive waste, some of which is used in the manufacture of related products. Paintmaker Ltd does export some paint but the majority of sales are local. The paint manufacturing industry is highly regulated with regard to pollution, emissions, etc.

Because raw materials are imported it is necessary for Paintmaker Ltd to hold substantial inventories of raw materials, many of which are highly flammable.

The board of directors believes strongly in sound corporate governance including compliance with King IV. The risk management process is overseen by a risk committee.

For the purposes of risk assessment, the risk committee categorises the risks faced by the company into the following types:

1. Strategic - the risks associated with strategic decisions to be taken by the company.
2. Financial - risks which have a direct effect on the financial aspects of the company.
3. Reputational - risks to the reputation of the company.
4. Compliance - the risk that a business decision may result in significant breaches of legislation.
5. Operational - risks which arise from the operation of a paint manufacturing process.
6. Information - risks facing the company's information technology systems.

YOU ARE REQUIRED TO:

a) discuss the composition of a risk committee for a company such as Paintmaker Ltd. (4)

b) identify and briefly explain four risk response options which any company may adopt to address risk. (5)

c) identify, from the information given above, risks which Paintmaker Ltd face. You must describe ***two*** risks for each risk type identified in the question. (18)

2.14 **(33 marks 40 minutes)**

As a part of stakeholder relationship management (Principle 16), King IV recommends that formal dispute resolution mechanisms be adopted by the company to resolve disputes.

KayDarren Ltd is a listed industrial company with interests in mining, engineering and manufacturing. The company has a large workforce, is involved in import and export and has a significant customer and supplier base. Some of the company's operations e.g. mining, are in remote areas of the country.

As with any company of this size, a wide range of disputes can arise with both internal and external parties, e.g. labour disputes, disputes with suppliers, land owners, etc. The company has a well staffed legal department and retains the law firm of Redfern and Findlay as its professional legal advisers.

Both the head of the internal legal department and Redfern and Findlay believe that where possible disputes should be settled by alternative dispute resolution and this philosophy has been endorsed by the board of KayDarren Ltd.

The following matters, inter alia, have arisen during the year at KayDarren Ltd:

1. A senior member of management in one of the company's divisions defrauded the company of approx R1m. The board wishes to recover this money and send a clear message to all employees that this type of action will not be tolerated by KayDarren Ltd under any circumstances.

2. The company and one of its major customers in France are in dispute about the amount owed to KayDarren Ltd in respect of a transaction between the two parties. Redfern and Findlay have advised that the problem appears to have arisen because of a difference in an important clause in the contract relating to the transaction. The way the French contract is worded, is different to how the same clause is worded in the English contract. This contract does not contain a dispute resolution clause.

3. The employees on a remote, recently opened mine belonging to the company have threatened to strike if KayDarren Ltd does not improve the living conditions of employees which they allege were promised when the mine opened. The mine employs most of the small local community, and the company is of the opinion that it has more than filled its promises. The employees do not belong to a union.

YOU ARE REQUIRED TO:

a) briefly explain the term alternative dispute resolution. (2)

b) explain with reference to the King IV Code why dispute resolution is considered to be part of sound corporate governance. (4)

c) explain the terms mediation, conciliation and arbitration. (6)

d) describe, with a brief explanation, the factors which should be considered by KayDarren Ltd in deciding in general, which dispute resolution method to follow. (10)

e) discuss which method of dispute resolution should be adopted in each of the matters listed above (1 – 3). Your discussion must include a justification of your choice. (11)

2.15 **(22 marks 26 minutes)**

1. Distinguish between compliance-based internal audit and risk-based internal audit. (3)

2. Should the internal audit function report to the external audit engagement partner? Discuss. (2)

3. Does internal audit form part of a company's combined assurance model? Explain. (2)

4. The chief audit executive should be appointed by the shareholders. True or false? (1)
5. Who is responsible for overseeing that the internal auditors and the external auditors co-operate where possible? (1)

6. The Companies Act 2008 requires that companies have an internal audit department. True or false? Justify. (2)

7. Internal audit's primary function is to detect fraud and corruption. True or false? Justify. (3)

8. What is the position taken by King IV with respect to companies having an internal audit function? (3)

9. The chief audit executive should not be given direct access to the chairman of the board as this undermines the authority of the members of the board. True or false? Justify. (2)

10. List 6 key attributes which the CAE should possess to be able to fulfil the function. (3)

2.16 **(26 marks 31 minutes)**

Patula Industries (Pty) Ltd is a large manufacturing company. They have always complied with sound corporate governance principles including the appointment of an audit committee, but do not have an internal audit function. In the past the board has taken the view that if the external auditors do their job properly, then there is no need for internal auditors. After complaints about this policy from a number of shareholders, Patula Industries (Pty) Ltd has decided to establish an internal audit function.

As an independent corporate governance consultant, you were requested to attend a meeting of the board to answer any questions the directors might have. The following questions were put to you:

1. Expressed simply, what is the difference between the internal and external audit functions? (3)

2. How frequently will internal audit report to us (the board)? (2)

3. Internal audit used to be compliance based but now it is risk based! Why must internal audit now use the risk based approach and not the compliance based approach? (3)

4. What are the key attributes of the internal audit function? (2)

5. How can we as a board provide the necessary 'conditions' for internal audit to attain and retain the status it requires to fulfill its role? (6)

6. The board will need to appoint a chief audit executive; what will we be looking for in this person? (4)

7. The idea of an internal audit function sounds impressive but how will having an internal audit function help us (the board) discharge our governance responsibilities? (4)

8. Could the board not just engage our external auditors to carry out the internal audit function? (2)

YOU ARE REQUIRED TO answer the questions put to you by the board.

2.17 **(30 marks 36 minutes)**

Dyson (Pty) Ltd is a large manufacturing company which adheres to high standards of corporate governance. The company has a strong internal audit department as well as an audit committee. The chief audit executive, Floyd Mayweather has obtained board approval to appoint a senior audit manager in his department. Floyd Mayweather, having provided human resources with the characteristics he is looking for in the appointee, is currently reviewing the comments pertaining to each of the applicants who had been interviewed. The comments are as follows :

Carmen Naidi	newly qualified chartered accountant, two years post-trainee experience as a line accountant in a retail organization. Very quietly spoken and nervous.
Zee Zidane	B.Comm (Accounting) six years of experience with internal audit at SARS. Very thorough, independent thinker, very aggressive in her approach to people.
Joe Royle	C.I.S. (Chartered Institute of Secretaries), five years experience as the company secretary of a large non-listed company. Five years experience as an internal auditor in a government parastatel. Member of the Institute of Internal Auditors.
Ashad Vialli	BA. LLB. MBA. Recently returned from a 2 year secondment to a large banking organization in New York where he was involved in takeover financing and risk management. Meticulous in his presentation, flamboyant and charming. Very ambitious.
Jon Carstens	No formal qualification. 20 years experience in internal audit. Very confident in himself to the extent that he does not value the opinion of others. Displays an attitude of "I've seen this all before…"
Cameron King	Eight years as a senior internal auditor at Dyson (Pty) Ltd. Regarded as a very hard worker and responsible individual. Generally very nervous when dealing with senior personnel. Has served on the Risk committee at Dyson (Pty) Ltd for two years, making a quiet but meaningful contribution.
Lance Carredo	A chartered accountant, member of the Institute of Internal Auditors and part-time wildlife conservationist. Resigned from his previous appointment as an internal audit manager because of an alleged leak of information to the media about environmental damage caused by one of

	the divisions of the company where he conducted an environmental audit.
Justice Matese	A chartered accountant and member of the Institute of Internal Auditors. Currently an internal audit manager at Eskom. Prior to that he had spent a number of years as an arbitrator in the labour market where he gained a reputation for his fair mindedness and hard work.
Scott Fines	A well qualified computer systems analyst who had been responsible for most of the financial systems at Dyson (Pty) Ltd. As he has worked on computer systems throughout the company at some time or other, he is very well known by the staff. Very friendly and popular with all. Currently in the final year of his internal auditing examination studies and looking for a career change.

YOU ARE REQUIRED to indicate for each of the applicants above, whether Floyd Mayweather is likely to consider the applicant suitable for appointment, based on the information given above. Your answer should convey your understanding of the characteristics/attributes needed by an internal auditor in this position.

2.18 **(20 marks 25 minutes)**

Stapleking (Pty) Ltd is a large manufacturer and wholesaler of a wide range of fasteners e.g. staples, tacks, drawing pins. The company has a number of divisions e.g. commercial fasteners, domestic fasteners etc. Controls are sound and include an internal audit department which is staffed by competent internal auditors. Internal audit activities are scheduled at the start of each financial year but during the year, numerous requests are received from within the company for "internal audit" to carry out various assignments. The following requests have been received:

1. Lindsay Haffejee, the chief audit executive, has been asked by the human resources director to serve on a selection committee for the appointment of a new company secretary.

2. The financial director has asked the internal audit department to design and implement a costing system for a new type of product which is to be manufactured.

3. The IT manager has asked internal audit to conduct a post-implementation review on a recently introduced telesales ordering system.

4. The warehouse manager has requested internal audit to perform an audit to determine whether the company is complying with all necessary safety regulations e.g. fire protection, ventilation etc.

5. The financial director has requested internal audit to schedule an investigation into the payroll and personnel cycle to determine whether there are fictitious employees, (dummy workmen), on the payroll.

6. The production director has requested internal audit to conduct inventory cycle counts in the finished goods warehouse on an ongoing basis.

7. The external auditors have requested internal audit to assist them with the verification of the existence of plant and equipment at an interim audit.

8. The board of directors has requested internal audit to assist in identifying, evaluating and assessing significant organizational risks.

9. The sales director has requested internal audit to evaluate the operational efficiency of the company's procedures for placing tenders for the supply of the company's products to government departments.

10. The financial director has requested internal audit to perform an analysis of the monthly management accounts and make a presentation to the Board on a quarterly basis.

YOU ARE REQUIRED TO indicate, giving reasons how Lindsay Haffejee, as the chief audit executive, should respond to the above. (20)

2.19 **(34 marks 41 minutes)**

Digitronic Ltd is a listed company in the electric and gas appliance industry. Some months ago the company acquired a majority interest in Pilot (Pty) Ltd, a large company specializing in home appliances. Pilot (Pty) Ltd has a public interest score way above 350 and has been one of your audit clients for many years. Digitronic Ltd has laid down a number of requirements relating to corporate governance which subsidiaries must put in place. The board of directors of Pilot (Pty) Ltd has received a written instruction from Digitronic Ltd which listed the following requirements:

1. Pilot (Pty) Ltd must appoint an audit committee as soon as possible. Members of this committee are required to satisfy the requirements of the King IV Report on Corporate Governance for South Africa 2016.

2. Once this committee is in place, Pilot (Pty) Ltd is to create an internal audit department forthwith. The board is to ensure that internal audit status in the company is such that it is strategically positioned to achieve its objective, as the Digitronic group regards internal audit at an important component of each subsidiary's combined assurance model.

Reaction to these requirements from the directors was mixed and as none of the directors has a background in auditing, you have been asked by Glen Gibb, the chief executive officer, to come to a meeting of Pilot (Pty) Ltd's seven directors (all of whom are active in the business) to answer questions which the directors might want to ask.

The following questions were put to you during the discussion:

1. If your firm (external auditors) is doing its job, which we think you are, why do we need internal auditors? (8)

2. What is "Pilot (Pty) Ltd's combined assurance model?" (6)

3. Who will be in charge of the internal audit department; will it be one of our present seven directors? (2)

4. What does "the board is to ensure that internal audit's status in the company is such that it is strategically positioned in the company to achieve its objective" mean and how do we do this? (6)

5. Is the audit committee part of internal audit? (2)

6. How many members of the audit committee must there be and what do we have to do "for members to satisfy the requirements of the King IV Report" as instructed? Which of us (the seven directors) has to be on the audit committee? (5)

7. If internal audit "achieves its objective" will that mean we no longer require an external audit from your firm? Isn't there some rule that private companies do not need to be audited by external auditors? (3)

8. Who bears the cost of internal audit? Will it be our holding company? (2)

2.20 **(28 marks 33 minutes)**

Whilst completing your training contract you spent many hours on corporate governance work, and have become quite knowledgeable on the various aspects thereof . A family friend who is the chief executive officer of Cranks (Pty) Ltd, a large manufacturing company and one of your firm's audit clients, is considering establishing an audit committee and has asked you around informally to give him a better insight into audit committees. You are not a member of the Cranks (Pty) Ltd audit team. During the discussion he posed the following questions:

1. Is my company under any legal obligation to appoint an audit committee or is it only the King Report IV which requires it? If we do appoint an audit committee who defines the composition, purpose and duties of the committee? (3)

2. Will it be my duty to appoint the committee and to be the chairman of the committee? (3)

3. What exactly is an audit committee and is it any different to our internal audit department? (5)

4. What should the composition of the audit committee be assuming that we would comply with the requirements of King IV? (4)

5. Can you give me six clear benefits of having an audit committee and are there any disadvantages? (6)

6. How can we, as a company, ensure that we have a successful audit committee? (7)

YOU ARE REQUIRED TO respond to the above questions.

2.21 **(30 marks 36 minutes)**

1. The recommended practices relating to Principle 8 of the King IV Code require that the board of any company which issues audited financial statements should establish an audit committee. State whether each of the following is true or false. Justify your answer.

   1.1 The majority of members appointed to the audit committee of a public company should be directors. (1)
   1.2 All members of the committee should be independent non-executive directors. (1)
   1.3 The company secretary must be a member of the audit committee. (1)

2. King IV recommends that members of the audit committee should, as a whole, have the necessary financial literacy skills and experience … State whether each of the following is true or false. Justify.

   2.1 The audit committee of a public company must consist of at least two members, but there is no maximum number. (1)
   2.2 All members must have at least an undergraduate financial qualification or have been directly involved in financial accounting for not less than ten years. (1)
   2.3 At least one member of the audit committee must have a legal background and a sound knowledge of corporate law. (1)

3. King IV recommends that the audit committee should oversee the integrity of the annual financial statements and other external reports. State whether each of the following is true or false. Justify your answer.

   3.1 The audit committee should be responsible for monitoring the integrity and completeness of the company's financial reporting. (1)
   3.2 The audit committee should encourage "opinion shopping" (e.g. approaching other auditors for a different opinion on the company's AFS), but only if the board unanimously supports this action. (1)
   3.3 The chairman of the audit committee should recuse himself from the AGM when the financial results are discussed with the shareholders so as not to undermine the position of the financial director. (1)
   3.4 The audit committee should review management's assessment of the going concern ability of the company at the financial year-end. (1)
   3.5 If the board deems it appropriate, the audit committee may be given the responsibility of reviewing the integrated report. (1)

4. King IV recommends that the audit committee should oversee that assurance services and functions are effective in achieving their objectives. State whether each of the following is true or false. Justify.

   4.1 The combined assurance model is made up of internal and external assurance providers. (1)
   4.2 The company secretary is not an assurance provider. (1)
   4.3 The chief audit executive (head of internal audit) is a part of the combined assurance model. (1)

5. Discuss the relationship between the audit committee and internal audit. (3)

6. State whether each of the following is true or false. Justify your answer.
   6.1 The audit committee may be responsible for overseeing the design, implementation and maintenance of a sound system of internal financial control. (1)
   6.2 The audit committee should conclude and report annually on the effectiveness of the company's internal financial controls, but only if weaknesses in internal control have resulted in fraud or theft. (1)
   6.3 The audit committee should play no role with regard to "whistle blowers" (internal or external) as this is a responsibility of internal audit. (2)

7. In terms of King IV can the board delegate the responsibility of risk governance to the audit committee? (2)

8. Section 94 of the Companies Act 2008 states that the audit committee is responsible for recommending to the shareholders, the appointment of the external auditor. State whether each of the following is true or false. Justify your answer.

   8.1 The audit committee of a listed company must ensure that the auditor it recommends to the shareholders for appointment, is independent of the company and is approved by the JSE. (1)
   8.2 The audit committee may approve any proposed agreement for the external auditor to provide internal audit services. (1)
   8.3 The audit committee is responsible for dealing with any reportable irregularity which may be reported to the company by the external auditor. (1)

9. List four matters on which the audit committee should express its views for disclosure by the company in the annual report. (4)

2.22 **(20 marks 24 minutes)**

JayB Ltd is a listed manufacturing company. Due to resignations from the audit committee, the company wishes to appoint three new members to join the only remaining member from the previous committee. The remaining member is Robbie Wessels, an independent non-executive director of JayB Ltd and a certified financial analyst. The procedure which the company will follow will be to request the nominations committee to present its recommendations to the shareholders as to who the shareholders should elect to the audit committee at the upcoming annual general meeting.

The nominations committee has called for the names of individuals to be submitted to it for consideration for appointment to the audit committee. The following names have been put forward:

1. Gambhir Gull - Company secretary of JayB Ltd.
2. Rod Dodger - Professor of corporate law at Unisa and not connected to JayB Ltd in any way.
3. Karl Zeiss - Chairman and non-executive director of JayB Ltd.

4.	Terry Ticker	-	Senior partner of Ticktock Inc, JayB Ltd's auditors. He is not the designated auditor, but does advise the company on taxation.
5.	Aaron Khumalo	-	CA(SA), senior manager of JayB Ltd's BB - BEE function.
6.	Klark Gayble	-	CA(SA) an independent non-executive director of JayB Ltd.
7.	Theuns Jordaan	-	Production director of MayB (Pty) Ltd, a subsidiary of JayB Ltd.
8.	Jennifer Jacobs	-	An industrial psychologist who has no connection with the JayB group, but is well known in business circles.
9.	Rod Grind	-	CA(SA) and former chairman of JayB Ltd who retired four years ago. He holds 4% of the shares in JayB Ltd and his company Rodds (Pty) Ltd supplies JayB Ltd with certain manufacturing materials. Although he resigned his chairmanship he still holds a position of non-executive director of JayB Ltd.

YOU ARE REQUIRED TO indicate whether each of the above is eligible for appointment to the audit committee of JayB Ltd if the company is to comply with the highest standards of corporate governance. Fully justify your decisions.

2.23 **(20 marks 24 minutes)**

Precaste Ltd is a listed company in the construction industry. The company maintains high standards of corporate governance and has in place a strong independent internal audit department, audit committee and other committees recommended/required by the King IV Code.

YOU ARE REQUIRED to indicate whether the ***audit committee*** should carry out the following procedures. Where the answer is no, indicate which person or body or committee at Precaste Ltd should do so.

1. Discuss the external auditor's engagement letter with the external auditors, prior to the commencement of the audit.

2. Identify risks facing the company.

3. Review the content of preliminary announcements of the company's financial results to be made to the public.

4. Determine Precaste Ltd's policy on executive remuneration.

5. Identify and nominate candidates to fill vacancies on the board as and when they arise.

6. Make suggestions to external audit as to problem areas which should be addressed by the external audit team.

7. Identify discriminatory labour practices at Precaste Ltd.

8. Investigate suspected fraudulent activity in one of the divisions of Precaste Ltd.

9. Make the directors aware of all laws and regulations relevant to their responsibilities and duties to Precaste Ltd.

10. Appoint a new financial director to join the company.

11. Negotiate the performance of non-audit services to be conducted by the external auditors.

12. Review any significant differences of opinion between internal audit and the heads of departments in which internal audit has conducted assessments or evaluations.

13. Identify key matters arising out of the current years management letter (from the external auditors) and monitor them to confirm that they are being followed up.

14. Ensure that the minutes of all shareholders' meetings are properly recorded in the minute register.

15. Select the departments or divisions of Precaste Ltd on which an operational audit is to be conducted.

16. Review material related party transactions.

17. Oversee the company's responsible corporate citizenship objectives.

18. Review the disclosures in the integrated report of Precaste Ltd's policies on environmental issues pertaining to the proposed construction of a factory near a sensitive ecological area.

19. Recommend amendments to Precaste Ltd's corporate code of conduct.

20. Evaluate the performance of the chairman of the board.

2.24 **(20 marks 24 minutes)**

Boston Ltd is the holding company in the Boston group of companies. The company is part of a large group of companies in the agricultural sector. The group has a properly constituted audit committee as well as other board committees recommended by King IV. These committees perform their respective functions for all companies in the group.

YOU ARE REQUIRED TO indicate giving brief reasons, whether each of the following should be a function of the audit committee:

1. Confirming the appointment of the Chairman of the Board of Boston Ltd.

2. Approving each of the members of the audit teams for the upcoming external audits of the group companies.

3. Settling disagreements between the external auditors and the financial director with respect to the appropriateness of various accounting policies.

4. Authorising terms and conditions of a major contract for Boston Ltd to supply agricultural goods to a subsidiary in the group.

5. Authorizing a contract in which a director of Boston Ltd has a material financial interest.

6. Carrying out an evaluation of the independence of the external auditor of Boston Ltd.

7. Authorising the bonuses paid to the directors of group companies.

8. Planning the work schedule for the group internal audit department.

9. Recommending a firm of auditors to replace the existing auditors of one of the group subsidiaries. The existing auditors have resigned.

10. Approving the audit fee charged by the external auditors for each of the group companies.

CHAPTER 3

PROFESSIONAL CONDUCT

AND

ETHICAL CONSIDERATIONS

3.1 **(20 marks 24 minutes)**

1. A conceptual framework approach to professional conduct is confusing; there should just be a fixed set of rules to regulate professional conduct. Comment. (4)

2. It is not necessary to have a Code of Professional Conduct as chartered accountants should know how to act ethically and professionally. State whether you agree or disagree. Justify. (4)

3. What are the fundamental principles on which the SAICA Code of Professional Conduct is based? (3)

4. What is the meaning of the phrase "public interest" in the context of the accounting profession? (3)

5. Chartered accountants ***in public practice*** must put safeguards in place against contravening the fundamental principles of the Code; however, this does not apply to chartered accountants ***in business*** as the Code is not aimed at them. True or false? Justify. (2)

6. Under what circumstances can a chartered accountant in public practice ignore a threat to his/her adherence to the fundamental principles? (1)

7. What are the two attributes identified by SAICA as the pre-eminent attributes of chartered accountants? (1)

8. The fundamental principles on which the SAICA Code is based do not apply to non-assurance engagements. Comment. (2)

3.2 **(20 marks 24 minutes)**

The SAICA Code of Professional Conduct adopts a conceptual framework approach as its basis of construction. To apply the approach, the chartered accountant must understand

* the fundamental principles on which the Code is based
* the types of threat to the chartered accountant's compliance with the fundamental principles
* the safeguards which may be put in place to address the threat of non-compliance.

YOU ARE REQUIRED TO:

a) discuss the steps which a chartered accountant should carry out in applying the conceptual framework approach. (8)

b) identify and briefly explain any four of the five categories of threat suggested by the Code. Examples are not required. (6)

c) describe briefly six general safeguards in the work environment of an audit firm which will contribute to ensuring that threats to compliance with the fundamental principles will be properly responded to. (6)

3.3 **(20 marks 24 minutes)**

1. Explain the differences if any, between a Registered Auditor and a Chartered Accountant. (2)

2. The SAICA Code of Professional Conduct (ET) consists of three parts, A, B and C. Distinguish between the three parts. (2)

3. Does the IRBA have its own Code of Professional Conduct? (1)

4. Do the Rules Regarding Improper Conduct of the Independent Regulatory Board for Auditors apply to all professional accountants who use the designation Chartered Accountant (SA)? Explain. (2)

5. Explain briefly the meaning of the phrase "public interest". (2)

6. Why is it very important that the profession recognizes its public interest responsibilities? (2)

7. List the five fundamental principles of professional conduct which should be adhered to by chartered accountants. (3)

8. List four characteristics which distinguish a profession. (2)

9. Explain the term "conflict of interest" and give three examples of situations which may give rise to "conflict of interest" for a chartered accountant. (4)

3.4 **(40 marks 48 minutes)**

1. Audit firms should never accept gifts from their clients.

2. If a chartered accountant does not have the necessary competence to complete all aspects of the audit he should not accept the assignment.

3. A chartered accountant may make use of confidential information obtained at a client to protect his professional interests in a court of law.

4. A chartered accountant may assist a client to evade tax by putting forward a proposal favourable to the client.

5. Advice given to a client by a chartered accountant on taxation matters should preferably ***not*** be put in writing as the chartered accountant may be held accountable at a later stage if anything goes wrong.

6. Chartered accountants in public practice may call on prospective audit clients to offer their services.

7. In their advertising campaigns, audit firms may
   7.1 include testimonials from their most prestigious clients

7.2 indicate their links to prominent figures in the business world.

8. Advertisements for professional services may
   8.1 state hourly charge out rates
   8.2 compare charge out rates to other firms' charge out rates.

9. A chartered accountant may not hold shares in an audit client.

10. A chartered accountant may enter into a trading transaction with an audit client.

11. A chartered accountant who ***inherits*** shares in his audit client which is a listed company is not required to dispose of the shares or give up the audit appointment.

12. If a chartered accountant who acts as a director of a company is offered the position of auditor of that company, he may accept the position as auditor immediately provided he resigns from his directorship.

13. If a chartered accountant's son is appointed as financial director of a company to which the chartered accountant acts as auditor, the chartered accountant may retain the audit provided he discloses the relationship in the audit report.

14. A situation in which a chartered accountant's fees from one client represent a disproportionate percentage of his total fee income should be avoided. This is because if that client is no longer able to pay his fees, the chartered accountant himself may not be able to meet his financial obligations, thereby bringing the profession into disrepute.

15. Fees should be charged in accordance with what the "market can bear".

16. Commission paid to a chartered accountant by a third party (e.g. service provider) as a result of the chartered accountant referring a product or service to his client should be disclosed to the client only if the provider of the product or service agrees to it.

17. Where a chartered accountant has audited a set of financial statements to be used by the client to support a loan application, the chartered accountant may charge a percentage of the loan as a fee if the application is successful.

18. With regard to money held on behalf of his clients, a chartered accountant should
   18.1 bank the money in a separately designated bank account unless the client agrees otherwise
   18.2 use the money only in accordance with client instructions
   18.3 not breach the fundamental principle of professional behaviour by enquiring about the source of the money.

YOU ARE REQUIRED TO state whether, in terms of the Code of Professional Conduct, each of the above is ***true*** or ***false***, giving a short explanation for your answer where necessary.

3.5 **(15 marks 18 minutes)**

The Code of Professional Conduct categorises threats to chartered accountants into five categories:

* self-interest threats
* self-review threats
* advocacy threats
* familiarity threats
* intimidation threats

YOU ARE REQUIRED TO explain the meaning of each threat and give two examples of how each threat could arise.

3.6 **(24 marks 29 minutes)**

YOU ARE REQUIRED TO indicate whether each of the following statements is true or false. Provide a brief justification for your choice.

1. Where an engagement partner holds shares in an audit client, a self review threat exists.

2. Where an engagement partner holds shares in an audit client, an acceptable safeguard against non-compliance with the Code will be to hold the shares in the name of a trust controlled by the partner and of which he is a beneficiary.

3. Intimidation threats can affect the auditor's objectivity and integrity.

4. The spouse of a chartered accountant in public practice is regarded as a close family member for purposes of applying the Code of Professional Conduct.

5. When conducting a review of the financial statements of a company with a public interest score of less than 100, the chartered accountant in public practice need not concern himself with the independence requirements of the Code of Professional Conduct.

6. Trainee accountants are not subject to the requirements of the Code of Professional Conduct. They will be disciplined by the firm with which they are serving their training contract.

7. A chartered accountant in public practice may not take custody of cash belonging to a client until he has satisfied himself that the money does not come from illegal sources.

8. A chartered accountant in public practice may accept gifts from a client provided the approval of SAICA is obtained prior to the gift being accepted. If the gift "is clearly insignificant" the approval need not be obtained.

9. If a chartered accountant in business is faced with a situation where his compliance with the fundamental principles of the Code of Professional Conduct conflicts with the

interests of the company which employs him, he must comply with the fundamental principles.

10. Where a chartered accountant in business owns shares in the company which employs him, a self interest threat which could threaten his compliance with the fundamental principle of objectivity, could arise.

11. In terms of the Code of Professional Conduct, if an audit client has a tight reporting deadline, the engagement partner may assign members of the audit team to assist the client's accounting personnel to prepare supporting schedules, carry out debtors and creditors reconciliations, and approve final journal entries to ensure that the reporting and audit deadlines are met.

12. In terms of the Code of Professional Conduct, provided the audit firm's personnel do not make any management decisions on behalf of the client, members of the audit team may assist an audit client in implementing "off the shelf" (packaged) software.

3.7 **(25 marks 30 minutes)**

Chartered accountants in public practice are frequently faced with situations with ethical implications in the course of offering their services. The Code of Professional Conduct provides a conceptual framework to assist chartered accountants in addressing ethical issues. The following situations have arisen:

1. Abbott and Co, a small audit firm has been the auditor of Circle (Pty) Ltd for a number of years. Circle (Pty) Ltd is required by its Memorandum of Incorporation to have an annual audit. Circle (Pty) Ltd intends to issue fifty R100 000 convertible debentures. Dave Abbott and Joe Peterson, the two partners of Abbott and Co, will be offered the opportunity to each take up one of the debentures. (4)

2. Fred Romano a former trainee at Abbott and Co, has recently been appointed the financial manager of Buildfast (Pty) Ltd, a supplier of building materials. Buildfast (Pty) Ltd is an audit client of Abbott and Co and before his resignation from the firm, Fred Romano had been the audit manager for this client. Fiona Romano, Fred's twin sister will be appointed as the audit manager to replace Fred, due to her experience in the building sector. (6)

3. Two of the younger chartered accountants who will shortly become partners at Abbott and Co want to be more aggressive in marketing the services of Abbott and Co. They wish to run a local radio and print advertising campaign based around a new slogan which they have proposed "Abbott and Co – better, brighter, in fact, brilliant!" (3)

YOU ARE REQUIRED TO:

(a) identify and explain the fundamental principles on which the Code of Professional Conduct is based and with which chartered accountants must comply. (8)

(b) explain the conceptual framework on which the Code is based. (4)

(c) discuss each of the situations described above in terms of the Code of Professional Conduct. Where you believe a threat or potential threat to compliance with the fundamental principles exists, you should identify the nature (category) of the threat. (13)

3.8 **(30 marks 36 minutes)**

1. Under what conditions may a chartered accountant in public practice breach his duty of confidentiality to his client without contravening the Code of Professional Conduct? (2)

2. If a chartered accountant who is the financial manager of a company, discloses confidential information about the company to other employees at a social function of the company, can he be charged with a breach of the Code of Professional Conduct? (2)

3. Give three examples where a chartered accountant in public practice has a right or duty to disclose confidential information about a client (without the client's permission). (2)

4. Explain why the receipt of a referral commission by a chartered accountant in public practice may pose a threat to the fundamental principles of the Code of Professional Conduct. Provide an example to illustrate. (3)

5. What is "lowballing" and why is it considered to be unacceptable in the context of the auditing/accounting profession? (2)

6. Ron Quin a chartered accountant in public practice, was notified by one of his audit clients, Windfall (Pty) Ltd, that the company had appointed Reg Minnaar as the financial manager at Windfall (Pty) Ltd with immediate effect. Reg Minnaar had recently left Ballen (Pty) Ltd, a company which is also an audit client of Ron Quin. From having read the minutes of directors' meetings whilst conducting the recent audit of Ballen (Pty) Ltd, Ron Quin was aware that Reg Minnaar had been dismissed from Ballen (Pty) Ltd for fraud, but for various reasons had not been charged and had been allowed to resign. Ron Quin immediately sent an email to each member of the board of Windfall (Pty) Ltd notifying them that Reg Minnaar had been dismissed for fraud. Comment on whether Ron Quin has breached the Code of Professional Conduct. (4)

7. Joe Tick, a chartered accountant in public practice, wrote an article on personal tax for a popular magazine "Moneycents". Next to the article Joe Tick paid for a full page advertisement promoting his firm. Is the inclusion of the advertisement a breach of the Code of Professional Conduct? Explain your answer. (3)

8. May a firm of chartered accountants advertise:
   3.1 in the Yellow Pages directory? (1)
   3.2 on the internet site "Facebook"? (1)

9. Donnie Brasco, a highly competent chartered accountant was not made a partner of the audit firm by which he was employed on the grounds that he did not hold the same

religious beliefs as the other partners and that this would affect the firm's relationship with a number of the firm's clients. Comment on this situation in terms of the Code of Professional Conduct. (3)

10. Krib Ltd (which is audited by Kissall Finesting Inc) have approached you, a chartered accountant in public practice to carry out a review of the salary structures including directors emoluments within the company. They insist that you do not inform Kissall Finesting of the engagement because of the "confidential nature of salaries and directors emoluments". Would you agree to this? Explain your answer. (2)

11. Harbejahn Sing, a senior manager at the firm of Mowitt and Partners, was phoned by a partner from Downs and Co. He was told in confidence that Downs and Co were opening an office in East London. The partner offered Harbejahn Sing the position of senior manager in the new office with a promise of a partnership within two years. The partner from Downs and Co told Harbejahn Sing to keep "the offer quiet for the moment", which Harbejahn Sing agreed to do. Comment on this situation in terms of the Code of Professional Conduct. (3)

12. May a partner delegate, under normal circumstances, the signing of an audit report to his audit manager provided the manager is a chartered accountant? Justify your answer. (2)

3.9 **(28 marks 34 minutes)**

You are a trainee accountant at the audit firm of Diesel and Dust. As part of your ongoing training, you are required to participate in discussions with other trainees about topical issues. Trainees are expected to respond to questions put by the audit manager who runs the discussion. The current discussion is on the SAICA Code of Professional Conduct and the manager, Peter Garrett, has posed the following situations:

1. "One of our audit clients, Crossmax Ltd wishes to raise finance for an expansion programme. The company intends to issue 12% non-convertible debentures to selected investors including all of its professional advisors. The debentures will be repaid in four years time at a premium of 15%. It is a very sound investment and they have offered the firm the opportunity of participating in the debenture issue. Is there anything in the Code which says that the firm should not take up this offer?"

   After some discussion the trainees decided that the firm could invest in the debentures as they were not convertible to shares and because the investment would be made by the firm and not the partners as individuals.

2. "Krankz (Pty) Ltd, a large manufacturing audit client of the firm, has embarked on a rationalisation programme throughout all its departments and is considering engaging our firm to provide the following services:
   2.1 the function of credit controller of Krankz (Pty) Ltd. We would maintain debtor records, approve credit limits for new debtors, follow up on overdue debtors accounts and decide whether long outstanding debtors should be handed over to the company's lawyers for collection, or written off.

2.2 assisting with the preparation of Krankz (Pty) Ltd's monthly VAT return and advising the company on tax legislation on an ongoing basis."

3. "One of our clients, BeeBee (Pty) Ltd, has asked us to perform an audit of a set of financial statements it has prepared for submission to the bank in support of a loan application. They have offered to pay us 5% of the value of the loan (if the application is successful) as our audit fee. However, the company has not paid our audit fee for last year's audit – it has been outstanding for nearly 9 months. In terms of the Code of Professional Conduct is there anything which we should be considering here in relation to our independence?"

4. "Kitty Katz, a chartered accountant in public practice and a registered auditor, held the appointment of auditor for Jarman (Pty) Ltd. During the current audit she came across evidence of a reportable irregularity. Kitty Katz was extremely busy at the time and rather than get involved, she ignored the matter, completed the audit, gave an unqualified report and resigned. Shortly thereafter our firm (Diesel and Dust) was offered the appointment of auditor of Jarman (Pty) Ltd. We approached Kitty Katz and in answer to our enquiries concerning taking over as auditors, she made no mention of the reportable irregularity".

YOU ARE REQUIRED TO:

a) explain briefly, the conceptual approach to be adopted by chartered accountants in public practice to ensure that the highest levels of ***independence*** are maintained. (3)

b) explain briefly, the terms "self-interest threat" and "familiarity threat". You are ***not*** required to provide examples. (4)

c) indicate, in respect of Crossmax Ltd (1 above), whether you agree with the trainees' decision concerning the investment in the debentures. Fully justify your answer. (4)

d) indicate, in respect of Krankz (Pty) Ltd, (2 above), whether our firm should:
   * perform the function of credit controller (2.1 above). (3)
   * assist with taxation matters (2.2. above). (3)

   Answer in terms of the independence requirements of the Code of Professional Conduct. Where appropriate, state the safeguards which should be put in place to ensure that any threats to independence are eliminated or reduced to an acceptable level.

e) respond to your manager's question in respect of BeeBee (Pty) Ltd. (3 above). (4)

f) with regard to the situation described in (4) above, comment on Kitty Katz' behaviour in terms of the SAICA Code of Professional Conduct. (7)

3.10 **(25 marks 30 minutes)**

Recently you were at a function at the audit firm of Pollok and Makaya, held to celebrate the success of a number of their trainee accountants in the recent qualifying examination. The following conversation took place between Drake Beagle, one of the successful candidates and Fred Ford an engineer and the father of another of the successful trainees:

Fred Ford: Congratulations Drake, now that you have passed all your examinations and completed your training contract, what are your plans?

Drake Beagle: Well the first thing I'm going to do is resign from this firm. All they have done is make me work hours of overtime, paid me a pathetic salary, and expected me to get the partners out of trouble with the clients. Most of our partners don't understand the accounting standards or for that matter the auditing statements. They just aren't up to date!

Fred Ford: So where are you going to work?

Drake Beagle: I'm starting my own firm. My father is the majority shareholder and chief executive officer in a group of companies. Although they are not public companies, all the companies in the group have public interest scores which require that they be audited externally each year. His shareholding is big enough to remove the existing auditors and appoint me. His existing auditors are Deloots and they are pretty useless anyway. With me there the group audit fee will be 50% of what it is now as I can agree with my father what he wants done on the audit and we can ensure everything goes smoothly.

Fred Ford: Sounds interesting but how are you going to get other clients?

Drake Beagle: I've got that covered. I'm going to get the addresses of all the customers and suppliers of my father's companies. I'm going to visit them offering discount audit services, information technology, and tax work. I will also approach all the clients I have worked on at Pollok and Makaya during my training contract and offer them discounts of fees as I can easily find out what this firm charges. Like all chartered accountants in public practice, Pollok and Makaya charge exorbitant fees!

Fred Ford: You are going to be really busy, how are you going to cope?

Drake Beagle: No problem, I'm going to take on a partner, Chris Crusher. Beagle and Crusher, sounds good. Chris has a building science degree but he got an MBA overseas, he is a really smart guy. We will also employ a few trainee accountants and bookkeepers.

Fred Ford: Yes, it sounds good, but aren't there some ethical issues here?

Drake Beagle: Ethics? That's just for study purposes Mr Ford. I'm talking business here! It's all about making money not about ethics.

YOU ARE REQUIRED TO discuss Drake Beagle's attitude to professional ethics. Your answer must include any potential contraventions of the Code of Professional Conduct should Drake Beagle carry out his plans.

3.11 **(26 marks 31 minutes)**

You have been appointed to an investigating committee which enquires into alleged improper conduct by chartered accountants. You are preparing for a forthcoming meeting and have been sent some information on the cases which are to be discussed.

1. Fanella Feelgood CA(SA), was employed by a large firm of auditors, Bigotts and Cads, for some years. Her dedication to computer auditing had earned her a reputation as a highly proficient and hard working member of the computer audit division of the firm. She was therefore very surprised when she was overlooked for the third time for appointment as a partner of Bigotts and Cads, and was in fact told that there was no prospect of her ever becoming a partner. She resigned immediately and, having cleared up all outstanding matters with her clients, left the firm. Shortly thereafter, one of Bigotts and Cads' clients, Chickbow Ltd, for whom Fanella Feelgood had carried out a number of assignments offered her a lucrative engagement to review their computerised accounting systems. To fulfil her professional obligations, Fanella Feelgood informed Bigotts and Cads of the approach, having notified Chickbow Ltd of her professional obligation to do so. Without informing Fanella Feelgood, Kirwin Cads CA(SA), the senior partner of Bigotts and Cads, immediately phoned the financial director of Chickbow Ltd and informed him that:
   1.1 Fanella Feelgood had been dismissed from Bigotts and Cads as she was not competent at her job and that
   1.2 Chickbow Ltd should have consulted Bigotts and Cads before offering the assignment to Fanella Feelgood.

   The financial director (who is not a chartered accountant) of Chickbow Ltd responded by asking Kirwin Cads whether the reason that Fanella Feelgood was no longer with the firm was because Bigotts and Cads had taken a decision not to appoint women as partners of the firm. Kirwin Cads replied that although that may be true, there are valid reasons, and that in any case, this decision was not relevant to Fanella Feelgood. (10)

2. The accounting firm of Hagler and Mitchell had conducted the audit of Powerpunch Ltd (a public but unlisted company) but Marvin Mitchell had refused to sign the audit report (unqualified) until the firm, Hagler and Mitchell, had been paid the full audit fee for the current year. Powerpunch Ltd refused to pay the fee as it was the subject of a serious dispute between the audit firm and the audit committee. The AGM of Powerpunch Ltd was held, at which the directors laid the annual financial statements before the members without the audit report. The audit firm was not represented at the meeting and the shareholders took the decision to report the firm to the IRBA and SAICA. (8)

3. Max Schmeling, a chartered accountant in public practice had brought to the attention of Merlin (Pty) Ltd, one of his non-assurance clients, a piece of vacant land in an industrial township to accommodate a proposed expansion of Merlin (Pty) Ltd's business. At Max Schmeling's suggestion the directors of Merlin (Pty) Ltd had agreed that he should negotiate this purchase. Unbeknown to them the property was owned by a company, the majority shareholder of which was Max Schmeling's brother, Buster. Shortly after concluding this deal for a considerable sum, Max Schmeling terminated his professional relationship with Merlin (Pty) Ltd. About a year later the directors of

Merlin (Pty) Ltd commenced their expansion programme only to discover that the provincial regulations pertaining to the property the company had bought did not allow them to carry on their type of business in that industrial township. These regulations had been in place for a number of years. Merlin (Pty) Ltd reported Max Schmeling to SAICA. (8)

YOU ARE REQUIRED TO discuss in terms of the Code of Professional Conduct, the actions taken by each of the chartered accountants mentioned in the situations above.

3.12 **(25 marks 30 minutes)**

1. Each of the following situations threaten a firm of chartered accountant's compliance with the fundamental principles of the Code of Professional Conduct. Indicate into which category of threat (as identified by the COPC) each will fall.
   1.1 The client threatens not to appoint the audit firm at the next AGM if the firm does not replace the manager of the audit team. The manager is regarded as extremely competent but does not get along with the financial director.
   1.2 An audit client offers the engagement partner's wife the opportunity of entering into a lucrative franchise agreement to distribute the audit client's products.
   1.3 The partners of an audit firm wish to appoint Jim Stone a chartered accountant, as a partner of the firm due to his financial expertise in the mining industry. The firm has a number of mining company audits, including the company of which Jim Stone is currently the financial director. Jim Stone will be the engagement partner on the audit of this company.
   1.4 The engagement partner is requested to carry out a complex valuation of one of the material investments included in an audit client's financial statements. The engagement partner's valuation will be used as the value of the investment in the financial statements, but the fee for performing the valuation will not be included in the audit fee but charged separately. (4)

2. Give four examples of a chartered accountant having a financial interest in an audit client (two examples must be direct and two indirect). (2)

3. Why is the financial involvement of a chartered accountant with an audit client generally regarded as being a breach of the Code of Professional Conduct? (2)

4. Mary Kidd CA(SA), holds 5000 shares in Lamb Ltd, an audit client. Mary Kidd is the audit manager. Lamb Ltd is a large listed company. Is Mary Kidd in contravention of the Code? Explain. (3)

5. Joan Jacobs purchased a vehicle from Arrow Motors (Pty) Ltd one of her audit clients. She is the engagement partner. Arrow Motors financed the deal. Has Joan Jacobs contravened the Code? Explain. (2)

6. Jan de Wet, a trainee accountant, has been engaged on the audit of Rainbows Ltd for the last two years. For the current audit he will be the senior-in-charge His fiancée Greta Horn has recently been appointed as financial controller of Rainbows Ltd. Because of Jan de Wet's experience on the audit, his firm does not wish to remove him from the audit team. Would the firm be justified in ***not*** removing him? (3)

7. During the course of the current year's audit of James (Pty) Ltd, Krish Singh, the engagement partner, was requested to design and implement a new computerised inventory system for James (Pty) Ltd. Krish Singh has the necessary expertise but believes that his independence would be threatened should he accept the request. However, he feels that the firm's IT division could design and implement the system if the necessary safeguards to address the threat to the firm's independence are put in place. Explain why Krish Singh would consider his independence to be threatened and discuss the safeguards which should be put in place if the IT division accepts the engagement. (5)

8. You are the engagement partner on the audit of Fast Travel (Pty) Ltd. Each year the company runs a lucky draw for its employees. The prize in the lucky draw is an overseas trip for two paid for by Fast Travel (Pty) Ltd worth R50 000. For the current year the directors of Fast Travel (Pty) Ltd included all the names of your audit team in the draw and your audit manager was named as the lucky winner. Should he accept the prize? Justify your answer. (4)

3.13 **(26 marks 31 minutes)**

You are a partner in the large audit firm of Benson Borthwick and Botha, generally referred to as BB and B. One of the quality control procedures which the firm has implemented is the review of the independence of partners and professional staff in relation to assurance clients. One of your functions is to review situations where independence may be impaired. The following situations have been referred to you for your consideration:

1. One of your fellow partners Mary Cross, is shortly to marry the financial director of one of BB and B's major audit clients. (6)

2. Your firm has been offered the appointment of auditor of Futuretech Ltd a company listed on the JSE. Three years ago Futuretech Ltd made an offer of shares to the public and as the company appeared to be a good investment, each of the partners of BB and B purchased a minor holding which they all still hold. (4)

3. A number of BB and B's staff who work for long periods on the audit of Tricom Ltd, want to form an indoor cricket team with members of Tricom Ltd's accounting staff. The team wishes to call itself BB and B Tricom (this will appear on their playing kit), and to play in the local indoor cricket league. (4)

4. Rockwater Ltd another of BB and B's major clients, has recently purchased 100% of the shares of Enterprises (Pty) Ltd and your firm has been offered the appointment of auditor. Enterprises (Pty) Ltd is currently involved in a drawn out and unpleasant lawsuit against Corban Agencies (Pty) Ltd, another of your long standing audit clients. Enterprises (Pty) Ltd alleges that Corban Agencies (Pty) Ltd enticed certain of their customers away by unfair means. From time to time during this lawsuit, a lawyer who works in BB and B's legal section has advised Corban Agencies (Pty) Ltd on certain matters pertaining to the lawsuit. (6)

YOU ARE REQUIRED TO:

a) explain the meaning of the term ***independence of mind*** in the context of a chartered accountant. (2)

b) briefly describe the policies and procedures you would adopt in an attempt to ensure that the highest standards of independence are maintained by the partners and professional staff of Benson Borthwick and Botha. (4)

c) classify each of the above situations in terms of the categories of threats to independence identified by the SAICA Code of Professional Conduct. Fully justify your choices and discuss the safeguards (if any) which could be put in place to reduce the threats to an acceptable level. (20)

3.14 **(21 marks 25 minutes)**

Roger Jollie is the senior financial manager with Pirats Ltd, a large listed manufacturing company. He qualified some years ago as a chartered accountant and has retained his membership of SAICA. In his capacity as a financial manager, Roger Jollie is influential in the preparation and reporting of Pirats Ltd's financial performance.

1. Does Roger Jollie have to comply with the SAICA Code of Professional Conduct? Justify your answer. (2)

2. Briefly explain intimidation threats in the context of a chartered accountant in business. (2)

3. Give 4 examples illustrating how a chartered accountant employed in a large company could be confronted by an intimidation threat to his compliance with the fundamental principles. Answer in the context of Roger Jollie and his position at Pirats Ltd. (4)

4. In his capacity as senior financial manager, Roger Jollie, as stated above, is influential in the preparation and reporting of Pirats Ltd's financial performance. He receives a call from a financial news magazine editor just before the release of the annual financial statements, requesting a preview of Pirats Ltd's performance in exchange for a fee to be paid into his private bank account. How should Roger Jollie respond to this in terms of his professional obligations? Justify your answer. (4)

5. Roger Jollie holds a substantial number of shares in Pirats Ltd, purchased over a number of years. Does this present any threats to his compliance with his professional responsibilities? (4)

6. Francois Specman, a young chartered accountant, has worked at Pirats Ltd for three years, and during this entire period has reported to Roger Jollie. He is very intelligent and on a number of occasions has come up with excellent ideas relating to financial matters which have benefited the company. He has never received any form of recognition for his good ideas which he has found rather surprising. He subsequently discovered that Roger Jollie had taken all the credit for his (Francois Specman's) ideas, claiming in written memorandums to the financial director of Pirats Ltd, that he

(Roger Jollie) had thought up and implemented the ideas. No mention of Francois Specman was made. Comment on Roger Jollie's actions in terms of the COPC. (5)

3.15 **(22 marks 26 minutes)**

Robinson Phipps and Co is a large auditing firm with offices in numerous towns and cities. The firm has a central ethics committee which considers issues relating to professional conduct which have arisen at the firm. The committee is currently dealing with the following matters which have been brought to its attention:

Matter 1. Brandon Wilmott, a registered trainee in the Port Elizabeth office is on the audit team at Houselites (Pty) Ltd, a wholesaler of lighting requisites. Brandon Wilmott's family runs a security company and whilst working on the revenue cycle at Houselites (Pty) Ltd, Brandon Wilmott noticed that the prices of security lighting sold by Houselites (Pty) Ltd were significantly less than his father paid for the same products supplied by another wholesaler. Brandon Wilmott immediately phoned his father to let him know. Later Brandon Wilmott also found out by scanning through copies of the purchase orders, that Globrite CC supplied the lights to Houselites (Pty) Ltd. He noted Globrite CC's contact details and prices and phoned his father again suggesting that he contact Globrite CC direct so that the family business could purchase security lighting at the even cheaper price. (8)

Matter 2. Derek Andrews a partner in the Knysna office, was requested by Ben Bridges (who was overseas at the time) to receive on his behalf, what he said was payment in respect of the sale of his small holding farm. Ben Bridges was not known to Derek Andrews at the time, but as it was a simple request and as Ben Bridges lived in the area, he agreed. Derek Andrews provided Ben Bridges with the Knysna office's banking details and within three days an amount of R1.5 million was deposited into the firm's current account by electronic funds transfer. A few days later one of the firm's audit clients, Woodworks (Pty) Ltd, a large furniture manufacturer, telephoned Derek Andrews to inform him that the company was facing an unexpected liquidity crises and needed R350 000 to pay wages in three days time. In response Derek Andrews immediately phoned his firm's bank manager, confirmed that the transfer of R1.5 million had been cleared and transferred R350 000 to Woodworks (Pty) Ltd's bank account. Woodworks (Pty) Ltd paid its wages the following day and repaid the R350 000 the following week. (8)

Matter 3. In an attempt to promote and expand the firm locally, Gary Greville, a partner in the George office donated R75 000 to the local sports club. In return the club voluntarily named their clubhouse the Robinson Phipps Clubhouse. To publicise the naming ceremony, Gary Greville took out a full-page advertisement in the local newspaper and invited all the members of the local Chamber of Commerce to a cocktail party, personally delivering the invitations to the members. At the party he gave a speech outlining Robinson Phipps and Co's history, comparing the firm to other local firms and explaining the superiority of the services which the firm offered. (6)

YOU ARE REQUIRED TO discuss fully, each of the above matters in terms of the SAICA Code of Professional Conduct.

3.16 **(28 marks 34 minutes)**

You are a trainee at the audit firm of Ngcobo and Frances. The firm has a professional conduct and governance committee, to which any related matters can be referred. The following matters are under consideration:

1. ***Senior-in-charge – Willem Ashwill***

Willem Ashwill, a recently qualified CA(SA) is the senior-in-charge of the audit team for the financial year-end audit of GoBoy (Pty) Ltd Ltd, a large industrial company. Willem's brother, Prince, a chartered accountant (SA), is the senior member of the internal audit department at GoBoy (Pty) Ltd. Without notifying anybody at Ngcobo and Frances, Willem Ashwill was absent from work and the audit for six days. He had persuaded his brother to supervise the (external) audit team in his absence and to complete as much of the audit work allocated to him (Willem) as possible. On returning to the audit, Willem signed off on the audit programme for the work Prince had done as well as what he had not been able to do, without actually completing or reviewing the work. The matter had come to light when the audit manager reviewing the audit file picked up, by chance, discrepancies between the hours charged by Willem on his time sheet for the period he had been absent, and the work documented in the audit file. Willem, after initially denying that there was any wrong doing, admitted the truth. He explained that he had been offered an (urgent) extremely lucrative private assignment which he did not want to lose out on and hence had been absent from the audit. (14)

2. ***Audit manager – Patricia Leon***

Patricia Leon has submitted to the conduct and governance committee, a copy of a letter she has received from Jakes Ngcobo, the senior partner, which read as follows:

Dear Patricia
We, the partners, would like to congratulate you on your outstanding presentations and interviews during the new partner admission process. You were the leading candidate. However, we have subsequently learned that you are engaged to be married during the coming year, which unfortunately disqualifies you from being a partner.

Although it is not stipulated in your employment contract, a letter on your personal file reveals that you were notified of this policy when you joined the firm. The responsibilities of a partner are onerous and it is our opinion that a married woman cannot fulfil the dual responsibilities of a family and the firm. You may remain on as a manager as we value your services.
A further problem relating to your appointment as a partner, is the fact that your husband-to-be is the financial director of your major audit client and thus the firm's independence will be compromised should you be appointed as a partner.

Yours sincerely
Jakes Ngcobo (8)

3. ***Audit team member – Rex Stutterheim***

Rex Stutterheim, a young chartered accountant, on the audit of German Motors Ltd, a large distributor of Mercedes Benz vehicles. The company recently ran a competition as part of a marketing and social responsibility campaign. For a R5 donation, a member of the public could obtain a ticket to the competition. The competition required entrants to estimate how many small plastic balls could be packed into a Vito microbus. Very few if any, correct "estimates" were expected as the microbus has numerous storage compartments etc where the small plastic balls could be placed. The first correct or closest entry drawn, would receive R10 000 in cash and four tickets to the upcoming concert of an international music artist.

Whilst physically inspecting new vehicles in the showroom, Rex Stutterheim overheard the marketing manager dictating a letter about the competition to his secretary. At the end of the afternoon when the marketing manager and secretary had left, Rex, suspecting that the answer to the question might be in the letter, entered the secretary's office, went through a file marked "confidential" which was in her top drawer, and found the "correct estimate". He immediately phoned his girlfriend, told her to buy four tickets to the competition in her name, one with a number very close to the correct estimate which he gave her, and three with the incorrect answer.

When the competition draw was made, his girlfriend was declared the winner. On Rex Stutterheim's insistence, she sold the concert tickets, and with the R10 000 the two of them went on holiday. (6)

YOU ARE REQUIRED TO discuss each of the above unrelated matters (1 – 3) in terms of the SAICA Code of Professional Conduct.

3.17 **(25 marks 30 minutes)**

You have recently joined an established, medium-sized firm of auditors as a junior partner. Because of your knowledge of the relevant pronouncements, Sam Sandman, the senior partner, discussed the following situations with you:

1. Ken Kildair, the partner in charge of your firm's tax department, has recently notified Sam Sandman that his daughter Kate Kildair has taken up a middle management position in the corporate finance section at AgriSpec Ltd, one of your firms audit clients. Ken Kildair is not part of the audit team, but any tax matters with audit implications are referred to him. AgriSpec Ltd's corporate finance section is not part of the accounting department and does not play any role in day to day accounting matters. Sam Sandman has requested your opinion whether the appointment of Kate Kildair poses any threat to your firm's compliance with the Code of Professional Conduct. (5)

2. The chief accountant of Cruz Ltd, a public, but unlisted company audited by your firm, left unexpectedly. The financial director has asked your firm to take control of the accounting function for the remaining three months of its financial year as this will give it time to appoint a suitable chief accountant. The company has requested that Varinda Saywag the manager on the audit of Cruz Ltd, be temporarily assigned for the

three month period. Sam Sandman has asked your opinion on whether, in terms of the COPC, the firm could agree to Cruz (Pty) Ltd's request. (6)

3. Your firm acts as auditors of Rexx (Pty) Ltd. Recently Rexx (Pty) Ltd received a loan of R5 million from Poziers (Pty) Ltd. As the loan is material, the board of directors of Poziers (Pty) Ltd, of which Sam Sandman (your firm's senior partner) is the non-executive chairman, approved the loan. Terms and conditions of the loan are market related and the loan was made to assist Rexx (Pty) Ltd with financing an expansion programme. Rexx (Pty) Ltd and Poziers (Pty) Ltd are not connected in any way and they both operate in the light industrial sector. Although the transaction has taken place, Sam Sandman is now concerned that he may not be in compliance with the COPC and has asked your opinion. (6)

4. Your firm has been approached by Calvin Ltd to provide a second opinion on some financial information. Thorpe and Co, Calvin Ltd's auditors provided the original independent opinion but the directors of Calvin Ltd have indicated that this was not the opinion they were expecting and hence have approached your firm for the second opinion. The directors have also indicated that they do not want your firm to contact Thorpe and Co and that as the opinion is required urgently they will pay whatever fee your firm wishes to charge. (8)

YOU ARE REQUIRED TO:

a) provide your opinion on each of the situations (1 – 3) as requested by Sam Sandman.

b) advise Sam Sandman on whether your firm should accept the engagement to provide a second opinion as described in situation 4 above. Fully justify your advice.

3.18 **(25 marks 30 minutes)**

Recently Herman Crawford and David Clure formed a company, Crawford and Clure Inc., to offer auditing and accounting services to the public. Both are registered with the IRBA and with SAICA as chartered accountants in public practice. One of the first things they did was to appoint Cullem Bester as a director of the company to look after tax matters. Although Cullem Bester had never worked in the accounting profession before he had spent four years with the South African Revenue Services and had built up a good reputation. To get the company off the ground, Crawford and Clure placed a series of advertisements in a selection of trade journals and Cullem Bester wrote to all of the companies and individuals that he had dealt with whilst working for the Commissioner (SARS) informing them of his appointment and detailing the audit, accounting and taxation services which Crawford and Clure offered.

Shortly after setting up the practice, Crawford and Clure Inc accepted an engagement to perform a valuation of Spirax (Pty) Ltd to be used in negotiations for the sale of Spirax (Pty) Ltd. As part of the engagement, Crawford and Clure would also sit in on the negotiations in an advisory capacity. As Spirax (Pty) Ltd's usual auditors Smit and Nguni were also the auditors of Autoforce Ltd, a company interested in purchasing Spirax (Pty) Ltd, they had declined the engagement citing a conflict of interest. Herman Crawford performed a comprehensive analysis of Spirax (Pty) Ltd and in doing so soon realised that the company would be very suitable for a friend of his, Tyrone Talbot, to purchase. On completion of the engagement, Crawford, without informing Spirax (Pty) Ltd, contacted Talbot, gave him some important details of the company, an estimate of what Autoforce Ltd was likely to offer and helped him to work out an attractive offer for Talbot to purchase the company. In response to this information Talbot contacted Spirax (Pty) Ltd (without disclosing his connection to Herman Crawford), entered negotiations with them (at which Herman Crawford was present) and purchased all the shares in the company for an amount greater than Spirax (Pty) Ltd's shareholders had anticipated. Herman Crawford turned down the fee which Talbot offered him for his services but suggested to him that he request the company's existing auditors to resign immediately and that he appoint Crawford and Clure Inc as auditors of and tax advisors to Spirax (Pty) Ltd. (Spirax (Pty) Ltd is required to be externally audited by virtue of its public interest score.) He also asked Tyrone Talbot if he would make a long term loan of R500 000 (at a market related interest rate) to Crawford and Clure Inc to assist the new practice in setting up its offices. As they were close friends Talbot agreed to this suggestion and request and the necessary formalities were completed.

YOU ARE REQUIRED TO:

a) comment on, in terms of the SAICA Code of Professional Conduct, the decision of Smit and Nguni to decline the audit engagement relating to the sale of Spirax (Pty) Ltd. (5)

b) discuss the conduct of Crawford and Clure Inc in terms of the SAICA Code of Professional Conduct, based on the information given above. (Regard the actions of Herman Crawford as being actions of Crawford and Clure Inc.) (20)

3.19 **(30 marks 36 minutes)**

Shortly after completing his training contract with a large international firm, Tobias Timm purchased the small auditing and accounting practice of Theodore Fox, who had decided to leave the profession to open his own transport business.

One of the audit clients which Tobias Timm took over was Yummyfoods (Pty) Ltd. In addition to the audit appointment, Tobias Timm was also to act for the company in tax matters, submitting the necessary returns and handling queries. Yummyfoods (Pty) Ltd manufactures foodstuffs which it supplies to hawkers, spaza shops and small supermarkets. The shares in the company are owned by seven individuals but only one of them, Pieter Pasta is active in the business. He is one of two directors and is the major shareholder. Primarily because the other shareholders are not active in the business, the company's Memorandum of Incorporation requires that the annual financial statements be externally audited.

Having commenced the audit of the current financial year, 28 February 2017 (Theodore Fox had completed the 2016 audit), Tobias Timm became convinced that Yummyfoods (Pty), Ltd was not accounting for all of its cash sales (hawkers and spaza shops pay cash whilst supermarkets are granted credit and invoiced accordingly). On raising this with Pieter Pasta, he just smiled and suggested that Tobias Timm talk to Theodore Fox about it. Although a little puzzled, Tobias Timm decided to do so.

On contacting Theodore Fox, Tobias Timm started to explain his problem but was interrupted by Theodore Fox who said, "Listen Tobias, I know about the failure to account for all the cash sales. Welcome to the real world! I know that you served your training contract with a big time, arrogant auditing firm where keeping clients and charging big inflated fees is not a problem but in the world of small firms it's all about compromise. You turn a blind eye to certain things and in return your client pays your fees, which he knows you charge a little high, and you get to keep the client. It's very easy, you come to an arrangement which suits the client or the client gets rid of you, there's always another small practitioner to take your place. With regard to Yummyfoods (Pty) Ltd, I suggest you regard Pieter Pasta as a friend and just leave things as they are. For the last few years it has been recording at least 50% of its cash sales and the accounting records for the rest of the business are excellent."

YOU ARE REQUIRED TO:

a) discuss Theodore Fox's attitude to the fundamental principles of professional conduct judged in the light of his statement to Tobias Timm. (22)

b) discuss the impact which the fundamental principle of ***confidentiality*** will have on the action taken by Tobias Timm arising from the situation described above. (8)

3.20 **(16 marks 19 minutes)**

Early in the financial year under audit, Abstrakt (Pty) Ltd made a substantial loan to Sennett (Pty) Ltd. An important condition in the loan agreement was that should certain ratios, calculated on the figures reflected in the ***audited*** year end financial statements, not be maintained at agreed upon levels, e.g. the current ratio cannot drop below 1.5 to 1, Abstrakt (Pty) Ltd would be entitled to demand repayment of the loan immediately. No other loans were raised by Sennett (Pty) Ltd.
On completion of the audit an unmodified audit report was issued. A few months thereafter, Sennett (Pty) Ltd found themselves in deep financial trouble with very little chance of recovery. Abstrakt (Pty) Ltd was alerted to this when Sennett (Pty) Ltd was late in meeting its monthly interest payment to Abstrakt (Pty) Ltd. On further investigation, Abstrakt (Pty) Ltd established that Sennett (Pty) Ltd had been in financial trouble for some time and that important account headings in the year-end financial statements, on which an unmodified audit report had been given, had been manipulated. This was done to satisfy the specified ratio requirements so that Abstrakt (Pty) Ltd would not demand repayment of its loan.

Abstrakt (Pty) Ltd are considering suing the auditors of Sennett (Pty) Ltd on the grounds that had the audit been properly carried out, the misstatements (manipulation) would have been uncovered, and the failure to maintain the specified ratios would have been revealed. Abstrakt (Pty) Ltd would have at that point demanded repayment of its loan as it was entitled to do so.

YOU ARE REQUIRED TO:

a) identify which of the fundamental principles of the COPC the auditors of Sennett (Pty) Ltd will have breached should they be found guilty of being negligent on the audit of Abstrakt (Pty) Ltd. Justify your answer. (4)

b) discuss whether Abstrakt (Pty) Ltd would be successful in suing the auditors of Sennett (Pty) Ltd. (12)

CHAPTER 4

BASICS
- : EVIDENCE
- : ASSERTIONS
- : INTERNAL CONTROL – GENERAL

COMPUTERISED ENVIRONMENTS
- : INTRODUCTION
- : GENERAL CONTROLS

4.1 **(12 marks 14 minutes)**

"The objective of the auditor is to design and perform audit procedures in such a way as to enable the auditor to obtain sufficient appropriate evidence to be able to draw reasonable conclusions on which to base the audit opinion."

(ISA 500 Audit Evidence)

The following questions are based on the abovementioned statement.

1. What is audit evidence? (1)

2. What does audit evidence include? Are the accounting records sufficient audit evidence? (2)

3. Upon what does the ***relevance*** and ***reliability*** of evidence depend? (3)

4. What is the relationship between audit evidence and audit risk? (2)

5. What is the relationship between audit procedures and audit evidence? (2)

6. Explain the term "further audit procedures". (2)

4.2 **(18 marks 22 minutes)**

The auditor has a number of different "tools" to obtain the evidence required to express an opinion. These "tools" are actually procedures which are carried out by the audit team.

YOU ARE REQUIRED TO:

(a) explain the term "risk assessment procedures" in the context of auditing. (2)

(b) explain the term "further audit procedures". (2)

(c) briefly describe the seven types of audit procedure for obtaining audit evidence. (7)

(d) explain the difference between tests of controls and substantive procedures. (3)

(e) comment on whether the procedures described in (c) above will be suitable for use when the auditor is assessing the risk of material misstatement. (2)

(f) comment on the following: "the most effective test of controls is observation, because the auditor himself is making the observation". (2)

4.3 **(30 marks 36 minutes)**

To gather the evidence which is required pertaining to the assertions, the auditor conducts procedures which have been developed and refined to meet the audit objective. The various procedures which will be conducted by the auditor will be mixed but balanced - no single procedure will supply all the evidence needed.

The procedures can be described as follows:

1. Inspection
2. Observation
3. Inquiry
4. Recalculation
5. Analytical Procedures
6. Reperformance
7. External confirmation

YOU ARE REQUIRED TO:

a) explain each of the above procedures. (7)

b) indicate whether each procedure can be applied as a substantive test, or a test of controls or both. (4)

c) give <u>one</u> example for each type of test (1 to 7 above). Your example can be a substantive test or a test of controls. (7)

d) state whether the above procedures can be used by the auditor when identifying and assessing the risk of material misstatement. Explain. (3)

e) identify six parties, other than the client’s directors and employees, from whom the auditor may obtain audit evidence and give an example of what that evidence may be. (9)

4.4 **(20 marks 24 minutes)**

Jett Bungle, performed the following procedures, inter alia, on the audit of Dalto (Pty) Ltd, a large manufacturing company.

1. During the inventory count he test counted a sample of inventory items selected from the client’s inventory list and compared the quantities counted to those recorded on the client’s inventory list.

2. He arranged for the financial manager to obtain a positive confirmation from Dalto (Pty) Ltd’s major overseas debtor. The debtor sent an email confirming the amount owed to the financial manager who forwarded it to Jett Bungle.

3. He obtained a bank confirmation relating to the client’s bank account (overdraft) direct from the bank. On previous occasions the confirmation from the bank had been incorrect but only by small amounts.

4. He inspected a sample of Dalto (Pty) Ltd’s delivery notes for the signature of Dalto (Pty) Ltd’s dispatch clerk indicating that the goods had been checked against the internal sales order, as well as the signature of the customer’s goods received clerk acknowledging receipt of the goods delivered.

5. He observed the off loading and receiving of deliveries by suppliers, to determine whether the goods were counted by Dalto (Pty) Ltd’s receiving clerks.

YOU ARE REQUIRED TO:

a) classify each of the above in terms of its source
   i) evidence developed by the auditor
   ii) evidence obtained from third parties
   iii) evidence obtained from the client. (5)

b) indicate whether each procedure is a test of controls or a substantive test. (5)

c) assess the evidence obtained in terms of reliability, giving reasons to support your assessment. Indicate the assertion to which the evidence would be relevant. (10)

4.5 **(16 marks 20 minutes)**

You are the auditor of Formstructures Ltd, a large manufacturing company with a number of manufacturing facilities around the country. You are currently conducting the audit at the company's head office in Benoni. Consider the following:

1. The company leases numerous items of machinery and equipment. The original of each lease is held at the manufacturing facility which uses the leased equipment, whilst a certified photocopy of the original is held at the head office. As you wished to conduct some important tests on the company's lease agreements, you asked a trainee to extract a sample and obtain the lease agreements selected. Using the correct sampling methods, the trainee selected a sample from the certified copies held at head office and presented them to you. (3)

2. A trainee was requested to obtain year-end bank certificates for the bank accounts used by each of the manufacturing facilities (each has its own bank account). This he did by contacting the accountant at each facility and asking them to request their banks to send a certificate as soon as possible as it was urgent. The accountants all obliged and faxed the bank certificates provided to them by the banks to Formstructures Ltd's head office for the auditor. (5)

3. The debtors credit control department is centralized at head office and the employees in this section share a performance bonus at year-end if the debtors "days outstanding" ratio is kept below 60 days. The amount of the bonus is reduced by the audited bad debts allowance at year-end. Trevor Thrift, the senior credit controller has provided one of the trainees with evidence to support the allowance for bad debts at year-end and the trainee has accepted the evidence without further procedures as the budget on the audit is tight. (4)

4. Formstructures Ltd holds large inventories at its various sites. The trainee in charge of the inventory audit concluded as follows: "Our test counts of items selected from the inventory sheets and counted in the various warehouses have provided sufficient evidence as to the valuation and completeness of the clients inventory." (4)

YOU ARE REQUIRED TO state whether you would be satisfied with the evidence gathered in (1) to (4) above. Consider each situation separately. Justify your answers.

4.6 **(10 marks 12 minutes)**

1. Whether the evidence gathered by the auditor is ***sufficient*** for the auditor to express an opinion depends on:
   1.1 the time spent on gathering the evidence.
   1.2 the auditor's assessment of the risks of material misstatement and the quality of the audit evidence.
   1.3 the audit strategy adopted for the audit.
   1.4 the nature and timing of the audit procedures conducted.

2. Whether the evidence gathered by the auditor is ***appropriate*** for providing support for the conclusions on which the auditor's opinion is based depends on:
   2.1 the audit strategy adopted for the audit.
   2.2 the relevance and reliability of the evidence gathered.
   2.3 the quantity of evidence gathered.
   2.4 the nature, timing and extent of the procedures conducted.

3. The ***reliability*** of audit evidence is influenced by:
   3.1 the source and nature of the evidence.
   3.2 the quantity and source of the evidence.
   3.3 the source and nature of the evidence and the circumstances under which it is obtained.
   3.4 the level of experience of the audit team.

4. The ***relevance*** of the audit evidence relates to:
   4.1 its degree of reliability.
   4.2 its suitability as corroborative evidence.
   4.3 its logical connection to an assertion.
   4.4 the scope of the audit.

5. In terms of ISA 500, audit evidence is obtained by performing:
   5.1 risk assessment procedures and substantive tests.
   5.2 tests of controls and substantive procedures.
   5.3 risk assessment procedures and further audit procedures.
   5.4 tests of controls, substantive procedures and analytical review.

6. The auditor may decide to examine the entire population of items that make up an account balance (100% examination). This is most likely when:
   6.1 the assessment of the risk of material misstatement in the account heading is low.
   6.2 analytical review procedures are not suitable.
   6.3 tests of controls are being conducted.
   6.4 the population consists of a small number of large value items.

7. Which of the following factors should ***not*** influence the auditor's decision on how much evidence he must obtain in respect of a particular assertion:
   7.1 the materiality of the account heading to which the assertion pertains.
   7.2 the results of previous tests carried out at an interim audit on the assertion.
   7.3 the availability of audit team members competent to gather the appropriate evidence.

7.4 the amount of corroborative evidence available from testing other relevant assertions.

8. Which of the following evidence pertaining to the existence of a piece of manufacturing equipment purchased during the financial year would be considered most reliable by the auditor:
   - 8.1 the purchase invoice provided by the supplier.
   - 8.2 a physical inspection of the equipment by a member of the audit team.
   - 8.3 the directors' minute authorizing the purchase accompanied by the purchase invoice provided by the supplier.
   - 8.4 the inclusion of the serial number and description of the item of equipment in the fixed asset register.

9. Which of the pieces of evidence listed below would be relevant to the auditor's decision as to whether the allowance for bad debts (part of the accuracy, valuation and allocation assertion) is appropriate:
   - 9.1 a response from the debtor to a positive debtors circularization confirming the balance owed.
   - 9.2 a written representation from the credit controller that the specific debtor is expected to pay the account in full.
   - 9.3 inspection of the delivery note signed and dated by the customer as proof of receipt of the goods sold to the customer.
   - 9.4 evidence that all sales made to the particular debtor have been included in the accounting records at the financial year end.

10. Where the auditor wishes to draw a conclusion about an entire population on the basis of testing a sample drawn from the population, he will need to conduct:
    - 10.1 audit sampling.
    - 10.2 specific item sampling and stratification.
    - 10.3 specific item sampling combined with analytical review procedures.
    - 10.4 estimation sampling.

YOU ARE REQUIRED TO select the most appropriate answer for each of the above questions (1 – 10).

4.7 **(16 marks 20 minutes)**

When gathering audit evidence the auditor is required to obtain sufficient appropriate evidence to support the audit opinion. For obvious reasons the auditor cannot test every transaction or event that has occurred during the year and generally what happens is that the auditor uses different means for selecting items. The means available to the auditor for selecting items for testing are:

a) selecting all items (100% examination) of a population or a stratum of a population
b) selecting specific items from a population
c) applying audit sampling, which is defined as the application of audit procedures to less than 100% of items within a population such that all sampling units in the population have a chance of selection.

A combination of the above may also be used.

On the audit of Marsbars (Pty) Ltd a manufacturer of a very large range of metal products and a subsidiary in the Steelman Ltd group, the following procedures will take place:

1. The company's finished goods inventory will be tested for completeness; items of inventory will be traced from the warehouse floor to the inventory records.

2. The minutes of the monthly director's meeting will be inspected to identify any important decisions taken of which the auditor should be aware.

3. Tests of controls will be carried out to determine whether all purchase orders are signed by the chief buyer. The company makes thousands of purchases each year.

4. Lease agreements entered into by the company will be inspected to determine whether those leases which have been categorized as finance leases and capitalized, meet the requirements for the capitalization of the leases. The company entered into twenty nine leases.

5. The recoverability of amounts owed by debtors which have been outstanding for longer than 90 days will be discussed with the credit manager and the financial manager. The company has over seven hundred debtors of which approximately 10% have amounts outstanding in excess of 90 days. The amount outstanding for longer than 90 days compared to the prior year has increased by nearly sixty percent, whilst sales have remained reasonably constant.

6. A positive circularization of debtors will take place. The company has twenty two major customers who between them, account for nearly fifty percent of the amount owed by debtors.

7. Our firm's software will be used to compare the cost price and selling price fields in the inventory masterfile. The company has nearly three thousand different products in its inventory masterfile.

8. Purchases from other companies in the Steelman group will be identified in the purchase journal for testing in detail.

YOU ARE REQUIRED TO indicate which means of selecting items for testing (as listed in a to c above) is most likely to be used for each of the intended procedures listed above (1 to 8). Justify your choice.

4.8 **(20 marks 24 minutes)**

The following procedures were carried out on the audit of Bathlight Ltd, a retailer of bathroom requisites.

1. Held discussions with Bathlight Ltd's credit manager and sales director on the prospects of collecting accounts receivable balances which are long outstanding.

2. Observed the client's counting teams (made up of competent employees independent of the inventory section) conducting an inventory cycle count.
3. Inspected Bathlight Ltd's documentation (delivery notes) for evidence that they were signed by the customer to acknowledge the receipt of goods purchased by that customer.
4. Obtained a confirmation of balance certificate directly from Bathlight Ltd's bank.
5. Computed the gross profit percentage for the current year, compared it with that achieved in the prior year, and analysed the difference.

YOU ARE REQUIRED TO:

(a) classify each of the above items of audit evidence according to its source, as follows:
  (i) evidence developed by the auditor
  (ii) evidence obtained from sources outside (external to) the entity
  (iii) evidence internally generated by the client (5)

(b) assess the reliability of each item of audit evidence using the following categories:
  (i) highly reliable
  (ii) moderately reliable
  (iii) less reliable.
  Give reasons to support your assessment in each case. (15)

4.9 **(20 marks 24 minutes)**

1. Explain the term "assertions" in the context of the annual financial statements of a company. (3)

2. Which of the following assertions is ***not*** applicable to an asset account balance?
   2.1 completeness
   2.2 rights
   2.3 occurrence
   2.4 existence. (1)

3. Which of the following assertions is ***not*** applicable to the repairs and maintenance expense account?
   3.1 cut-off
   3.2 accuracy
   3.3 completeness
   3.4 existence. (1)

4. The following disclosure has been made in the notes to the financial statements of JomoC (Pty) Ltd, a manufacturing company

   Note 12: Contingent Liability

   The company is currently engaged in a court case with Trident Ltd pertaining to the malfunction of a machine manufactured by JomoC (Pty) Ltd and purchased by Trident Ltd. Trident Ltd alleges that the malfunction caused extensive damage to its production line. JomoC (Pty) Ltd is being sued for R5 000 000.

Explain what a user of the financial statements may infer from the note pertaining to the contingent liability at JomoC (Pty) Ltd. (5)

5. Explain the link between audit evidence and the assertions. (2)

6. When conducting risk assessment procedures, the auditor does not consider the assertions. True or False? Justify your answer. (3)

7. Indicate whether each of the following statements is true or false. Justify.
   7.1 Physical inspection of the company's vehicles confirms that the company owns the vehicles and can contribute evidence as to the valuation of the vehicle. (1)
   7.2 Inspection of the title deeds to the company's property provides evidence as to the company's rights (ownership) of the property. (1)
   7.3 From an audit perspective, the completeness assertion relating to trade creditors is generally far more important than the existence assertion relating to trade creditors. (1)

8. Explain the term "direction of testing" in the context of the assertions. (2)

4.10 **(16 marks 19 minutes)**

When gathering evidence about a particular assertion relating to an account balance or transaction and their related disclosures, the auditor must be satisfied that the evidence gathered is ***relevant*** to the assertion he is auditing. Consider the following statements:

1. Careful inspection of a vehicle's registration documents provides evidence of the existence of the vehicle.

2. Selecting a sample of inventory items from the perpetual inventory records, and (physically) counting the items on hand for the sample selected provides evidence of the completeness of inventory.

3. Inspecting the repairs and maintenance account (and similar accounts) in the general ledger for items which may actually be purchases of plant and equipment, provides evidence relating to the completeness of plant and equipment, and classification of repairs and maintenance transactions.

4. Inspecting the lease agreements for capitalized leased assets to determine whether the risks and rewards of ownership have transferred to the audit client, provides evidence relating to the valuation of the asset.

5. Observing the receiving clerk counting the goods being delivered by a supplier, provides evidence as to the accuracy of purchases.

6. Reperforming the depreciation calculations provided by the client for plant and equipment for the financial year, provides evidence relating to the valuation of the asset.

7. Comparing the names and amounts on the list of creditors at the end of the current financial year to the list of creditors at the end of the previous financial year, provides evidence relating to the completeness of accounts payable.

8. Conducting a positive circularisation primarily provides evidence as to the valuation of accounts receivable.

YOU ARE REQUIRED TO indicate whether each of the above statements is ***true*** or ***false***. Explain your choice.

4.11 **(15 marks 18 minutes)**

The following account headings appear in the trial balance of Safe-T (Pty) Ltd.

Accounts receivable	R2 631 981
Sales	R39 246 124

Whilst briefing your audit team on the upcoming audit of Safe-T (Pty) Ltd, you asked a first year trainee who had just completed his undergraduate studies, to explain the assertions applicable to the two account headings above. After some hesitation he responded as follows:

Accounts receivable

Accuracy: all credit sales have been appropriately recorded.

Existence: the possibility does exist that debtors included in the R2 631 981, will not pay the amount they owe.

Obligation: all debtors included on the list have agreed to pay, and therefore have an obligation to do so.

Occurrence: only genuine debtors have been included in the balance of R2 631 981 i.e. there are no fictitious debtors.

Sales

Recognition: All revenue in the form of sales has been recognized.

Collectability: The proceeds from all sales recorded have been or will be collected.

Valuation: The amount of R39 246 124 represents the total value of sales made.

Rights: Safe-T (Pty) Ltd has the right to include all sales even though some debtors may not pay.

YOU ARE REQUIRED TO indicate whether your first year trainee's understanding of financial statement assertions is good, reasonable or weak. Justify your answer.

4.12 **(10 marks 12 minutes)**

The following procedures where carried out on the year-end audit of Justtimber Ltd, a forestry company.

1. The audit team conducted test counts on a sample of the piles of logs which had been cut into 6 metre lengths and stacked in a number of locations in the forests.

2. A trainee accountant inspected the vehicle registration documentation for a sample of the company's trucks used for transporting the labour force into the forests to confirm that the vehicles were registered in the name of Justtimber Ltd.

3. Members of the audit team inspected a sample (selected from the asset register) of the company's heavy duty machinery, noting the condition of the equipment.

4. The audit manager verified the data used by the company to construct the formula used by the company to calculate the cost of the timber on hand at year end.

5. Whilst carrying out procedure 3 above, the audit team also agreed the serial numbers on the items of machinery selected to the numbers taken from the asset register.

6. A trainee obtained the spot rate at the financial year end and recomputed the amount owed to foreign creditors at year end in local currency.

7. A trainee selected a sample of material purchases from the purchase journal for the month following the year end, and by inspection of the relevant GRNs, confirmed that the goods were supplied after year end and not before.

8. The senior trainee on the audit carried out of physical verification of all head office employees included on the salary payroll.

9. The audit manager discussed the recoverability of each of the company's long outstanding debtors (over 90 days) with the credit controller and the financial manager.

10. The senior trainee inspected the relevant agreements for all leases of equipment classified as financial leases, to confirm that the classification was correct.

YOU ARE REQUIRED TO identify the assertion(s) to which each of the procedures listed above (1 to 10) is relevant.

4.13 **(15 marks 18 minutes)**

The following procedures were carried out on the audit of Laurens Ltd:

1. Selected a sample of expensive power tools from the factory floor and traced them to the fixed asset register.

2. Evaluated the recoverability of bad debts in discussion with the financial accountant.

3. Inspected the lease agreements relating to three leases capitalized as finance leases to confirm that the capitalization was appropriate.

4. Selected a sample of inventory items from the inventory count sheets, counted the items on hand and compared the quantities counted to the count sheet.

5. Inspected the dates on supplier delivery notes and the corresponding goods received notes to confirm that the purchase was made during the financial year under audit.

6. Inspected the documentation relating to the impairment review carried out by the directors in respect of plant and equipment.

7. Selected a sample of purchases from the purchase journal and inspected the corresponding documentation to confirm that the supplier invoice was made out to Laurens Ltd and that the goods supplied were of a type used/purchased by Laurens Ltd.

8. Read (inspected) the company's accounting policy note in relation to foreign currencies in the financial statements to ensure it was clearly described and relevant and understandable in terms of IFRS.

9. Whilst conducting tests of detail on a sample of sales invoices, confirmed that prices charged and extensions, additions and VAT calculations were correctly recorded.

10. Selected a random sample of Laurens Ltd dispatch notes and matched them to the corresponding sales invoice.

11. Positively circularized a sample of debtors.

12. Conducted a search for unrecorded disposals of plant and equipment.

13. Inspected the title deeds to Laurens Ltd's properties to determine whether there were any encumbrances on the properties.

14. Checked the postings from the sales journal to the various accounts in the general ledger, e.g. debtors control, VAT, and to the debtors ledger.

15. Confirmed the conversion rate on transaction date used for a currency translation of a machine imported from America.

YOU ARE REQUIRED TO identify the assertion(s) to which each of the procedures listed under 1 – 15 is relevant.

4.14 **(25 marks 30 minutes)**

You are the auditor of Brumbies (Pty) Ltd, a company which manufactures and sells horse riding equipment. The company also imports some of its product lines. The following information has been gathered at the "identifying and assessing the risks of material misstatement" stage:

1. One of the types of racing bridle manufactured and sold by the company has been declared illegal as it can damage the horses jaw. The machine used to manufacture the steel mouthpiece for the bridle is no longer in use.

2. The company has recently leased a machine which manufactures stirrups.

3. The company discontinued making sales for cash. All sales are on credit to account holders or by credit card to non-account holders. The number of account holders has increased accordingly.

4. Brumbies (Pty) Ltd is currently being sued for R5 million by a riding school. One of the riding school's clients fell off a horse and suffered serious injury. The cause of this is alleged by the riding school to have been that the saddle broke causing the client to fall from the horse whilst galloping.

5. In an effort to boost sales the company relaxed certain of its credit limits during the year.

6. A container of saddles being shipped from Argentina is scheduled to arrive two weeks after year-end.

7. Significant improvements have been made to the company's corporate governance policies and procedures.

YOU ARE REQUIRED TO:

a) explain the link between the risk of material misstatement and the assertions. (4)

b) identify the assertions which may be affected by each of the above (1 to 7). Justify your answer. Consider each one individually. (14)

c) state whether each of the above (1 to 7) will increase or decrease the risk of material misstatement in the account heading to which the assertions relate. (7)

4.15 **(20 marks 24 minutes)**

In a business, management is responsible for running all aspects of the entity. In theory, the broad objectives for the business will be set, e.g. operating the business efficiently and effectively, the risks which threaten the objectives set will be identified, and suitable responses to the risks will be put in place. These responses will include implementing a proper information system (including proper books, records and documents), employing competent staff, and implementing policies and procedures, including sound control activities.

YOU ARE REQUIRED TO:

a) identify four broad objectives which management of any business will set (other than operating the business efficiently and effectively). For each broad objective, give a specific example of a risk which may threaten the achievement of the objective. (4)

b) explain, from an internal control perspective, why it is important for a company to set the objectives of all aspects of the company. (2)

c) define internal control. (2)

d) identify the components of internal control and state to which component each of the following is most relevant
   (i) stipulating procedures to process sales transactions
   (ii) obtaining board approval for capital expenditure
   (iii) independent assessment of the credit management department by internal audit
   (iv) the appointment of a senior risk officer
   (v) the publication and distribution of a code of conduct to all employees. (5)

e) state four ways in which a large company may address the need to identify and assess the numerous risks faced by the company. (3)

f) describe what the information system is, and what the term "related business processes" means. Explain briefly how the information system and business processes are linked. (4)

4.16 **(21 marks 25 minutes)**

Management is ultimately responsible for running all aspects of the business in an orderly and efficient manner. The objectives of the business will be set, the risks relating to achieving those objectives will be identified and suitable internal controls in the form of books, records and documents, as well as policies and procedures will be in place to address those risks.

However, even the best designed internal control systems have inherent limitations.

YOU ARE REQUIRED TO:

(a) identify broadly the objectives management will set as a framework for identifying the risks relating to those objectives. (3)

(b) identify, with brief explanations, the inherent limitations of internal control. (12)

(c) give an example of each of the inherent limitations of internal control in the context of a sales/cash receipts system of a supermarket. (6)

4.17 **(43 marks 51 minutes)**

Morgan Chetty, a friend of yours and owner of Chetkit (Pty) Ltd, patented a useful kitchen device which has proved popular in the market place. Initially he manufactured and sold the device himself, but as sales increased, he found it necessary to move into a small factory park and employ seventeen staff to assist with manufacture, selling, inventory, accounting, etc. He soon realised that he would have to improve his internal controls, and having no accounting background or formal business training, he decided to make an appointment with a business consultant. However, he found what he was told was very confusing and has now asked you to explain some of the views expressed by the consultant.

The business consultant says I must implement control activities including segregation of duties and proper access/custody controls over the assets of the business and that I must watch out for collusion. He also told me that I would have to ensure a strong control environment, and that although having a risk assessment process is an important part of good internal control, as an owner/manager of a small company I didn't need to worry about it. I really do not understand what he is talking about! He also says my financial statements must be prepared in terms of IFRS for SMEs.

At this stage Morgan Chetty will not computerise his business.

YOU ARE REQUIRED TO :

a) explain (see Note 1) to Morgan Chetty what the consultant means by
   (i) control activities (see also Note 2 and Note 3) (12)
   (ii) segregation of duties (see Note 4) (10)
   (iii) access/custody controls (5)
   (iv) collusion (4)

b) explain to Morgan Chetty what the term control environment means, and how he can ensure a strong control environment in his business. (8)

c) comment on the consultant's contention that Morgan Chetty does not need to worry about a risk assessment process. (4)

Note 1: You must explain points (i) to (iv) to Morgan Chetty in the context of his business. Use examples to assist your explanation.

Note 2: Include in your answer to (i), an explanation of how control activities will relate to the accounting system of the business.

Note 3: You are not required to explain the categorisation of control activities as preventive, detective or corrective, or as general or application controls.

Note 4: In you explanation of segregation of duties, use a purchase (and payment) transaction as your illustrative example.

4.18 **(16 marks 19 minutes)**

Armsdeal Ltd is a large manufacturer of various hand weapons used by the military (defence force). The following actions, policies and procedures are in place at the company.

1. All prospective employees are required to agree to undergo psychological testing before they are employed at the company.

2. On arrival at the visitors entry security gate, all visitors' vehicles are searched before they enter the premises. Items taken from visitors, e.g. cameras, firearms, are recorded in a register by the security officer and the register is signed by the visitor.

3. The dispatch area is security controlled, and every dispatch of goods is checked against the supporting documentation by a dispatch clerk who signs the documentation. The dispatch manager then re-checks everything thoroughly and signs a "dispatch release form". At this stage the goods are loaded onto an armoured vehicle in the presence of a member of the defence force.

4. Every asset at Armsdeal Ltd has a metal tag securely stuck onto it which displays a unique asset number.

5. Entry to the small arms and ammunition warehouse is strictly controlled by the use of retina scanners and security alarms.

6. Armsdeal Ltd's organizational department has an ongoing project which aims at improving and refining the company's policies and procedures for defining authority, responsibility and reporting relationships throughout the organization.

7. Any member of staff who is found in the small arms and ammunition warehouse and is not authorised to be there is dismissed immediately. All employees are regularly made aware of this strictly enforced regulation.

8. Each month an Armsdeal Ltd board committee meets with senior personnel from the defence force to discuss national security and military activity on the African continent and its potential effect on Armsdeal Ltd.

9. Every year Security Watch Inc, an independent consultancy, performs a comprehensive review of Armsdeal Ltd's physical security as well as its information system security.

YOU ARE REQUIRED TO identify the component of the internal control process to which each of the above actions, policies or procedures relates and for each action, policy or procedure which you consider to be a "control activity" indicate with a brief explanation the type(s) of control (e.g. segregation of duties) you consider it to be.

4.19 **(24 marks 29 minutes)**

The following actions, policies or procedures have been put in place at Fusion (Pty) Ltd, a company which sells a wide variety of lights and light fittings to the general public.

Fusion (Pty) Ltd pays its creditors by electronic funds transfer. A combination of any two of three authorised senior employees is required to effect (put in motion) an EFT payment. The first employee is required to authorise the EFT payment file and the second employee is required to release the file. This is basically achieved by the use of passwords.

1. Gavin Globe, the financial manager and one of the three employees authorized to effect EFT payments, scrutinizes very carefully all supporting documentation, which is

signed and presented to him by Lilly Lite, the creditor's clerk, before authorising the payments file. The file is then transferred to the second senior employee for release. Before the second employee releases the file, he also scrutinizes the supporting documentation, confirming inter alia that it has been signed by Gavin Globe.

2. Whenever a delivery is made to Fusion (Pty) Ltd, Fred Fillement, whose only function is to receive goods, completes and signs a sequenced preprinted multi part goods received note. No other employees are authorized to receive goods. Before signing the GRN, Fred Fillement counts the goods being delivered and matches the quantities and description of the goods received to the corresponding purchase order.

3. Larry Lamp, the human resource manager follows up on all previous work references supplied by prospective employees. All new employees, regardless of what they are employed to do, spend the first two weeks at Fusion (Pty) Ltd, learning about all aspects of the business. Employees are fairly remunerated and treated with respect by management.

4. The Board of Directors who are clearly committed to sound corporate governance, meet each month to discuss in detail the performance of the company in comparison to budgets and forecasts for the month, and will provide constructive suggestions to management.

5. Every three months an inventory count takes place. A team of four employees independent of the "inventory" function, counts the inventory in the warehouse and the shop. Physical quantities counted are then compared to the quantities per the inventory records. All discrepancies are followed up.

YOU ARE REQUIRED TO:

a) identify with an explanation, the ***type(s)*** of control activity if any, which is (are) evident in each of the statements (1 to 5) above. If you decide that the statement does not describe a control activity, justify your decision. (18)

b) comment on the control environment at Fusion (Pty) Ltd based on the information given above. (6)

4.20 **(22 marks 26 minutes)**

Plant-tech Ltd is a pharmaceuticals company engaged in the formulation, manufacture and sale of medications derived from indigenous plants. The following actions, policies and procedures form part of Plant-tech's internal control process:

1. Plant-tech Ltd requires each of its employees to sign an ethical code of conduct agreement every year, the conditions of which are set by the directors. The conditions and consequences of breaching the code are explained to employees at a seminar attended by the chairman and the board. Any alleged violations of the code are investigated by a committee of the board. (3)

2. Plant-tech Ltd does not allow any of the research staff to remove laptops or any other portable data storage devices from the laboratory. This is enforced by monitored electronic and X-Ray scanners that are located at the laboratory's only entrance. (2)

3. Plant-tech Ltd employs a research cost accountant who records the ongoing cost and details of different research projects. He makes use of specialized software to do this. (2)

4. The financial director of Plant-tech Ltd meets with the research director on a quarterly basis to compare actual and budgeted costs and follow up on any unexpected variances. (2)

5. On a monthly basis, the financial director and the sales director meet to assess the trade accounts receivable. Plant-tech Ltd's terms are 30 days, and debts over 120 days are considered to be bad debts, and will usually be written off with the approval of the financial director. Both directors sign necessary journal entry supporting documentation at the conclusion of the meeting. (3)

6. Every two months a Plant-tech Ltd board committee meets to discuss the industry's regulatory environment, potential market developments and health care trends. (3)

7. Finished goods (medications) are kept in an air-conditioned/temperature controlled warehouse. (2)

8. The Plant-tech Ltd marketing department has set up a customer phone-in service which enables customers to phone in complaints relating to product quality, pricing, availability, etc. Phone calls are recorded and analysed. (2)

9. The warehouse manager has read access only to the inventory masterfile and pickers have no access to the inventory masterfile. (3)

YOU ARE REQUIRED TO identify the component(s) of the internal control process to which each of the above relates. Give reasons for your choice. If you have chosen "control activity", state which type(s) of control is (are) being implemented, e.g. segregation of duties.

4.21 **(18 marks 22 minutes)**

You were recently appointed internal auditor of Swade (Pty) Ltd, a company which manufactures and distributes imitation leather. Although the company makes most of its payments by EFT, it does make a reasonable number of payments by cheque. Because a far greater number of payments are made by EFT, controls over cheque payments are often not complied with.

Your first assignment was to investigate a fraud where an administration clerk in the sales section gained access to one of the company's blank cheque books (Swade (Pty) Ltd's bank requires that new cheque books be ordered in multiples of five). He wrote out two cheques payable to his girlfriend, forged the signatures of two of the signatories (which he copied from some paid cheques he found lying around) and deposited the cheques into her private bank account. The fraud was not picked up for six months.

The result of your investigation established that one of the weaknesses in internal control which allowed the fraud to take place, was the company's lack of control over blank (unused) cheque books (and other important stationery).

YOU ARE REQUIRED TO:

a) recommend control procedures which should be implemented in respect of the company's unused cheque books. (12)

b) comment, based on the information given in the question, on the control environment at Swade (Pty) Ltd. (6)

4.22 **(24 marks 29 minutes)**

A computer environment has a "language" all of its own. To be able to audit in such an environment the auditor must have an understanding of that "language". The following terms are frequently used and must be clearly understood.

1.	Hardware	5.	Systems software
2.	Source documents	6.	Application software
3.	Central processing unit	7.	Generalised audit software
4.	Back-up	8.	Security software
9.	Control totals	13.	Field
10.	Hash totals	14.	Record
11.	Run to run totals	15.	File
12.	Batch totals	16.	Masterfile
17.	Database	21.	Limit check
18.	Database administrator	22.	Record count
19.	Network	23.	Reasonableness check
20.	Database management	24.	Password

YOU ARE REQUIRED TO explain briefly, in your own words the terms listed above.

4.23 **(30 marks 36 minutes)**

PART A **(10 marks 12 minutes)**

Computerised accounting systems often require that information be entered by a user directly into the computer, rather than onto a source document. Obviously the information entered should be complete and accurate; the following control techniques can assist in achieving this.

* mandatory fields
* alphanumeric checks
* screen dialogue
* screen formatting

* minimum entry

YOU ARE REQUIRED TO illustrate your understanding of the control techniques above by explaining how they would assist in ensuring that an order you wish to place on the Internet is accurate and complete.

PART B **(20 marks 24 minutes)**

It is very important for a company to protect the integrity of its hardware and software, in fact, it's computer system as a whole must be carefully controlled. Physical protection, security policies, access controls, a sound control environment and a host of other controls are put in place to achieve the necessary protection.

Consider the following:

1. the principle of least privilege
2. disaster recovery procedures
3. encryption
4. logging
5. the principle of fail safe
6. logical access control
7. access tables
8. authentication of users
9. physical access controls
10. the principle of defence in depth

YOU ARE REQUIRED TO explain briefly the terms/phrases above in the context of a company's computer system.

4.24 **(18 marks 22 minutes)**

Consider each of the following sentences separately.

1. A risk with computerized financial information systems is that the computer will perform as it is programmed to perform, so if there is an error in a programme instruction, every transaction processed through that programme will contain the same error. (1.5)

2. The inability to successfully implement segregation of duties is a disadvantage in computerised financial information systems. (2)

3. A mandatory field check requires that every field must be completed when keying in data. (1)

4. "Select and click" techniques such as "drop down lists" ensure that in an on-line ordering system, only valid orders are placed. (1)

5. Physical security controls over hardware are considered to be part of ensuring continuity of operations. (1.5)

6. Batch control totals are an effective input control in on-line/real-time systems. (1)

7. In computer terminology the collective name for a number of fields pertaining to say, an individual debtor, is a file. (1)

8. The use of computer generated logs is a useful control activity for management. (2)

9. Sound general controls means that fewer (less) application controls will be required. (2)

10. Limit tests and reasonableness tests are essentially the same. (2)

11. Sign tests are used to validate the number of characters which should be included in a specific field. (1)

12. Where effective input and processing controls are in place, output controls become less important. (2)

YOU ARE REQUIRED TO state, giving a brief reason, whether each of the above is true or false.

4.25 **(26 marks 31 minutes)**

In terms of ISA 315 (Revised) – Identifying and assessing the risks of material misstatement, the components of internal control are as follows:
(i) control environment
(ii) the entity's risk assessment process
(iii) the information system relevant to financial reporting and communication
(iv) control activities and
(v) monitoring of controls.

The statement recommends that dividing internal control into the above components provides a useful framework for the auditor to consider the client's internal control.

At Black 'n Blue Ltd the following policies, procedures or conditions exist.

1. There is strong segregation of duties in the inventory cycle between receiving inventory, its custody, the issue of inventory and the recording of all movement in the perpetual inventory records.

2. The board of directors and senior management meet every six months to identify the challenges facing the company and how successfully they are being addressed.

3. The company's organizational structure is designed in such a way as to provide the board with a realistic chance of achieving its objectives on an ongoing basis.

4. The human resource department goes to great lengths to define the skills necessary for each job category and to recruit suitable personnel.

5. The financial director meets frequently with the financial accountant to ensure that information required to be disclosed by IFRS (the reporting standard used by the company) is properly accumulated, recorded and processed.

6. Access to the company's network is controlled by the use of comprehensive logical controls e.g. user IDs, user profiles, passwords, and is granted on a need to know basis.

7. The recording in the general ledger of sales, purchases etc, processed by the computer is achieved by passing journal entries. All journal entries are scrutunised and authorized by two senior financial accounting department employees.

8. All transactions keyed into the computer via terminals are subject to a wide range of input controls.

9. The internal audit department conducts frequent reviews of breakdowns in internal control and how these are corrected.

10. To enter Black 'n Blue Ltd's computer facility, warehouse and processing plant, an individual must place his thumb on a biometric scanner.

YOU ARE REQUIRED TO:

a) briefly describe each of the components of internal control as identified by ISA 315 (Revised). (10)

b) indicate to which component each of the policies, procedures or conditions listed in points 1 to 10 relate. (10)

c) explain the difference between an automated control and a manual control. (2)

d) suggest 4 ways in which computerization (IT) benefits a company's internal control. (4)

4.26 **(10 marks 12 minutes)**

1. General controls can be categorized as policies, procedures and practices relating to
   - 1.1 the control environment
   - 1.2 systems development and implementation
   - 1.3 access control
   - 1.4 continuity of operations
   - 1.5 system software and operating control
   - 1.6 documentation.

   Most of the above categories can be broken down further into sub-categories e.g. the control environment can be broken down into enforcement of integrity and ethical values, commitment to competence, management's philosophy and operating style, etc.

   The following policies, procedures and practices are in place at TransP (Pty) Ltd, a large oil refinery:

1. The company's IT steering committee meets monthly to consider inter alia, the most up to date information on existing and emerging IT risks.

2. The company has a policy in place which facilitates the dismissal of an IT employee (or other employee) guilty of behaviour which demonstrates a lack of integrity or ethics.

3. The company has implemented the principles of least privilege, defence in depth etc, in its computerization.

4. A senior employee in the IT section regularly reviews the log of activity on the system which details all activity which has taken place.

5. The system at TransP (Pty) Ltd regularly sends a screen message to users to change their passwords. Users are permitted to enter their existing password on three further occasions. Thereafter access will no longer be granted until a new password is entered.

6. Pedro Scott, the chief information officer, presents a report on the company's IT activities to the directors at the monthly board meeting. The report is then discussed in detail by the directors and the chief information officer.

7. TransP (Pty) Ltd duplicates its critical processing on a second computer installation which is very secure (mirror site).

8. Several months after introducing a new inventory application, TransP (Pty) Ltd's internal auditors conducted a post implementation review of the system.

9. All personnel in the IT section including the CIO are subject to an annual performance review. This includes an interview with the steering committee which covers career development, how well the individual is performing his function, and disciplinary matters which may have arisen.

10. Management at TransP (Pty) Ltd encourages employees to identify ways in which the applications which they use can be improved. This may result in the need to modify the application software. If so, the request to modify the software must be clearly documented and approved by the user department head, the CIO and the steering committee.

YOU ARE REQUIRED TO identify the category of general control and, if applicable, the sub-category into which each of the above (1 to 10) falls.

4.27 **(10 marks 12 minutes)**

The following controls have been implemented at GoodReads (Pty) Ltd, a large book wholesaling company which has a fully computerised accounting system.

1. When a delivery is made from a supplier to GoodReads (Pty) Ltd, the receiving clerk enters the order number for the goods into the system. If the order number is not valid, the receiving clerk will not accept the delivery.

2. A new employee cannot be successfully added to the employee masterfile without a valid income tax reference number being entered.

3. GoodReads (Pty) Ltd recently appointed a committee to monitor and advise on the specific risks faced by the IT department.

4. When an application programme change request is made by a user department, it must be approved by the IT steering committee and the head of the user department before it is effected.

5. All creditors are paid by electronic funds transfer. To effect a transfer, two senior employees must independently enter their unique passwords.

6. Entry to GoodReads (Pty) Ltd's data centre (which houses important hardware) is restricted. Swipe cards and PIN numbers are used to limit access.

7. The company makes use of firewall and anti-virus software.

8. A purchase order must be supported by a stores requisition signed by the warehouse controller.

9. If a debtor has not paid its account within two working days of exceeding its credit terms, for example 60 days, Barry Potter the credit controller, contacts the debtor to request payment.

10. The chief information officer conducts regular meetings with IT personnel on an individual basis, to enforce the importance of a strong ethical culture and discuss ethical situations which may have arisen.

YOU ARE REQUIRED TO indicate whether each of the controls listed under 1 to 10 above, is a general control or an application control. For those controls which you identify as ***general*** controls, indicate the category of general control to which each relates.

4.28 **(25 marks 30 minutes)**

Your audit firm was recently engaged by Pumpflow (Pty) Ltd, a manufacturer of industrial pumps to review the general controls at the company.

The report on the review which was presented to you contained, inter alia, the following:

"The company employs three computer technicians. They are responsible for ensuring that the company's network functions satisfactorily. The technicians report to Jill Clinton, the financial controller. However, she does not interact very much with the technicians, as she is, by her own admission, not strong on computer technology. The technicians are responsible for making programme changes as they see fit, or at the request of a user of that particular programme, training new staff members to use the company's computerised system, operating the help desk and managing the database. The three technicians are all on the same employment grade and generally work well as a team allocating the various tasks amongst themselves. The three technicians are located in a general office in the accounting section in which the network servers and various other pieces of computer equipment are located.

Jill Clinton is the senior financial employee in the company. There are two executive directors and one non-executive director but all three of these individuals are from a manufacturing background and have little interest in the financial/administrative side of the business which is left up to Jill Clinton.

All employees at Pumpflow (Pty) Ltd are given access to the network. Factory personnel can access the network from two terminals in the staff canteen if, for example they want to send emails or browse the internet during tea or lunch breaks. To get into a particular application, the employee must enter a unique password. Controls over passwords are as follows:

With the help of one of the technicians, the employee accesses the "new password file" which is resident on the system. A list of two hundred four letter passwords then appears on the screen and the employee must select one password by "clicking on" it. If a password has already been taken, it appears in bold italics and cannot be selected. A new list of passwords is produced every six months and employees must select a new password using the same procedure. Passwords of staff who have left the company are also invalidated at this time. The password file is encrypted and only the three technicians, all of whom have root access/super user access, can access the password file. This password application software was written by one of the three technicians.

Other supplementary access controls such as shut down after three access violations, time out facilities, and access logs are in operation. The company has a fire wall in place and makes use of anti-virus software. There is a suitable disaster recovery plan and back up strategies appear to be effective. "

YOU ARE REQUIRED TO discuss weaknesses in the general controls of Pumpflow (Pty) Ltd based on the information given above. Give careful consideration to the structure of your answer.

4.29 **(25 marks 30 minutes)**

You are in charge of the audit of Musicmix (Pty) Ltd a company which wholesales CDs, DVDs and related products from its premises in Johannesburg. Recently your firm's computer audit division completed a general controls review at Musicmix (Pty) Ltd and submitted its report to you. The following points, inter alia, were raised in the report:

1. The company has a centralised data processing department linked to terminals in each of the departments e.g. warehouse, debtors, marketing, etc. The "computer room" in which the central processing unit and related equipment are located is situated in a secure part of the head office. Earlier in the year some damage was caused to equipment in the computer room when heavy rain came through a window which had been left open overnight. The operator had opened the window during the day to improve ventilation.

2. Access to the computer room is restricted after working hours by a steel gate and the activation of an electronic surveillance system by the last person leaving the room at the end of the day.

3. About six months ago an expensive piece of computer equipment had been damaged when a member of Musicmix (Pty) Ltd's computer club had, without noticing, spilled a Coke on the device. Subsequently the member opened the device "to see what, if any, damage had been caused" and in doing so, data had been lost/corrupted and processing had been disrupted for some time as nobody knew how to resolve the problem. Restructuring of the data had to be carried out from source documentation held in the user department. Wes Hall, the IT manager explained that the company's computer club has access to the computer room after hours to do "whatever computer fanatics do!"

YOU ARE REQUIRED TO:

a) distinguish between general controls and application controls in a computerised environment. (4)

b) state the recommendations you would make to improve the general controls at Musicmix (Pty) Ltd based on the information given above. Justify your recommendation. (21)

4.30 **(40 marks 48 minutes)**

Your firm has recently been approached by Marzoc (Pty) Ltd, a manufacturer of bicycle components. The company which is situated in East London is organised into two sections, namely, Administration: accounting and sales; Operations: purchases, inventory control and manufacture. The company employs about 100 wage earners as well as twenty salaried personnel.

The head of operations is Mark Zochi, an engineer and founder of the business. He is also the managing director. The only other director is Jim Steinman who is also head of administration. Although from an accounting background, Jim Steinman spends most of his time on selling and marketing. The responsibility for the accounting function is left to Tuffy Lidgetton, who has been with the company for some years. Besides spending a short time reviewing a brief monthly report presented to them by Tuffy Lidgetton, the directors do not involve themselves much in accounting matters.

The company's accounting systems are all computerised. The system consists of a number of microcomputers (workstations) linked together on a local area network (LAN). All Marzoc (Pty) Ltd employees are able to input data, receive output and interrogate any transaction file or masterfile from any workstation on the LAN.

The company's network (hardware and software) was supplied and installed by Fasttrack (Pty) Ltd, a small computer company owned by Lennie Lidgetton, Tuffy's brother. In addition to supplying the hardware, Fasttrack (Pty) Ltd installed the necessary system software as well as a number of packaged applications, including a comprehensive monthly financial reporting facility. There is also an informal agreement whereby all program maintenance and development, (with the exception of the wage application) is carried out by Fasttrack (Pty) Ltd. From time to time Tuffy Lidgetton engages Fasttrack (Pty) Ltd to render other computer services.

Due to the complicated manner in which wage earners are remunerated (based on production, not on time) a suitable packaged wages program could not be found. Two years previously Tuffy Lidgetton had engaged an independent wage systems analyst and programmer to work with Zoey Altman who is in charge of the salaries and wages section. As part of this project Zoey Altman was trained in programming. This has enabled her to effect program changes as required and as far as Tuffy Lidgetton is concerned, has run the wages application successfully for the past two years. However, it has also given Zoey Altman the unofficial title of "computer expert" in the company! As Tuffy Lidgetton is not particularly computer literate, he has welcomed Zoey Altman's regular involvement in assisting other account personnel with running their applications.

In fact Tuffy Lidgetton's attitude to Zoey Altman is typical of his management style. He believes that people work best when given responsibility and when encouraged to work unsupervised but as a team. As a result, the accounting staff assist each other in performing their duties whether it be inputting data, performing reconciliations or updating masterfiles, all matters with which Tuffy Lidgetton does not wish to involve himself. On a number of occasions it has only been the intervention of Zoey Altman that has prevented the failure by the accounting department, to meet important processing deadlines. These crises have usually been brought about by a lack of planning or data being mislaid or lost.

As manager of the computer audit division of your firm you have been approached by Mark Zochi to perform a review of the general controls at Marzoc (Pty) Ltd and to make recommendations where necessary. He is not keen to engage additional staff but is prepared to involve your firm in improving control if you deem it necessary.

YOU ARE REQUIRED TO identify and comment on the general control weaknesses at Marzoc (Pty) Ltd based on the information given above and to make recommendations as to how these weaknesses may be addressed.

CHAPTER 5

PRELIMINARY ENGAGEMENT ACTIVITIES AND PLANNING

5.1 **(18 marks 22 minutes)**

1. What should an auditor approached by a prospective audit client, do to establish whether the preconditions for an audit are present in respect of the prospective client? (4)

2. Why does the auditor need to determine whether the preconditions for an audit exist? (4)

3. Which member of the audit team bears ultimate responsibility for the quality of the work of the members of the audit team, the manager, the senior in charge of the team actually working at the client, or the engagement partner? (1)

4. What is the objective of the auditor in implementing quality control procedures on the audit? (2)

5. It is the engagement partner's responsibility to remain alert for evidence of non-compliance with ethical requirements by members of the engagement team.
   5.1 What are the ethical requirements to which the members of the audit team must adhere? (2.5)

6. When considering accepting a prospective audit client, the audit firm should evaluate (broadly stated) three important matters. List these three matters. (1.5)

7. Are determining whether the preconditions for an audit and evaluating the matters referred to in 6 above considered to be part of the preliminary engagement activities or the planning activities of an audit. Justify. (2)

8. If an auditor is satisfied that a prospective audit client prepares its financial statements in terms of an acceptable financial reporting framework, but the management of the prospective client will not agree to providing written acknowledgment and acceptance of its responsibilities relating to the auditor's access, the auditor may not accept the audit. True or false? Justify. (1)

5.2 **(10 marks 12 minutes)**

The following procedures/actions take place during the ***audit process***.

1. Performing a physical inspection of plant and equipment.

2. Deciding on the need to use other audit firms to assist in attending inventory counts at a large client operating in multiple locations.

3. Analysing the change in gross profit percentage from the prior year to the current year to gain a better understanding of the client's trading activities.

4. Making enquiries about the integrity of the client's management.

5. Selecting trainee accountants with specific skills for the audit team.

6. Carrying out tests of controls on the company's new payroll system.

7. Evaluating the effect of uncorrected misstatements in the financial statements.

8. Considering the audit firm's independence in relation to an audit client.

9. Drawing up a diagram which shows the companies within a group as well as the directors and officers of each, inter alia, to identify related parties.

10. Discussing the suitability of planning and performance materiality limits used on the prior year audit with the engagement partner.

The audit process consists of the following stages: preliminary engagement activities, planning, responding to assessed risk and concluding.

The planning stage can be further broken down into the following activities:
* establishing the (preliminary) audit strategy and
* materiality
* planning risk assessment procedures
* conducting risk assessment procedures
* planning further audit procedures

YOU ARE REQUIRED TO identify the stage of the audit process into which each of the above procedures/actions falls. Briefly explain your choice and where you select the planning stage, identify the activity within planning to which the action relates.

5.3 **(20 marks 24 minutes)**

1. Once the engagement letter for a new audit client has been signed by the client, preliminary engagement activities can begin. True or false? Justify. (2)

2. When carrying out preliminary activities to decide whether or not to take on a new audit client, the engagement partner must satisfy himself regarding three important matters. Identify and briefly explain these three matters. (5)

3. Identify five ways in which proper planning benefits the audit of financial statements.(3)

4. Broadly stated, what competence and capabilities should the audit team as a whole possess? (3)

5. If planning has been properly carried out, the audit strategy and plan which have been decided upon, should not be changed. True or false? Justify. (2)

6. The audit strategy and plan should be approved by the client's audit committee. True or false? Justify. (2)

7. Which of the following decisions relate to the audit strategy:
   7.1 the number of trainees to be allocated to the client's inventory count
   7.2 sample sizes for a debtor's circularization
   7.3 hours to be allocated to the various sections of the audit in the budget
   7.4 scheduling the date, time and venue for engagement partner reviews
   7.5 engaging an expert to assist with the valuation of work-in-progress. (3)

5.4 **(18 marks 22 minutes)**

Consider each of the following separately:

1. The audit strategy relates to the nature, timing and extent of testing. (2)

2. The nature of an audit procedure relates to its purpose and its type. (2)

3. Tests of controls must be carried out on all internal control systems if the auditor is to comply with the auditing standards. (2)

4. Because it is actually carried out by the auditor, ***observation*** is the most valuable test of controls. (2)

5. Generally, effective internal control can result in a reduction of substantive testing. (2)

6. Irrespective of the assessed risk of material misstatement, the auditor must design and perform substantive tests for each material class of transaction, and account balance.(1)

7. Where significant risks are identified, testing can be limited to analytical procedures but they must be extensive. (2)

8. At the audit of an extensively computerised client, the external auditor must not co-ordinate the timing of the audit to suit the availability of the client's information technology manager because doing so will automatically impair the independence of the audit. (2)

9. The decision to make use of risk assessments carried out by the client's internal audit department will be made when determining the overall audit strategy. (1)

10. Stricter materiality limits set by the auditor will result in more testing. (2)

YOU ARE REQUIRED TO indicate whether each of the above statements is ***true*** or ***false***. Give brief reasons.

5.5 **(22 marks 26 minutes)**

Recently your audit firm received a letter from Gregory Grace, the financial director of Foil (Pty) Ltd, a medium-sized engineering company, requesting that the firm submit a tender proposal for the appointment as auditor of Foil (Pty) Ltd. Gregory Grace is not a shareholder of Foil (Pty) Ltd. The contents of the letter was as follows:

Dear Partner

This letter is an invitation to you to make a presentation to the audit committee of which I am the chairman on the services you have to offer. I am the newly appointed financial director of Foil (Pty) Ltd and I will be removing the existing audit firm as soon as I have appointed a firm to replace them. I find the existing firm, like most auditors I might add, to be inefficient, too expensive and simply incapable (or unwilling) of doing things my way. So that you don't waste my committee's time, I have the following conditions you should consider before you make a presentation.

Although our public interest score requires the company to have its annual financial statements audited, we are not a listed company so we do not expect you to conduct a comprehensive audit. The audit committee requires that the annual audit be conducted on a verification of year-end balances only basis. I am not interested in interim audits, engaging experts etc, risk assessments, internal control evaluations and all the other so called audit procedures which simply increase the audit fee.

At the presentation you must state your fee for the audit. I have explained that we require only a verification of the year-end balances and I have allowed 10 working days for this. Quote accordingly. If we appoint you, the audit committee will determine your audit fee.

If you wish to be considered, you have a week to respond to this letter. I have extended the invitation to make a presentation to several other firms. You will each be given 30 minutes to sell your product.

Gregory Grace

YOU ARE REQUIRED TO indicate whether your firm should accept the invitation to make a presentation for the audit of Foil (Pty) Ltd based on the contents of the letter from Gregory Grace, the financial director. Your answer must explain fully, all the reasons for your decision.

5.6 **(20 marks 24 minutes)**

Before your firm accepts any additional ongoing engagements, eg. new audits, the partners meet to decide on whether the engagement should be accepted. The firm is mindful of the requirements to conduct preliminary engagement activities including compliance with ISA 220 – Quality control for an audit of financial information. The following prospective audit clients are being evaluated. Your firm has seven partners and a diverse portfolio of clients ranging from small business entities to medium-sized companies. None of its existing audit clients is a listed company.

1. Vaughan's Porn (Pty) Ltd, a recently opened retailer of adult entertainment requisites. The business is lucrative and efficiently run. It is owned by a group of businessmen who are not active in the business itself. They require that the financial statements be audited and have included the requirement in the company's Memorandum of Incorporation.

2. Fishy Business Ltd, a large fishing company in Durban, which was recently convicted for exceeding its fishing quotas, and threatened with closure by the authorities should it occur again as this was not a first offence. Should your firm accept the engagement, it will be the third auditing firm to have been appointed in the last four years. The previous auditors have resigned. The company is a public company but is not listed.

3. Middleman (Pty) Ltd, a medium-sized company which is about to expand considerably through a Black Economic Empowerment deal which involves a large listed company.

The listed company requires that Middleman (Pty) Ltd be externally audited annually. Our firm has no experience in the industry in which Middleman (Pty) Ltd and the listed company operate.

4. Stonebridge (Pty) Ltd, a small company which is owned by Harry Jack, the father of one of your firm's partners. Harry Jack believes that having the company audited externally adds to its credibility when negotiating with prospective business partners.

5. Mishin (Pty) Ltd, is a medium-sized company in the light engineering sector. The directors informed your firm that they were changing their auditors because their previous auditors had "different views" to them (the directors) on which accounting policies were appropriate for their company. They have declined to provide specific details. The previous auditors would not comment on this stating only that the directors of Mishin (Pty) Ltd had not given them permission to discuss the company's affairs.

6. Soldier Boy (Pty) Ltd, a company which provides companies and governments operating in Africa with security personnel, including bodyguards and equipment such as armoured vehicles and firearms. The audit fees paid to the previous auditors were substantial.

YOU ARE REQUIRED TO discuss the matters to which your firm should give consideration, when deciding on whether to accept the above prospective audit appointments.

5.7 **(26 marks 31 minutes)**

Your audit firm was recently appointed as auditors of Anivet (Pty) Ltd, a large chemical company which manufactures veterinary products for the domestic and agricultural markets. The following information was gathered during the preliminary engagement phase.

* The financial year-end of the company is 31 March.
* Anivet (Pty) Ltd has a public interest score well in excess of 300.
* The company is a subsidiary of Multivet International which has its head office in New York. Every subsidiary of Multivet International must appoint an audit committee and must include in its financial statements a standard schedule of numbers and statistics relating to sustainability. This schedule must be reviewed by the auditors.
* Anivet (Pty) Ltd has depots in a number of African countries in which it stores its products for distribution into Africa.
* The company also holds veterinary products on a consignment basis for a French veterinary company.
* The company has a very complex computerised inventory system which interfaces with both the acquisitions cycle and the revenue cycle and which facilitates the tracking of inventory moving between the head office warehouse and the depots in Africa.
* The previous auditors of Anivet (Pty) Ltd was a local firm Petra Jordan and Co.
* Multivet International sends the group's internal auditors to its subsidiaries from time to time to evaluate aspects of the business.

* The company prepares its financial statements in terms of the International Financial Reporting Standards.

After a successful meeting with Anivet (Pty) Ltd, Tarique Kerak, the engagement partner, conveyed the above information to you and requested that you draft an appropriate engagement letter.

YOU ARE REQUIRED TO:

a) comment on who Tarique Kerak is most likely to have agreed the terms of the audit engagement with at Anivet (Pty) Ltd. (2)

b) discuss the matters/points which you will include in the engagement letter to be issued to Anivet (Pty) Ltd in respect of the first audit of the company. You are not required to draft the letter. (24)

5.8 **(24 marks 29 minutes)**

1. What is the objective when planning an audit of financial statements? (1)

2. There is no point in the auditor attempting to determine the nature, timing and extent of risk assessment procedures relating to ***disclosures*** at the planning stage. True or false? Justify. (4)

3. Once the audit strategy and plan are formulated, they should not be changed. True or false? Justify. (2)

4. What is the overall audit strategy? (2)

5. Does the process of setting the audit strategy assist the auditor in determining the resources necessary for the audit? Discuss. (2)

6. The availability of audit resources should be a major factor in determining the audit strategy and plan. True or false? Justify. (2)

7. Do preliminary engagement activities form part of planning? Explain. (1)

8. In what way does adequate planning benefit the audit of financial statements? (3)

9. What is the audit plan and what does it include? (3)

10. Should the audit strategy and plan be discussed with the audit client? (2)

11. Explain why it is necessary to set a (preliminary) planning materiality level before conducting risk assessment procedures. (2)

5.9 **(18 marks 22 minutes)**

Consider each of the following separately:

1. The audit strategy relates to the nature, timing and extent of testing. (2)

2. The nature of an audit procedure relates to its purpose and its type. (2)

3. Tests of controls must be carried out on all internal control systems if the auditor is to comply with the auditing standards. (2)

4. Because it is actually carried out by the auditor, ***observation*** is the most valuable test of controls. (2)

5. Generally, effective internal control can result in a reduction of substantive testing. (2)

6. Irrespective of the assessed risk of material misstatement, the auditor must design and perform substantive tests for each material class of transaction, and account balance.(1)

7. Where significant risks are identified, testing can be limited to analytical procedures but they must be extensive. (2)

8. At the audit of an extensively computerised client, the external auditor must not co-ordinate the timing of the audit to suit the availability of the client's information technology manager because doing so will automatically impair the independence of the audit. (2)

9. The decision to make use of risk assessments carried out by the client's internal audit department will be made when determining the overall audit strategy. (1)

10. Stricter materiality limits set by the auditor will result in more testing. (2)

YOU ARE REQUIRED TO indicate whether each of the above statements is ***true*** or ***false***. Give brief reasons.

5.10 **(25 marks 30 minutes)**

You are an audit senior and are currently planning the audit of an existing client, Footwhere (Pty) Ltd.

As you go through the planning process you record your steps on your firm's standard "planning memorandum" form. Assisting you during this planning phase is a junior trainee, Jan Friedman.

Whilst conducting the audit planning stage Jan asks you the following questions:

a. It seems to me that you are not carrying out any preliminary engagement activities which I read somewhere are very important. I have three questions.
   1. How would you describe preliminary engagement activities? (1)
   2. Why do we carry them out? (4)
   3. Can you describe four procedures which would be carried out as preliminary engagement activities? (2)

b. What practical purpose is served by planning the audit? Is it not just done to comply with the auditing standards? (5)

c. I see there are risks called significant risks. What is a significant risk and what circumstances might give rise to a risk being significant? (5)

d. As I understand it, analytical review procedures are done at the end of the audit for the purpose of assessing the overall reasonableness of the annual financial statements; why are you carrying them out now - we haven't even got the annual financial statements yet? (3)

e. Can you explain why we need to set planning materiality before we conduct risk assessment procedures? (2)

f. In this planning that I am assisting you with, are we planning the audit strategy or the audit plan? (3)

YOU ARE REQUIRED TO respond to your trainee's enquiries.

5.11 **(30 marks 36 minutes)**

Your audit firm has recently been appointed as auditor of Mellow Music (Pty) Ltd. You have been placed in charge of the audit and in carrying out procedures to gain an understanding of Mellow Music (Pty) Ltd and its environment you ascertained, inter alia, that

1. Mellow Music (Pty) Ltd is a subsidiary of Worldsound Ltd. The holding company has numerous subsidiaries all of which are in the music industry. Subsidiaries are required to comply and report on their compliance with group corporate governance policies.

2. Mellow Music (Pty) Ltd sells CDs, DVDs and sound equipment to the general public through its 25 retail outlets situated in shopping malls around the country. It has a central warehouse at head office in Johannesburg from where inventory is sent to the outlets.

3. Worldsound Ltd has a large internal audit department which it uses to carry out risk evaluations and internal control and systems reviews at its subsidiaries.

4. Mellow Music (Pty) Ltd has standardized accounting systems and related internal controls at all its outlets, for example, all branches use the same in-house developed software. Branches are not linked to head office. A small IT department is located at head office.

5. Standardised monthly reports on sales, cash flow, sundry expenditures etc, are sent by the outlets to head office.

6. Profit margins are not high, overall revenue has declined and certain outlets are starting to show monthly trading losses. The declines in revenue are attributed to competition in the music industry, particularly from music downloads off the Internet, and reductions in consumer spending on luxury goods.

7. The outlets sell only for cash or by credit card. No cheques are accepted and no accounts (debtors) are operated.

8. Each outlet operates its own bank account at branches of Nedbank located in the shopping mall in which the outlet is situated.

9. Mellow Music (Pty) Ltd must present its year-end audit pack to Worldsound Ltd within 21 days of the financial year-end 31 March.

10. The annual inventory count takes place simultaneously at all outlets and the head office warehouse after the close of business on 31 March so as to ensure no disruption to trading.

YOU ARE REQUIRED TO indicate how each of the above (1 to 10) will affect your audit strategy for the up coming audit.

5.12 **(30 marks 36 minutes)**

In terms of ISA 300 – Planning an audit of financial statements, the engagement partner and the key engagement team members must establish the audit strategy and develop the audit plan.

Your audit firm has recently been appointed as auditors of Action Ltd, a listed company, and you have been assigned to assist with planning the audit for the 30 June 2017 year-end. Due to a number of reasons the appointment was only finalised in March and as a result, work has already begun on formulating the overall audit strategy. You have ascertained, inter alia, that

1. Action Ltd is engaged in importing sports equipment.

2. Its head office (and one warehouse) is located in Tshwane, and it has distribution warehouses in four other major cities.

3. The turnover of the company is around R900m per annum and the company is consistently profitable.

4. There is a workforce of 250 employees spread around the five locations, e.g. buyers, admin clerks, warehouse personnel.

5. The company has an internal audit division which is regarded as very efficient and effective.

6. The company's systems are all computerized and are resident on a wide area network and local area networks.

7. The company sells to the retail sports trade and has in excess of 8 000 debtors. It sells only on credit.

8. The reporting deadline is 28 July 2017.

9. The year-end inventory count takes place on either the last or second last Sunday of the financial year but at least 7 days before the end of the year, to facilitate the clearing of problems before year-end. All inventory is counted at the same time.

10. The board of Action Ltd is regarded as highly competent and enjoys a good reputation in the business world. Because of the late appointment, the audit committee has requested a monthly meeting with the auditors to discuss audit progress commencing with a meeting in April.

The engagement partner has requested you give some thought to a preliminary audit strategy for the first audit.

YOU ARE REQUIRED TO:

a) identify two pieces of information from those given above (1 – 10), which will positively affect your assessment of risk at the financial statement level. Explain your choice. (3)

b) identify which of the three components of the overall audit ***strategy***, i.e. scope, timing and direction, will be affected by the information given in the question. Give brief reasons for your choice. (27)

5.13 **(25 marks 30 minutes)**

1. "ISA 315 (Revised) – Identifying and assessing the risks of material misstatements through understanding the entity and its environment, is perhaps the most important statement for the auditor." Comment. (3)

2. Define the following terms:
   2.1 business risk
   2.2 significant risk
   2.3 risk assessment procedures (3)

3. Identify five (different) types of risk assessment procedure. (2)

4. ISA 315 (Revised) requires, with regard to the entity and its environment, that the auditor obtain an understanding of five broad categories of information. Two of those categories are "the nature of the entity" and "the entity's objectives and strategies and the related business risk that may result in risks of material misstatement". What are the other three? (2)

5. In terms of ISA 315 (Revised), the clients internal control system can be broken down into five components, one of which is the "monitoring of controls". What are the other four? (2)

6. If the auditor understands the client's business environment it is not that important for the auditor to evaluate the company's accounting system and related internal controls. True or false? Justify. (2)

7. Computerised systems pose specific risks to an entity's internal control system achieving its objectives. An example would be that a programmed sales transaction processing error will be repeated every time a sales transaction is processed. List four other specific risks. (2)

8. Give six examples of control activities. (3)

9. Identify the (common) characteristics of significant risks. (3)

10. How does the auditor respond to a high level of assessed risk of material misstatement at financial statement level? (3)

5.14 **(35 marks 42 minutes)**

You are a senior on the audit team of Dynamix Ltd, a company which manufactures components for the engineering industry both locally and throughout Africa. The company has a number of subsidiary companies. You are currently involved in the planning stage of the audit, and with your manager you have compiled the audit plan reflecting the nature, timing and extent of risk assessment procedures. A meeting of the audit team has been called. The team includes two trainee accountants who have just started with the firm. All members of the audit team are encouraged to ask questions about the risk assessment procedures they will be carrying out and although the new trainee accountants will not be conducting procedures on their own, they are expected to have an understanding of what they will be doing. The following questions have been raised:

1. One of the new trainees asked why risk assessment procedures are carried out and why the team does not simply get on with "doing the audit". (5)

2. The other new trainee (who will be working with a senior trainee) asked why it was necessary for the two of them to be taken on a guided tour of the company's complete manufacturing process. He asked what the benefits would be particularly as he didn't understand how this guided tour would help identifying risks relating to financial reporting. (10)

3. A senior trainee who is allocated to evaluating the control environment, asked for guidance on the elements of the control environment which he should consider when gaining an understanding of it. (12)

4. The same trainee has also been given the responsibility of identifying related parties and related party transactions. He says he has noted that he should identify significant related party transactions outside Dynamix Ltd's normal course of business, but asks if you could give him some examples of related party transactions which may be outside the normal course of the company's business. (5)

5. One of the new trainees then asked why we are concerned with risks arising from transactions with related parties, adding that he would have thought that transacting with people or companies which Dynamix Ltd knows, would be a good thing. (3)

YOU ARE REQUIRED TO respond to each of the questions posed by the trainees (1 to 5 above).

5.15 **(40 marks 48 minutes)**

Your firm has held the appointment of auditor of Craftwell (Pty) Ltd, a manufacturing company, for the last seven years. At the start of the financial year the two major shareholders (in total 55%) sold their shares to Axiom Ltd, a large listed company. Axiom Ltd puts a great deal of pressure on its subsidiaries to perform. Although Craftwell (Pty) Ltd is itself a reasonably large company consisting of four separately located manufacturing plants as well as storage facilities, the company has never had an internal audit department. Axiom Ltd on the other hand has a large internal audit department which is located at head office but which performs internal audit functions for the companies in the Axiom Ltd group. Subsidiary companies pay Axiom Ltd a fee for this service and are obliged to use the Axiom Ltd internal auditors. Consequently the internal audit department had visited Craftwell (Pty) Ltd on a number of occasions during the current financial year to assess business risk, test systems and the implementation of group policies.

Two months before commencing the year-end audit your firm received an aggressively worded letter from the financial director of Axiom Ltd stating that your firm (the external auditor) was required to place extensive reliance on the work which the internal audit department had carried out at Craftwell (Pty) Ltd during the year. The letter stated that this would enable your firm to reduce the Craftwell (Pty) Ltd audit fee (which Axiom Ltd required) and would enable Craftwell (Pty) Ltd to meet the tight group reporting deadlines. The letter also made it very clear that should you not comply, your appointment as auditor would be in jeopardy. Axiom Ltd have also appointed two of its directors to sit on the board of Craftwell (Pty) Ltd as non-executive directors. Your firm and Mark de Wet, the managing director and a minor shareholder of Craftwell (Pty) Ltd, would like your firm to retain the audit.

YOU ARE REQUIRED TO:

a) explain whether the letter sent by the financial director of Axiom Ltd threatens your firm's compliance with the fundamental principles of professional conduct. (4)

b) discuss how your firm should respond to Axiom Ltd's demands and their threat to remove you from your appointment. You should include in your answer any action your firm should take. (6)

c) discuss the factors which would influence you in deciding on the extent to which you could rely on Axiom Ltd's internal audit department. (15)

d) discuss how Axiom Ltd's internal audit department could be used to assist our audit team in:
   1. establishing the overall audit strategy. (5)
   2. identifying and assessing the risk of material misstatement. (10)

   Note: You may assume that the internal audit department can be relied upon.

5.16 **(50 marks 60 minutes)**

Your firm has held the appointment of auditor of Haliwell (Pty) Ltd, a wholesaler of imported and locally manufactured household goods, for some years. Earlier this year, Homewares Ltd purchased a majority shareholding in Haliwell (Pty) Ltd which resulted in Haliwell (Pty) Ltd becoming, for the first time, a subsidiary company within the large group of "Homewares Ltd" companies.

In prior years there has been little pressure on your firm to complete the audit timeously. In fact, it had normally taken the directors of Haliwell (Pty) Ltd, two months after year-end, to prepare for the annual audit. Becoming a subsidiary of Homewares Ltd has changed this dramatically, as the audited financial statements are now required in Johannesburg on 21 August, three weeks after the financial year end.
The senior in charge of the Haliwell (Pty) Ltd audit recently left the firm to sail around the world. Hank Phrank, the audit manager, has asked you to fill the role of audit senior on the estimated five-man audit team despite the fact that you have not worked at this client previously. As this will be the first time that you have been in charge of a medium-sized client, he has indicated that he will direct and supervise you closely but that you will be "in charge." To this end, he arranged a meeting late in March with Peter Plodd, Haliwell (Pty) Ltd's financial controller to introduce you and for you to discuss any developments at the client which may affect your audit. Prior to the meeting, you had a look at the audit work papers from the previous year and found them to be reasonably comprehensive, including systems flowcharts, audit programmes, a list of matters to be followed-up from the 2016 audit, the usual audit schedules and copies of the 2016 annual financial statements. No work has been done on the 2017 audit. The initial meeting with Peter Plodd was brief but you did obtain the following information:

1. To facilitate efficient working capital management within the group, Homewares Ltd requires that all companies within the group, make use of a particular suite of software packages in the revenue and receipts cycle. The group IT division is responsible for installing the new software at Haliwell (Pty) Ltd. Preparatory work has already commenced and it is anticipated that the May debtors statements will be the first run produced by the new system. As part of the post-implementation review, internal audit will include a letter requesting debtors to indicate any errors on their statements.

2. All companies in the group count inventory on the Sunday two weeks prior to the financial year end. This is due mainly to the tight reporting deadline, but is also due to the fact that as all companies in the group are involved in manufacture, wholesaling or retailing household products of one kind or another, there is a considerable movement of inventory between group companies which requires careful reconciliation. This reconciliation is carried out during the two weeks prior to the financial year end.

3. In addition to the audited financial statements, all subsidiaries in the group, must lodge a number of audited schedules with Homewares Ltd, by deadline date.

4. On becoming a subsidiary, Haliwell (Pty) Ltd appointed an audit committee as well as a risk committee.

On returning to the firm's offices, Hank Phrank suggested that the first thing you should do, is to outline how you intend to ensure the deadline is met.

YOU ARE REQUIRED TO draft a memorandum to Hank Phrank which outlines the timing of each stage of the audit of Haliwell (Pty) Ltd, indicating why you have chosen the timing, and also indicating the work which will be carried out at each stage (detailed audit programmes are NOT required.) Structure your memorandum (answer) as follows:

Stage: Planning 1 – (preliminary) overall audit strategy.
Planning 2 – Identifying and assessing the risks of material misstatement through understanding the entity and its environment (planning and conducting risk assessment procedures).

Stage: Responding to assessed risk- interim audit
- final audit

Stage: Concluding.

5.17 **(32 marks 39 minutes)**

You have recently joined the audit firm of Bath and Cutter, and have been appointed as senior-in-charge of the audit of Foodfare (Pty) Ltd, a medium sized company in the domestic foods sector. The company has a 31 July year-end and this year will be the first year that your firm has held the appointment as auditor. The company has a public interest score in excess of 350, due mainly to the size of its labour force.

Foodfare (Pty) Ltd has a number of food production facilities spread around KwaZulu Natal with its head office in Pinetown. The company has fully integrated computerised financial accounting and management reporting systems which were developed some years ago in-house. The systems were developed in-house to accommodate a number of unique (and complex) features pertaining to the company's business model and financial reporting system. Most data processing takes place at the IT centre at head office. The production facilities are all linked to head office and each other which allows for real time processing of certain applications.

The audit firm to which you belong has five partners and about twenty additional audit staff members. The Foodfare (Pty) Ltd audit will be the firm's largest and most computerised client. The fact that you have been appointed as senior-in-charge has presented you with an important opportunity to use your experience gained at your previous firm in auditing in complex computerised environments.

Unfortunately things did not get off to a good start. Willy de Ville, the manager in charge of the audit has (like most of the other staff members) little experience in "more complex" computerised audit environments and believes that adopting a strategy of auditing around the computer is perfectly adequate. The "planning meeting" for the 31 July audit, in fact turned out to be Willy de Ville simply issuing instructions to the audit team, mainly about the verification of year-end balances, with hardly any discussion of Foodfare (Pty) Ltd's computerisation being held.
On challenging Willy de Ville he responded as follows:

> "I don't know what you did at your previous firm but this firm adheres to the planning statement ISA 300 in developing the overall audit strategy plan. This statement does not even mention the word computers which suggests to me that auditing around the computer is a perfectly adequate strategy for the audit."

YOU ARE REQUIRED TO:

a) comment on whether Bath and Cutter should have accepted the audit engagement of Foodfare (Pty) Ltd, based on the information given in the question. (5)

b) discuss whether Willy de Ville's decision to audit "around the computer" is appropriate and whether his justification is valid. (11)

c) explain why a combination of "auditing through the computer" and "with the computer" is often the most appropriate audit strategy and plan on an audit such as Foodfare (Pty) Ltd. (6)

d) identify the components of Foodfare (Pty) Ltd's internal control pertaining to its computerisation, about which the audit team should gain an understanding, to be in a position to perform an effective audit. Provide a brief comment on each component.(10)

CHAPTER 6

MATERIALITY, RISK AND FRAUD

6.1 **(10 marks 12 minutes)**

Listed below under "A" are the first parts of ten sentences. Listed under "B" are the second parts of each sentence. When the parts "A" and "B" are combined, a complete and correct sentence is made.

List A

A1 The components of audit risk are inherent risk, detection risk and ....

A2 Collusion and human error are ....

A3 Risk which requires special audit consideration is referred to as ....

A4 If the auditor considers that control risk and inherent risk are high, detection risk must be ....

A5 Before carrying out further audit procedures, the auditor must assess the ....

A6 The auditor assesses risk for the financial statements as a whole, and ....

A7 The risk of material misstatement is made up of control risk and ....

A8 Selecting an inappropriate audit procedure is an example of ....

A9 The risk that the auditor expresses an inappropriate opinion when the financial statements are materially misstated, is referred to as ....

A10 The fact that most audit procedures are conducted on samples, is a ....

List B

B1 .... inherent risk

B2 .... detection risk

B3 .... limitations inherent in internal control

B4 .... at assertion level

B5 .... audit risk

B6 .... significant risk

B7 .... limitation inherent in the audit function

B8 .... low if audit risk is to be kept to an acceptable level

B9 .... control risk

B10 .... risk of material misstatement

YOU ARE REQUIRED TO select the part of the sentence from List B which when matched to a part of the sentence from List A, forms a complete and correct sentence.

6.2 **(24 marks 28 minutes)**

Consider each of the following statements separately.

1. Gaining an understanding of the ***business*** risk faced by a client is not an important objective for the auditor when conducting risk assessment procedures.

2. "Other" audit procedures which the auditor conducts will be determined by the results of risk assessment procedures.

3. The risks of material misstatement at the assertion level consist of two components, namely inherent risk and control risk.

4. Collusion and management override are regarded as factors which increase control risk.

5. A weak control environment can increase the risk of material misstatement at both the financial statement level and at assertion level.

6. A properly planned audit carried out by an engagement team with the necessary level of expertise and competence will reduce detection risk to zero.

7. Despite the fact that extensive risk assessment procedures may be carried out, the "further" audit procedures to be conducted will be a matter of professional judgement.

8. If it can be said that control risk and inherent risk relate to risk identification and assessment, detection risk can be said to relate to responding to assessed risk.

YOU ARE REQUIRED TO indicate whether each of the statements above is true or false and explain your answer.

Mark plan: 1 for getting "true" or "false" correct.
2 for the explanation.

6.3 **(20 marks 25 minutes)**

You are a trainee accountant at a large firm of registered auditors which has a very varied client base. All of the companies listed below hold large quantities of inventory at their respective year-ends.

Airtime Ltd: This company manufactures and sells a range of gasses to industry e.g. oxygen, carbon dioxide. The cost of the different gasses produced varies considerably as does their shelf life.

Witehouse (Pty) Ltd: This company sells (only) "white goods" e.g. stoves, fridges, to the general public from a huge warehouse located in Gauteng. An efficient perpetual inventory system facilitates sound inventory control.

Fishybusiness Ltd: This company cultivates edible fish at its fish farm in Zululand. Inventory consists of very young fish in tanks, larger fish in man made lakes/ponds and harvested fish held in the company's temperature controlled warehouse.

Secondhand Rose (Pty) Ltd: The company deals in second-hand goods which it purchases from members of the public. Where necessary, items are repaired in the company's workshop.

YOU ARE REQUIRED TO categorise the risk of material misstatement applicable to inventory held by each of the companies above as low, medium or high, based on the information given. Justify your choice.

6.4 **(20 marks 24 minutes)**

During the "understanding the entity and its environment" stage of planning for the audit of Novex (Pty) Ltd you obtain the following information, inter alia, about the company.

1. The company imports large quantities of inventory.

2. Some of the products which Novex (Pty) Ltd sells have expiry dates, after which they are not usable/saleable.

3. The company sells, inter alia, chemicals.

4. Inventory is stored in several warehouses around South Africa.

5. 30% of the company's sales are cash sales made to the informal health care sector.

6. During the year under audit, credit terms and policies were made less stringent to boost sales.

7. The company's manufacturing division leases some of its assets.

8. Obtaining spares for some of the manufacturing assets which the company owns, is extremely difficult which has resulted in a number of machines standing idle.

9. The work force at Novex (Pty) Ltd fluctuates quite significantly from month to month. Casual labour is brought in frequently for short periods.

YOU ARE REQUIRED TO identify the assertions which will be affected by the above information. Provide reasons.

6.5 **(14 marks 17 minutes)**

The following seven errors occurred during the year in the revenue and receipts cycle of Basher (Pty) Ltd, an audit client. The company has a 31 March financial year-end.

1. A batch of sales made between 1 April and 7 April 2017 were inadvertently included in the sales journal for March 2017.

2. Receipts totalling R75 322 from debtors were incorrectly posted from the cash receipts journal to the repairs and maintenance account in the general ledger.

3. Inventory belonging to Basher (Pty) Ltd was transferred from the main warehouse to a country branch of the company. To control the movement, delivery notes were prepared. These inadvertently gave rise to sales invoices which in turn were recorded in the sales journal.

4. Credit sales invoices for one month of the financial year were incorrectly prepared by a temporary sales clerk who used a price list which was out of date and which did not reflect the increases made to selling prices the previous month. (All price increases had been accepted by Basher (Pty) Ltd's customers.) The customers were re-invoiced at the correct price but the sales journal was never corrected.

5. Goods were delivered to and accepted by customers but the despatch section failed to prepare delivery notes - consequently no invoices were raised and no entries were made in the sales journal.

6. On 9 April one of Basher (Pty) Ltd's customers returned goods which had been received by the customer early in March to the value of R100 400. The goods returned were in perfect condition but did not meet the customer's safety standards. Basher (Pty) Ltd's sales policy is to accept returned goods without penalty if they are in perfect condition.

7. Drivers of delivery vehicles have been failing to return delivery notes (signed by the customer) to the accounting section. However the related sales invoices (for the delivery notes) were sent to customers as they were prepared from a copy of the delivery note.

YOU ARE REQUIRED TO state, with reasons, which assertion relating to ***sales*** will be affected by each of the above (1-7) assuming any errors were not corrected.

6.6 **(15 marks 18 minutes)**

In a recent semester test, the majority of students indicated in their answers that the following statements were ***true***. However, the tutor who marked the tests awarded no marks for a "true" answer as he felt that the statements were "false".

1. If the auditor conducts his audit competently and in terms of his firm's quality control standards, audit risk is reduced to zero.

2. The components of audit risk are inherent risk, control risk and materiality.

3. Not all significant risks identified on an audit involve fraud or manipulation of the financial statements.

4. Risk assessment procedures can also be described as "further audit procedures".

5. If an audit client's financial accounting personnel are not up to date with the accounting standards, detection risk is significantly increased.

6. Audit procedures such as enquiry, observation and analytical procedures are not carried out as risk assessment procedures, they are carried out as tests of controls.

7. The risk of material misstatement is the same as audit risk.

8. Audit risk can be defined as the risk that the auditor will express an inappropriate opinion when the financial statements are materially misstated.

9. When conducting risk assessment procedures, the auditor should gain a thorough understanding of, inter alia, the control environment at the audit client.

10. The most effective response to an increase in the assessed risk of material misstatement at financial statement level is to increase the extent of tests of controls.

YOU ARE REQUIRED TO indicate, for each of the above (1 – 10) whether you agree with the majority of the students or the tutor. Justify your choice for each statement (1 – 10).

6.7 **(16 marks 20 minutes)**

You are currently carrying out risk assessment procedures at your client Swinn (Pty) Ltd, a manufacturing company and subsidiary within an industrial conglomerate. The following information pertains to this assessment:

1. The financial director has been very evasive in answering questions, generally displaying a very dismissive attitude to the audit.

2. Some of the products manufactured by Swinn (Pty) Ltd have not kept up with market requirements.

3. In prior years directors annual bonuses were based upon earnings reflected in the audited annual financial statements. This policy has been abandoned and directors monthly salaries have been increased.

4. The company decided to retrench its internal auditors in a cost cutting exercise; the holding company internal auditors will be available if required.

5. Close to the end of the year a number of complex entries relating to asset revaluations were put through.

6. For the six weeks prior to the year end, the credit controller was absent from work due to ill health. During this period a number of employees in the section took over his duties, e.g. authorizing credit terms, passing credit notes, etc.

7. Management is regarded by the staff as being very dictatorial as certain members of management will frequently override controls. Some staff members have expressed the view that the holding company puts too much pressure on management to perform.

8. Numerous transactions take place with other companies within the group.

YOU ARE REQUIRED TO explain whether each of the above will increase or decrease your assessment of the risk of material misstatement. Your explanations should indicate whether the risk of misstatement at financial statement level or at assertion level will be affected. You are not required to consider the information collectively.

6.8 **(35 marks 42 minutes)**

You are a trainee accountant at a small audit firm. Your firm was recently appointed as auditors of Under18 (Pty) Ltd, a company which sells upmarket fashionwear to the female teenage market. The previous auditors had resigned after a dispute with the company's directors about the audit fee. The company has been operating for the last five years and has a number of outlets in each of the five major cities in South Africa.

A unique feature of the company is that they sell only for cash or on account, no cheques or credit cards are accepted. Accounts must be opened in the name of a person over the age of 21 years e.g. a parent. On average thirty five percent of annual sales are made for cash.

Most of the company's inventory is imported. There is a large central warehouse in Johannesburg from which inventory is dispatched to the company's outlets where it is either displayed on the shop floor or kept in a small storeroom.
Although sales have generally been good in previous years, sales for the financial year-end 31 March 2017 have shown a decline. The directors of the company attribute this to two things, negative fluctuations in foreign exchange rates which have resulted in increased costs for the company's imports, and increased competition in the market place. In an attempt to increase sales the directors decided during the year to relax the granting of credit by extending the credit limits and terms for all existing and new account holders. The company has a small overdraft on its bank account but which is within the facility granted by the bank.

When the company was formed five years ago, it was financed by 10 private investors who provided long-term loans. (The company has a very small share capital). None of these 10 long-term loans is secured, but in terms of the loan agreement the investors are entitled to call up their loans immediately if the company does not achieve a pre-determined net profit before tax. The loan agreement requires that an annual audit of the company be carried out. The directors are very anxious that the stipulated (pre-determined) net profit before tax is achieved.

YOU ARE REQUIRED TO:

a) discuss the factors which your firm would have considered prior to accepting the appointment of auditor of Under 18 (Pty) Ltd, based on the information given above. (10)

b) define audit risk. (2)

c) evaluate the risk of material misstatement relating to the following account balances or classes of transaction at 31 March 2017 based on the information given above
   * inventory (12)
   * sales (5)
   * accounts receivable (6)

You are advised to consider the risk relating to each assertion applicable to each of the above account balances or classes of transaction and related disclosures.

6.9 **(30 marks 36 minutes)**

You are on the audit team of Chemtrade (Pty) Ltd, a company which manufactures and distributes a range of industrial chemical products to other manufacturers. Whilst conducting risk assessment procedures on the 31 March 2017 audit, you gathered the following information inter alia, about the company:

1. During the course of the year Edgar Hoover the newly appointed chairman of the company, requested the resignation of the financial director John Dillinger, a conservative, independently minded and well respected chartered accountant who had

been at Chemtrade (Pty) Ltd for some years. John Dillinger had angered the chairman by refusing to implement certain accounting policies which would improve the performance of the company as reflected in the financial statements. As their working relationship had become untenable, John Dillinger resigned.

2. John Dillinger had been replaced by Floyd Nelson, a young and inexperienced but aggressive chartered accountant whom the chairman had recruited from another company. Floyd Nelson was also appointed as chairman of the audit committee by Edgar Hoover. John Dillinger has sued the company for R5 million in respect of monies due to him when he left the company some months prior to year-end.

3. Under the direction of Edgar Hoover, the company has recently set up a number of joint ventures and other business alliances and a fair number of transactions have taken place between them and Chemtrade (Pty) Ltd. Documentation relating to these entities and transactions appears to be minimal.

4. The valuation of inventory at year-end had in prior years been conducted in conjunction with the external auditors, by an independent specialist chemical engineer on the insistence of John Dillinger to satisfy audit requirements. For the current year Floyd Nelson decided against this practice as he deemed it unnecessary, stating that the auditors don't make the rules here, they must accept the valuation arrived at by myself and the production manager."

5. During the financial year, the company had ceased production of a particular range of chemicals which it only exported to Europe. However, due to the economic downturn in Europe, the orders for this range of chemicals have virtually ceased. Because the company had, and still has, a very large stockpile of this range of chemicals, the plant and equipment used in the manufacture of these products has been lying idle for the seven months prior to the year-end. According to the production manager, there are no plans to commence with production of this range or to adapt the plant and equipment to manufacture another type of chemical.

6. During the financial year, a government environmental agency filed a lawsuit against the company for the material sum of nearly R10m for what it describes as "extensive environmental damage to certain wetland areas". The matter is being handled by the company's lawyers, but at the financial year end the matter was unresolved. Should the decision go against the company, there could be serious consequences other than financial for the company, e.g. loss of certain manufacturing licences.

7. An analysis of the accounts receivable balance at year-end revealed that the percentage of debt owed by foreign debtors (in Europe) had increased substantially compared to the prior year due mainly to the fact that the company's trading partners in Europe are taking considerably longer to pay than they had in prior years. Management attributes this to the economic downturn in the European markets. Sales to this market in prior years have been material.

YOU ARE REQUIRED TO evaluate, based on the information given above, the risk of material misstatement at financial statement level and at assertion level for the year-end audit of Chemtrade (Pty) Ltd. Where you believe that there is risk of material misstatement at assertion level, you must identify the assertion(s) to which the misstatement relates.

6.10 **(32 marks 38 minutes)**

Your firm was recently (February) appointed as auditors of BigSky (Pty) Ltd, a company which retails equipment for a range of outdoor activities. BigSky (Pty) Ltd is one of a number of subsidiaries of Leisure Time (Pty) Ltd. All companies in the group have a 30 September year-end and each subsidiary company's annual financial statements and supporting schedules must be lodged with the holding company's head office by 25 October. BigSky (Pty) Ltd is the only company in the group which is audited by your firm. Your firm was appointed auditors when the previous audit firm resigned from the appointment. Although not prepared to hand over their audit work papers, the partner who had been in charge of the audit is quite prepared, with the permission of Big Sky (Pty) Ltd, to discuss any aspects of the audit with your firm, if so required.

You have been placed in charge of the first audit of BigSky (Pty) Ltd; this will be the largest audit you have controlled to date and your manager has informed you that although he will monitor you closely, he would like you to plan and control the audit. The first thing you did late in March, was to arrange a meeting which was attended by the previous audit partner, BigSky (Pty) Ltd's financial controller and the Leisure Time (Pty) Ltd group internal audit manager.

At this meeting you obtained the following information, inter alia;

1. BigSky (Pty) Ltd has 50 retail outlets situated in major cities and towns around South Africa.

2. The company's accounting systems are fully computerised with all application software having been developed and maintained by the Leisure Time (Pty) Ltd group information technology department. Discussions with the former audit partner, confirmed that BigSky (Pty) Ltd's system was compatible with "Extract it" the audit retrieval software used by your, and many other audit firms.
   Each retail outlet maintains its own accounting records and has its own accounting staff. In effect, each retail outlet is a separate business (see 3 below) but monthly reports are submitted to BigSky (Pty) Ltd's head office accounting staff for analysis and consolidation into the monthly managements reports.

3. BigSky (Pty) Ltd has a centralised buying department at head office. Retail outlets are required to requisition inventory from the central warehouse, they do not purchase directly from the company's suppliers. The central buying office purchases only from approved suppliers both locally and internationally. Imported goods come from numerous countries in the Far East, Europe and America. The central buying office also controls, using a sophisticated software package, the frequent movement of inventory items between the 50 retail outlets. For example, if one outlet is not selling a particular item and another outlet has a demand for the item, an inter-retail outlet transfer will take place.

4. Many of the companies in the Leisure Time (Pty) Ltd group, manufacture or wholesale products sold by BigSky (Pty) Ltd. All of these companies are approved suppliers to BigSky (Pty) Ltd and as a result there are a large number of inter-group company transactions.

5. During the months of June and July, the group internal auditors will select fifteen of BigSky (Pty) Ltd's retail outlets. These outlets will be visited by an internal audit team which will evaluate and audit various aspects of the outlet's business.

6. The year end inventory counts at the 50 retail outlets and central warehouse will be conducted after the close of business on Friday 30 September. Proper planning on the part of BigSky (Pty) Ltd combined with effective count controls is likely to ensure that all inventory will be accurately counted at all locations before midnight on 30 September.

YOU ARE REQUIRED TO:

a) discuss the matters which the partners of your audit firm would have considered prior to accepting the audit of BigSky (Pty) Ltd. Wherever possible relate your answer to the information given in the question. (9)

b) explain the difference between the risk of material misstatement and audit risk. (2)

c) identify and discuss the factors which would affect the ***audit risk*** relating to the audit of BigSky (Pty) Ltd, based on the information given in the question. Your answer must include your decision as to whether each factor identified, will increase or decrease audit risk. (18)

d) indicate whether any of the factors you have identified could give rise to a ***significant risk*** of material misstatement in the financial statements. Justify. (3)

6.11 **(40 marks 48 minutes)**

You are the senior-in-charge on the audit of TeeBaggs (Pty) Ltd, a company which processes and packages raw tea which is then sold to wholesalers and retailers. Your firm has held the audit appointment for the last five years and during this period no problems had arisen. Competent, conservative and ethical management, and good internal controls had resulted in the risk of material misstatement in the financial statements being regularly assessed as low and no modifications (qualifications) to the audit opinions for the previous five years had been considered.

Early in April you arrived at TeeBaggs (Pty) Ltd's premises to commence the "understanding the entity and its environment" stage of planning the 30 June 2017 audit and were very surprised to find that there had been a number of changes:

1. Earlier in the financial year under audit all the shares in TeeBaggs (Pty) Ltd had been bought by a group of entrepreneurs, who had promptly replaced the directors and senior management of TeeBaggs (Pty) Ltd with their own team. None of the shareholders work in the company.

2. Whilst you had no reason to doubt the competence of the new financial management team, you found them to be aggressive and unsupportive of the audit function. The financial manager told you "not to bother the staff or waste his time with petty audit problems".

3. The company had expanded, installing some expensive machinery to blend various types of raw tea, and upgrading the packaging process. The expansion had been financed by a large loan from the bank as well as long-term loans from the new shareholders in the company.

4. During the year TeeBaggs (Pty) Ltd commenced importing raw tea direct from numerous tea plantations in Sri Lanka and India through the Durban harbour. Previously the company had purchased all its raw tea from a local company which imported the tea.

5. A new remuneration system, which has proved to be popular, had been introduced; non-management employees are paid monthly bonuses if certain performance indicators are met and management will be paid bonuses based upon reported profits for the year.

6. The company is facing numerous lawsuits:
   6.1 a number of the previous management team who were replaced are suing the company for unfair dismissal
   6.2 two of the company's major competitors are suing the company for allegedly copying the blend (mixture) of some of their tea brands and infringing on their brand names. TeeBaggs (Pty) Ltd have temporarily withdrawn these blends (brands) from the market place on the advice of their lawyers. The company still holds large quantities of these blends in their finished goods warehouse.

   Neither of the above matters is expected to be resolved by 30 June 2017.

7. Inventory at year-end is expected to be valued at approx R8.5 million making up nearly 60% of current assets. It will consist of
   7.1 ***raw tea*** which is stored in the wooden boxes (tea boxes) in which it is sent by the suppliers. The supplier's name, type and grade of the raw tea is stamped on the box.
   7.2 ***blended tea*** which has come off the processing line and is stored in huge stainless steel bins awaiting packaging. There are approximately forty of these bins which at any point in time could be full or partially full of any of the company's twenty different blends. The value of the blended tea varies substantially from blend to blend depending on the grade and cost of the raw tea used in blending. This tea is regarded as work-in-progress.
   7.3 ***packaged tea.*** Once it is packaged, the date of manufacture and expiry date (sell by date) are stamped on the package and the packages are stored, by brand, on wooden pallets in the finished goods warehouse. Physical controls over all categories of inventory are very sound.

   Although the blending process has not changed significantly from the previous years the company has introduced a number of new brands (including those that are subject to the lawsuit referred to in 6.2).

   Note. Inventories of consumables, packaging materials etc are immaterial.

8. One of the problems associated with imported teas is that they are less pest resistant than locally grown teas. Raw tea and blended teas can become contaminated, in which case it must be destroyed.

YOU ARE REQUIRED TO:

a) state whether the audit plan adopted for the 30 June 2016 audit is likely to be suitable for the 30 June 2017 audit. Justify your answer. (6)

b) discuss the risk of material misstatement relating to the treatment of the lawsuits facing TeeBaggs (Pty) Ltd in the financial statements at 30 June 2017 (8)

c) based on the information given in the question, discuss the factors which will ***increase*** risk at the financial statement level in respect of the 30 June 2017 audit of TeeBaggs (Pty) Ltd. (6)

d) quantify your assessment of the risk of misstatement relating to ***each*** assertion applicable to the inventory account balance at 30 June 2017 as low, medium or high. Justify your assessments. (20)

6.12 **(58 marks 70 minutes)**

Metalman (Pty) Ltd is a scrap metal dealer situated in Germiston. You have worked on the audit for the last three years and have been placed in charge of the audit for the current year 28 February 2017. Metalman (Pty) Ltd's shareholders have included a clause in the company's Memorandum of Incorporation which requires that the company's annual financial statements be externally audited.

Most of the company's inventory (scrap metal) is bought on credit from eleven mines and four car manufacturers in Gauteng, although it does purchase for cash, a certain amount from other lesser sources. When scrap is delivered to Metalman (Pty) Ltd's premises, it is sorted by type, weighed, and then dumped on the existing stockpiles using front-end loaders. The weights are recorded on the perpetual inventory records, and the documentation is then passed through to the accounting department for processing.

Roughly seventy percent of the company's scrap is sold to ten to fifteen Taiwanese industrialists who purchase the scrap for recycling. The scrap is loaded into containers, transported to Durban and shipped to Taiwan. Sales to local foundries make up the balance of the company's turnover and are mainly made for cash. As with purchases, sales are made on the basis of weight and the type of metal sold.

Early in January you received a call from Ben Burger the company's major shareholder and managing director. He informed you that the company's bank were concerned about the increase in the overdraft and would require the year end audited financial statements by no later than 21 March 2017. On this date, a meeting is to be held with Ben Burger to consider the state of the company and the bank's continued support. You had scheduled an interim audit at Metalman (Pty) Ltd for the middle of January but in view of this development, you decided to get started a few days after the phone call.

After sorting out some administration matters, you commenced your risk assessment procedures and ascertained inter alia, the following:

1. Metalman (Pty) Ltd has been experiencing cash flow problems for some months and the overdraft has increased alarmingly.

2. This has been due mainly to falling prices on the world markets, an unstable local market which is in decline and slow payment from overseas debtors.

3. Because of the difficult trading conditions, the financial director left the company to take up a position at another company, leaving Ben Burger and Louis Green (operations director) as the only two directors of the company. Louis Green is also a shareholder.

4. A number of other administrative staff mainly in the accounting section, have also left or been retrenched leaving Miles Julius the financial accountant, as the most senior accounting employee. Whilst he is competent, his role in the company has been to run the computerised accounting system. The financial director had in prior years, made all major financial decisions and overseen the preparation of the annual financial statements. Financial decisions are currently being made by Ben Burger. Miles Julius will prepare the annual financial statements with Ben Burger who has some accounting knowledge from his years in business. In his normally aggressive manner, Ben Burger has indicated that the financial statements will "show the bank what they need to see".

5. Metalman (Pty) Ltd has continued to purchase scrap from the mines (the company is contracted to do so) which has resulted in a material increase in the stockpile of scrap metal.

YOU ARE REQUIRED TO:

a) assess the risk of material misstatement at the ***financial statement level*** for the financial statements of Metalman (Pty) Ltd at 28 February 2017. (15)

b) discuss briefly your firm's overall response to the risk of misstatement at the financial statement level. (5)

c) assess the risk of material misstatement at the account balance/class of transaction level for the financial statements at 28 February 2017. (18)

d) discuss the nature, timing and extent of the "further" audit procedures at the assertion level and "other" planned procedures required to comply with the ISAs which the audit team will conduct. (20)

6.13 (10 marks 12 minutes)

List A below contains the first part of ten sentences. List B below contains the second part of each of the ten sentences. When the parts (A and B) are combined, a complete and correct sentence is formed.

List A

A1. Material misstatements in the financial statements can arise from…..

A2. The statement that the auditor is specifically responsible for detecting material fraud in the financial statements but is not responsible for preventing it, is ….

A3. An event or condition which indicates an incentive or pressure to commit fraud is termed…

A4. Management override is a risk of material misstatement due to fraud and is therefore regarded as …..

A5. Management override and collusion are both regarded as ….

A6. Fraud, whether fraudulent financial reporting or misappropriation of assets, involves incentive or pressure to commit fraud and …

A7. The statement that the risk of not detecting a material misstatement resulting from fraud is higher than the risk of not detecting one from error is ….

A8. Where the directors of an audit client have provided personal guarantees for the debts of the company, the risk of material misstatement is ….

A9. Where the directors of an audit client appear to make numerous payments for their personal expenses through the company, there will be an increase in ….

A10. Where management does not display a strong sense of control awareness, there will be an increase in ….

List B

B1. …. a significant risk.

B2. …. true.

B3. …. increased due to the incentive which the directors may have to manipulate the financial statements.

B4. …. error or fraud.

B5. …. a fraud risk factor.

B6. …. the risk of material misstatement arising from the poor control environment.

B7. …. the risk relating to the misappropriation of assets.

B8. …. false.

B9. …. a perceived opportunity to do so.

B10. …. limitations of internal control.

YOU ARE REQUIRED TO select the part of the sentence from List B which, when matched with a part of a sentence from List A, forms a complete and correct sentence.

6.14 **(20 marks 24 minutes)**

The word "materiality" is used frequently in auditing. ISA 320 – Materiality in planning and performing an audit, and ISA 450 – Evaluation of misstatements identified during the audit, relate directly to the concept.

YOU ARE REQUIRED TO:

1. Define materiality in the context of auditing. (2)

2. When determining materiality the auditor uses professional judgement to decide what the financial information needs of users of the financial statements are. In this context, what assumptions may the auditor reasonably make about users? (3)

3. What do the judgements about materiality made at the planning stage provide a basis for? (2)

4. If a misstatement is detected which is below the materiality limit, can it be ignored? Justify. (3)

5. Provide four reasons, with brief explanation, why management may refuse to correct material misstatements in the financial statements which have been identified by the auditor. (6)

6. List four circumstances where a misstatement which is not quantitatively material may be considered to be qualitatively material. (4)

6.15 **(15 marks 18 minutes)**

1. When planning and performing an audit of a set of financial statements, the auditor need only apply the concept of materiality if he deems it necessary. (3)

2. When setting materiality levels for the audit of a ***public*** company, the auditor must obtain written notification from the audit committee that the levels to be adopted are appropriate. (2)

3. Generally, misstatements including omissions, are considered to be material if they, individually or in aggregate, could reasonably be expected to influence the economic decisions of users taken on the basis of the financial statements. (1)

4. Even if a misstatement falls below the materiality level determined by the auditor, it can in some cases be regarded as material. (2)

5. Planning materiality is set by the auditor solely to determine the nature, timing and extent of further audit procedures. (2)

6. When making judgements about what is material to users of the financial statements, the auditor is entitled to assume that users have, inter alia, a thorough understanding of IFRS or IFRS for SMEs, depending on which framework has been adopted by the company whose financial statements are being used. (2)

7. Once planning and performance materiality have been set by the auditor they should ***not*** be changed. (2)

8. It is acceptable for an auditor to make use of benchmarks when quantifying planning materiality. (1)

YOU ARE REQUIRED TO state whether each of the statements (1 – 8) is ***true*** or ***false***. Justify your answer.

6.16 **(35 marks 42 minutes)**

You are the senior in charge of the audit of Inside Out (Pty) Ltd, a company which sells a range of products for both inside and outside the home, e.g. furniture, appliances, lawnmowers and shrubs. Like most retail companies, Inside Out (Pty) Ltd has been affected by changes in consumer spending patterns. This has resulted in a decline in profits, as well as a noticeable shift to customers purchasing on account and not for cash. It has also resulted in pressure being placed on Syd Spade, the financial director and the other directors, to improve the situation.

The company operates out of rented premises in the Johannesburg area, and in addition, owns a piece of vacant land used for storing seedlings and shrubs for its garden section.

You have commenced the concluding stage of the audit and are currently evaluating the schedule of uncorrected misstatements (unresolved audit differences) with a view to determining whether adjustments are required to the draft financial statements at 28 February 2017.

Your evaluation is recorded on a workpaper attached to the schedule of audit differences for the audit manager to review. The manager on the Inside Out (Pty) Ltd audit is Megan Margret.

Final materiality guidelines

Megan Margret has suggested that in your evaluation you consider the following final materiality guidelines and any other factors you believe are relevant.

Net profit before taxation	R272 943
Current Assets	449 887
Current Liabilities	192 421
Revenue	331 049

Extracts from the draft financial statements and other sources

	2017 R	2016 R
Net profit before tax	5 458 868	8 374 040
Current assets	9 197 740	8 311 002
Inventory	4 034 428	4 326 936
Debtors	4 788 874	3 492 024
Bank	374 438	492 042
Property plant and equipment	2 348 631	2 264 473
Land	895 000	895 000
Vehicles	840 215	720 258
Fittings, computers etc	613 416	649 215

Current liabilities	3 848 425	3 809 478
Revenue	33 104 910	35 652 826
Credit sales	21 849 240	19 609 050
Cash sales	11 255 670	16 046 224

Unresolved Audit Differences

Difference 1 – Foreign creditor

The company has one foreign supplier, Homegoods PLC, which is located in the United Kingdom. Consignments of goods are purchased from Homegoods PLC about three times a year.

At 28 February 2017 the balance on Homegoods PLC's account amounted to R627 300, converted at an exchange rate of R19 to £1 which was the ruling rate at the date of transaction for a consignment of goods imported in November. By the financial year-end (28 February 2017) the exchange rate had worsened to R24 to £1. Inside Out (Pty) Ltd does not make use of forward cover or any other form of hedge. Syd Spade does not believe that any adjustment to the financial statements at 28 February 2017 is necessary as the amount owed had been settled on due date shortly after year-end.

Difference 2 – Land revaluation

One of Inside Out (Pty) Ltd's accounting policies is to revalue its piece of land (where plants and shrubs bought in bulk are stored) to market value each year just prior to the financial year-end. The details pertaining to the land are as follows:

original cost:	purchased December 2013	R895 000
:	carrying value at 29 February 2016	R895 000
:	carrying value reflected in the draft AFS at 28 February 2017	R895 000
:	market value per Proprand Inc certificate at 28 February 2017	R780 000

The property valuation has been carried out by Proprand Inc, a reputable firm of valuers, each year since the property was acquired. This is the first year in which the property value has declined but Syd Spade has decided that no "fair value" adjustment will be made as he feels that Proprand Inc have been too conservative in their valuation, particularly in view of the fact that the market value has remained stable since the property was acquired.

Difference 3 – Security

During the course of the year the three directors of the company had taken loans of R500 000 each, from Inside Out (Pty) Ltd's bank, in their personal capacities, to enable them to participate in a private investment venture. Having obtained the appropriate statutory authority in terms of Sec 45 of the Companies Act 2008, Inside Out (Pty) Ltd provided security for the three loans. Syd Spade believes that no disclosure of this matter is necessary as the Board of Directors is satisfied that whilst there is a risk that the private investment venture may collapse resulting in the three directors failing to repay their loans to the bank, the risk is "nothing to worry about".

Difference 4 – Allowance for bad debts

Carly Singh, the trainee responsible for the audit of all major allowances, believes that, based on the information presented below and the testing she carried out on the debtors age analysis and in discussion with Syd Spade, the allowance for bad debts has been understated by between R250 000 and R320 000. Syd Spade's response was simply to reject Carly Singh's opinion as unfounded.

Pertinent information is as follows:

	2017	2016
Debtors at year-end	R4 788 874	R3 492 024
Allowance	R167 610	R314 282
Days outstanding	89	65

Difference 5 – "Cut-off" testing

A supplier's invoice and related documentation selected in respect of a purchase transaction from the March 2017 purchase journal revealed that the goods in question had been received before 28 February 2017. On discovering this, the trainee accountant carried out comprehensive "cut-off" procedures and established that goods costing R211 613 had been received prior to 28 February 2017, but the purchases had not been raised in the accounting records at year end. Inside Out (Pty) Ltd does not operate a perpetual inventory system. A review of the records of the thorough inventory count which was conducted after hours on 28 February revealed that these goods had been included in the count. Syd Spade's response was simply that "the company makes purchases in excess of R15 million annually so R211 613 is hardly a factor". (Ignore VAT).

YOU ARE REQUIRED TO prepare the workpaper in respect of your evaluation of the uncorrected misstatements (unresolved audit differences) to be presented to your manager, Megan Margret.

Your workpaper must be set out as follows,

Matter No 1 - 5	Known (factual) or likely (judgemental/projected) misstatement	Materiality guideline considerations	Other factors to consider and recommendation

followed by an overall conclusion relating to all matters. You will need to look at all matters collectively to be in a position to draw a conclusion.

6.17 **(35 marks 42 minutes)**

Printplan (Pty) Ltd, is a commercial art and printing requisites company. In terms of its public interest score, Printplan (Pty) Ltd is not required to have its financial statements audited, but the shareholders have included a clause in the Memorandum of Incorporation which stipulates that the company's annual financial statements must be externally audited as they believe this adds to the credibility of the financial statements.

Extracts from the draft financial statements at 31 December 2016 are as follows:

		R'000
Current assets		
Inventory		3 240
Trade debtors		1 728
Total current assets		4 968
Non-current assets		
Property	- warehouse	1 875
	- vacant land	652
Fixtures and Fittings		145
Total non-current assets		2 672
Long term liabilities		
Long term loan		3 500
Debentures		550
		4 050
Current Liabilities		
Trade creditors		1 483
Bank overdraft		362
		1 845

You have also obtained the following information:

1. Turnover and operating figures, previous year and the current year are as follows

	2016	2015
Turnover	13 142 066	12 981 326
Gross Profit	4 468 302	4 179 351
Net income before taxation	1 787 320	1 713 534

2. The long-term loan is from Prestige Finance Ltd. The agreement with Prestige Finance contains a loan covenant in terms of which, should the ratio of current assets to current liabilities as reflected in the audited financial statements fall below 2.5:1, Prestige Finance Ltd will have the option of increasing the interest payable on the loan significantly. The loan is repayable in full in 2020.

3. The debentures are secured to their full value by a bond over a vacant section of Printplan (Pty) Ltd's property which has been sub-divided from the main lot. The value of this piece of property is reflected in the financial statements at R600 000.

4. As a guideline your firm uses the following percentages when evaluating the materiality of uncorrected misstatements:
   4.1 3% of total assets.
   4.2 7.5% of net income before taxation.

The following matters have been raised:

1. Included in the trade debtors balance at 31 December 2016 is an amount of R96 500 owing by Art Stencils CC. However, this sale, which was raised late in December is not supported by an order. According to Printplan (Pty) Ltd's accountant, the sale was raised on the instruction of the sales manager based on a quote given to Art Stencils CC. No delivery of goods has taken place as no order has been received. The sales manager is confident that the order will be received.

2. Procedures carried out subsequent to the year end revealed that an order of printing inks invoiced out at R72 000 (cost R35 000) to Printmedia (Pty) Ltd during November 2016 had in fact never been delivered. The inks had been packaged but had been left in the despatch area. Printmedia (Pty) Ltd cancelled the order in mid-January 2017 and Printplan (Pty) Ltd passed a credit note for the full amount of R72 000. Neither the client nor the audit team have been able to establish whether the inks had been included in the inventory count at 31 December 2016.

3. The workpapers on allowances/impairments revealed the following notes from the senior on the audit team:

   3.1 My opinion is that the clients bad debts allowance is understated by R75 000 based upon extensive work we have carried out in respect of aging, ratio analysis and previous year debt write offs. The financial director does not agree.

   3.2 I further believe that certain inks valued at R136 126 should be written down to nil as they are not saleable. This is based upon the fact that these inks had reached their expiry date by 31 December 2016. If they are not used by expiry date the inks thicken up and may block the ink jets on printing machines. The sales manager says that some printing companies aren't that fussy and will buy the inks at a reduced cost. There is no evidence to support this claim. (The inks were not sold by 31 January 2017.)

4. An amount of R52 148 has been capitalised to property – vacant land. This represents costs incurred in cleaning up the vacant land owned by Printplan (Pty) Ltd to comply with municipal regulations.

5. Whilst conducting procedures to identify unrecorded current liabilities, the senior on the audit team identified two goods received notes for which no invoice had been received from the suppliers at year end. The goods had been received on 28 December 2016 and included in the year end inventory count. However, the corresponding creditor had not been raised in the accounting records at year end. The suppliers invoices (received in January 2017) revealed that the cost of the goods amounted to R63 210.

6. The return documentation received on 25 January 2017, from one of Printplan (Pty) Ltd's agents who sells printing requisites on consignment for Printplan (Pty) Ltd revealed that net sales (after commission) of R92 625 (cost R45 175) had been made during December 2016. The amount of R45 175 had been included in inventory at 31 December 2016. An electronic transfer for R92 625 was made into Printplan (Pty) Ltd's bank account on the same day.

YOU ARE REQUIRED TO evaluate whether any adjustments should be made for the above matters in the financial statements at 31 December 2016. Your evaluation should consider each matter individually as well as all matters collectively. Ignore any VAT implications.

6.18 **(14 marks 17 minutes)**

Consider each of the following situations individually:

1. The directors obtained fake title deeds for a fictitious property included in the company's statement of financial position. (1)

2. The operations director used the company's staff transport vehicles at the weekend as taxis for his own account. (1)

3. The chief buyer places orders with the supplier who provides the largest discount for the company but only if the supplier deposits five percent of the purchase price into the chief buyer's bank account, and provided the goods supplied are of the required quality. (2)

4. The directors accounted for a complex transaction in a manner which was the most favourable for the company. (2)

5. The financial director elected not to disclose a contingent liability in the notes to the financial statements on the grounds that it might be harmful to the company. All information pertaining to the matter was deliberately hidden from the auditors. (2)

6. All scrap from the manufacturing activities of the company is sold for cash. The cash is not accounted for in the records but is banked intact, and used to pay for the official, very expensive year-end function held in December for all employees. The company has an October year-end. (3)

7. The financial director increased the sales revenue for the year by pre-invoicing a number of large orders which would be filled in the new financial year. All the customers concerned were related parties of the company. (2)

8. The warehouse manager, in collusion with a supplier and the warehouse administration clerk, receives short deliveries from the supplier but has them recorded as full deliveries. (1)

YOU ARE REQUIRED TO indicate whether each of the above amounts to misappropriation of assets or fraudulent financial reporting. Briefly justify your answers.

6.19 **(20 marks 24 minutes)**

In terms of ISA 240 - The auditor's responsibilities relating to fraud in an audit, the auditor is required to test the appropriateness of journal entries recorded in the general ledger and other adjustments made in the preparation of the financial statements.

1. The senior-in-charge on the audit of Steedsteel Ltd has assessed the risk of management override of controls to be high and has, inter alia, decided that journal entries should be more extensively tested. Comment on whether you agree with this logic. (2)

2. List five factors which may be of relevance to the auditor when identifying and selecting journal entries for testing. (5)

3. Outline the unique identifying characteristics which inappropriate journal entries will often have. (4)

4. Identify four indicators which may suggest that significant transactions that are unusual or outside the normal course of business may have been entered into, to engage in fraudulent financial reporting or to conceal misappropriation of assets. (4)

5. Outline the written representations the auditor should obtain from management relating to fraud at the client. (4)

6. Poor internal control provides an incentive for employees to misappropriate assets. True or false? Justify. (1)

6.20 **(20 marks 24 minutes)**

The following conditions or events exist at various of your firm's audit clients.

1. The company adheres to the principles of sound corporate governance.

2. The company has converted itself from a complex corporate structure to a more simple structure by unbundling itself.

3. The directors' remuneration is largely dependent on the company's financial results.

4. Management decisions are strongly influenced by the managing director, a clever but forceful autocratic man.

5. The company's motto is "no question - we will be number one" and employees are encouraged to be aggressive and competitive as progress and promotion depends upon results.

6. The financial director has little regard for the auditors, describing the annual audit as an irritation.

7. Recommendations made by the auditors to the company at the conclusion of the audit are implemented timeously.

8. The IT department of a large company is generally inexperienced and has a number of vacancies.

9. The company has two major customers, which are both experiencing a serious decline in the demand for their products.

10. The financial director is proposing changes in accounting policies which will improve the financial position of the company in appearance, but not necessarily in fact.

11. A number of complex year-end adjustments have been made.

12. A large number of consultants have been engaged during the year to render advice or services, but no tangible benefits or services seem to have accrued to the company.

13. Independent reviews of financial reconciliations e.g. cash book, creditors, inventory, are carried out by internal audit on a surprise basis.

14. Systems development controls are sound but subsequent program changes are not always documented, approved and tested properly.

15. There are numerous transactions with related parties but authority is obtained from the Board for such transactions.

16. The company has a well defined formal risk assessment process in place.

YOU ARE REQUIRED TO indicate whether each of the above conditions or events will increase, decrease or have no noticeable effect on the risk of fraud/misappropriation of assets occurring at these companies. Provide brief reasons for your answer. Consider each one separately.

6.21 **(40 marks 48 minutes)**

During the current financial year the following matters arose at Harbour Ltd, one of your firm's audit clients. Both matters were uncovered by the newly established ***internal*** audit department at the client.

1. It emerged that Jim Jones the head storeman had been, for a number of years, operating the following scheme: One of his duties was to check deliveries of raw materials for quantity and quality against purchase orders prepared by the purchasing department and supplier delivery notes. In collusion with a supplier's delivery driver he has consistently accepted short deliveries but signed a goods received note for the quantity of goods ordered. The delivery driver has subsequently sold the goods short delivered and shared the proceeds with Jim Jones.

2. Sam Smith the chief buying officer, and the financial controller Bill Brown had an arrangement with a major supplier to the company whereby they would accept a commission from the supplier in their personal capacities, for placing orders with that supplier. This has also been going on for some years.

The financial director of Harbour Ltd is extremely annoyed about these two matters and is of the opinion that your firm (as auditors) should be held responsible for not having uncovered these fraudulent practices in prior years.

YOU ARE REQUIRED:

a) to outline the external auditors responsibility with regard to the prevention and detection of fraud. (3)

b) discuss the attitudes/actions/procedures the external audit team should adopt/undertake to fulfil its responsibilities with regard to fraud at an audit client. (20)

c) for each of the practices described in the question, indicate whether the practice
   1. amounts to fraudulent financial reporting or misappropriation of assets or neither(3)
   2. is employee fraud or management fraud or neither? (2)
   3. should be treated as a reportable irregularity? (2)

d) discuss whether the financial director of Harbour Ltd is justified in believing that your firm should have uncovered the fraudulent actions of Jim Jones, Sam Smith and Bill Brown. (10)

6.22 **(26 marks 31 minutes)**

You and your audit team are engaged on the audit of Grassroots (Pty) Ltd, a company which builds low cost housing on contract to municipalities and regional councils. The three directors of the company are paid an annual bonus which is based on the net profit figures reflected in the audited financial statements. During the course of the audit for the financial year-end 31 March 2017, you extracted a small sample of receipts from the cash book for detailed audit testing. One of the receipts selected was an amount of R1 445 846 received from the Eastwest Regional Council during March 2017. Initial enquiries of Wesley Snipes, the financial controller, revealed that the receipt was the result of an incentive scheme administered by the Council. He informed you that, in terms of the scheme, the Council would subsidise wages paid to labourers by building contractors on housing projects undertaken within the Council's region. This subsidy is subject to certain conditions, one of which is that the contractor employs only labourers who are resident within the Eastwest Regional Council's jurisdiction. The subsidy is calculated using a formula (provided by the Council) which makes use of the gross wage bill for labourers on the contract, hours worked and a range of percentages applicable to different contractors.

To participate in the scheme, contractors are required to sign an agreement to abide by the terms and conditions of the subsidy. To claim their subsidy, the calculation of the amount due must be submitted to the Regional Council on the standard “Claim Form” signed by the financial director of Grassroots (Pty) Ltd. An inspection of the claim form supporting the receipt of R1 445 846 revealed that Grassroots (Pty) Ltd had claimed a subsidy on thirty four labourers employed on the West Extention No. 2 Housing Scheme.

Having performed procedures on the personnel, wage and contract records it became evident to you that the subsidy claim made by Grassroots (Pty) Ltd was intentionally grossly overstated. You have worked on the audit for some years and to the best of your knowledge, nothing like this had occurred at Grassroots (Pty) Ltd before. On raising this with the financial director, his response was "The company submits the claim, its up to the Council to check it!"

YOU ARE REQUIRED TO:

a) comment on whether this intentionally overstated claim amounts to fraudulent financial reporting or to misappropriation of assets. (5)

b) comment on whether the situation would increase, decrease or have no affect on your assessed risk of material misstatement at financial statement level for the audit of Grassroots (Pty) Ltd on which you are currently engaged. (4)

c) based on your answer to (b) above, discuss your overall response to the risk of material misstatement at financial statement level. (5)

d) state whether this situation amounts to a reportable irregularity in terms of Sec 45 of the AP Act 2005. Justify your answer. (8)

e) discuss whether your firm should report this matter to the Eastwest Regional Council. (4)

6.23 **(35 marks 42 minutes)**

Your firm has recently been appointed as auditor of Frameworks (Pty) Ltd, a large company which operates countrywide. The company leases out and sells scaffolding and other construction requisites e.g. concrete mixers. The previous auditor, a sole practitioner, resigned from the audit as he felt he could no longer service Frameworks (Pty) Ltd properly. The company's bank has insisted that the company provide audited annual financial statements if Frameworks (Pty) Ltd wishes to retain its financing facilities with the bank.

70% of the shares in the company are owned by the Lamberti brothers who act as joint managing directors. The remaining 30% are held by private investors. The brothers are extremely aggressive about maximising reported profits. They have shares in seventeen other companies which also operate in the construction and allied products sector. None of the eighteen companies hold shares in each other and the Lamberti brothers do not hold more than 60% of the shares in any of the other companies. However, to create a corporate identity the names of all companies in which the brothers have shares commence with the word "Frame", for example, Framecrete (Pty) Ltd, Framewood (Pty) Ltd.

The only other director of Frameworks (Pty) Ltd is Alan Kaplin who is the financial director. Alan Kaplin is extremely fearful of upsetting the Lamberti brothers and will do whatever they require. Both he and the Lamberti brothers are paid an annual performance bonus based on the financial statements and to lose his directorship would severely affect him financially.

The accounting systems at Frameworks (Pty) Ltd are all computerised. To rationalise costs, all the companies in which the Lamberti brothers have shares, maintain their accounting records on Framework (Pty) Ltd's computer facilities. All accounting records are controlled by Alan Kaplin.

The brothers operate all of their businesses out of one large warehouse/builders yard in Durban and a number of smaller yards around the country.

Frameworks (Pty) Ltd itself, is the largest company owned by the Lamberti's. The construction requisites market has become very competitive and the Lamberti brothers have only managed to keep the company operating by cutting profit margins (to win sales/lease contracts) and borrowing funds from their other companies when liquidity crises have arisen. Although they have a reputation amongst competitors for being ruthless, they will do anything to satisfy the needs of their customers.

Alan Kaplin has informed you that the annual general meeting is always held within fifteen working days after the financial year-end. A total of nine different audit firms (excluding your audit firm) audit the eighteen companies owned by the Lamberti brothers. All liaison between the auditors and the companies is channelled through Alan Kaplin.

YOU ARE REQUIRED TO assess, based on the information given above, the risk of material misstatement arising from ***fraudulent financial reporting*** in the annual financial statements of Frameworks (Pty) Ltd. Support your assessment with reasons.

CHAPTER 7

AUDIT SAMPLING

7.1 **(15 marks 18 minutes)**

There is a great deal of terminology in auditing and sampling is no exception. ISA 530 - Audit Sampling includes the following terminology:

1. Audit sampling
2. Anomaly
3. Population
4. Sampling risk
5. Sampling unit
6. Statistical sampling
7. Stratification
8. Tolerable misstatement
9. Tolerable rate of deviation
10. Non-sampling risk.

YOU ARE REQUIRED TO define each of the above terms.

7.2 **(16 marks 19 minutes)**

1. Explain the difference between deviations and misstatements in the context of audit sampling. (2)

2. If a sample is not a statistical sample, on what basis is the sample size determined and the sample selected? (1)

3. What are the two characteristics which a sampling approach (method) must have to be regarded as statistical sampling? (2)

4. Are all auditing procedures conducted on a sample basis? Justify. (2)

5. Explain the difference between audit effectiveness and audit efficiency. (3)

6. Before the auditor undertakes a sampling exercise, he should ensure that the population from which the sample is to be drawn, conforms to two characteristics. Identify these characteristics. (2)

7. When a tests of detail statistical sampling exercise is carried out, it is necessary to project the monetary errors found in the sample over the population, but this is not necessary if the sampling exercise was not statistical. True or false. Justify. (2)

8. If the auditor expects a decrease in the rate of deviation from the prescribed control procedures when conducting a sampling exercise for tests of controls, the sample size will have to be increased. True or false. Justify. (2)

7.3 **(18 marks 22 minutes)**

For many years auditors have been employing sampling techniques, both statistically based and non-statistically based.

YOU ARE REQUIRED TO:

(a) state the objectives of sampling (2)

(b) explain the terms "statistical sampling" and "non-statistical sampling". (4)

(c) discuss the circumstances in which an auditor might use ***statistical*** sampling. (6)

(d) summarise the difficulties associated with the use of statistical sampling. (6)

7.4 **(10 marks 12 minutes)**

Listed below in column A are the first parts of ten sentences (A1 to A10); listed under column B are the remaining parts of the ten sentences (B1 to B10).

Column A

A1 The application of audit procedures to less that 100% of items in a population with audit relevance …

A2 An anomaly is a misstatement or deviation …

A3 The individual items constituting a population are defined as …

A4 Tolerable misstatement is …

A5 A sampling approach must have random selection of the sample items …

A6 The misinterpretation of audit evidence when sampling …

A7 The lower the level of sampling risk the auditor is willing to accept …

A8 The greater the increase in the tolerable rate of deviation …

A9 The method of determining a starting point haphazardly and the selection of every 40th sampling unit for a sample would be regarded as …

A10 The method of selecting a sample without following a structured technique would be regarded as …

Column B

B1 … haphazard selection.

B2 … sampling units.

B3 … systematic selection.

B4 … is categorized as non-sampling risk.

B5 … such that all sampling units have a chance of selection is defined as audit sampling.

B6 … and make use of probability theory to evaluate sample results if it is to be regarded as a statistical sample.

B7 … a monetary amount set by the auditor.

B8 … that is demonstrably not representative of misstatements or deviations in the population.

B9 … the lower the sample size will need to be.

B10 … the greater the sample size will need to be.

YOU ARE REQUIRED TO match the parts of the sentences under column A to those in column B to form ten statements which are correct in themselves.

7.5 **(25 marks 30 minutes)**

You are the senior on the audit of Tigger Ltd. Your junior on the audit has heard you refer to statistical sampling. She knows a little about statistics but does not understand how it combines with audit procedures.

YOU ARE REQUIRED TO give a brief explanation, with examples where appropriate, of the nine stages (given below) of an audit test where statistical sampling is to be used.

1. Determine the objectives of the procedure.
2. Determine the procedure to be performed.
3. Confirm the population is appropriate and complete.
4. Define the sampling unit. (Units of the population.)
5. Determine the sample size.
6. Decide on the sample selection method and select sample.
7. Perform the audit procedures.
8. Analyse the nature and cause of deviations and misstatements.
9. Project the sample results over the population.
10. Conclude/evaluate.

7.6 **(18 marks 22 minutes)**

The following are factors that the auditor may consider when determining the sample size for tests of detail.

Factor

1. An increase in the auditor's assessment of the risk of material misstatement.

2. A decrease in the use of other substantive procedures directed at the same assertion.

3. An increase in the auditor's required confidence level.

4. A decrease in the total misstatement that the auditor is willing to accept (tolerable misstatement).

5. A decrease in the amount of misstatement the auditor expects to find in the population.

6. Stratification of the population when appropriate.

YOU ARE REQUIRED TO indicate the effect (either increase or decrease) each of the factors listed above would have on the sample size. Provide a brief explanation for your choice.

7.7 **(16 marks 19 minutes)**

Stratification is a technique commonly used by auditors when carrying out a sampling exercise. You are on the team for the year end audit of Westwood Ltd a large wholesaler of golf equipment to the public. Equipment is imported and purchased locally and sold to golf clubs, sports shops and specialist golf retail outlets. The majority of the company's customers purchase on credit, but there are a significant number of cash sales made as higher discounts are given for cash sales than for credit sales.

YOU ARE REQUIRED TO:

a) give the reason why auditors stratify populations when sampling. (1)

b) discuss whether stratification can be used when conducting:
   * haphazard sampling
   * monetary unit sampling (4)

c) give two examples of stratification which may be appropriate on the audit of Westwood Ltd based on the information given above. One to illustrate stratification when conducting tests of detail and one to illustrate its use when performing tests of controls. (4)

d) If a population is stratified by value and a conclusion is to be drawn about the population, it is not necessary to select any items for testing from the lowest stratum if the total value of the highest stratum is greater than 50% of the value of the population. True or false? Justify. (2)

e) The most suitable sample selection method for testing completeness of current liabilities is monetary unit sampling. True or false? Justify. (3)

f) Haphazard selection is not appropriate when using statistical sampling. True or false? Justify. (2)

7.8 **(22 marks 26 minutes)**

You are an audit manager at Fergusson and Co. You are reviewing the plan of the audit of a manufacturing company, Rowz (Pty) Ltd. The planning has been done by Steven Denham, the senior on the audit. This is his first large audit as senior.

Fergusson and Co, as part of their standard planning procedures, requires the completion of a pre-printed document titled "Sampling Methods", which details the sampling methods to be used on all major areas of an audit.

Steven Denham's completed "Sampling Methods" form for the upcoming Rowz (Pty) Ltd audit, part of which, is reproduced below:

Area	***Method***	***Reasoning***
1. Inventory count	I will choose large value items from the inventory. I will continue doing this until 50% of the inventory value has been counted.	As the auditor's concern is generally over- statement of assets, inventory items must be selected with the emphasis on large items. (4)
2. Purchases	A haphazard selection of 200 purchases of R5 000 or more made by the junior trainee working on the purchases section.	By making a totally random selection, we can, at a later stage, evaluate the results on a statistical basis should we want to. (6)
3. Completeness of Creditors	The completeness of creditors' balances at year end will be tested using monetary unit sampling.	I can use our firm's step by step instructions to implement this statistically based sampling plan as completeness is an important assertion for creditors. (5)
4. Directors Minutes	I suggest a statistical sample here but need advice on which one would be appropriate.	There is a directors meeting held every two weeks other than when the company is shut down for holiday periods. This year there were 24 meetings. I know that we usually review all directors minutes but this seems excessive. A statistical sample would give us a better result quicker. (3)
5. Cost of Plant and Equipment	To verify the cost of plant and equipment, all we need to do is full verification procedures on ***all*** additions for the year. No sampling required.	If we agree the opening balance on the cost of plant and equipment accounts to our prior year work papers and verify all additions, the year end balance will be correct.(4)

YOU ARE REQUIRED in your capacity as audit manager, to evaluate, with full explanation, Steven Denham's planned sampling methods and reasoning.

7.9 **(20 marks 24 minutes)**

You are the audit senior on the audit of Chess (Pty) Ltd. Shortly after the commencement of the audit, you overhear the following conversation between Zeth Konti and Trish Moxham, a second year and first year trainee respectively on the audit team:

> "Auditors never test any population 100%, the reason being that even 100% testing would still not give you evidence relating to some of the assertions, such as completeness. All populations therefore are sampled. The sampling can of course be judgemental or statistical. Statistical sampling is far better as it takes away the need for professional judgement and provides you with complete certainty about what you are testing. For example, if you are carrying out tests of an internal control such as whether the director has authorised all purchases of fixed assets, we can take a sample from the fixed assets register of all new fixed assets acquisitions and check for the director's signature on the order form or purchase contract. If we find that he has signed all of the orders we selected in our sample, we can be certain that all purchases of fixed assets are properly authorised before they are acquired and recorded in the fixed asset register and therefore that they exist.
>
> A good thing about statistical sampling is that if you select items properly you always get a sample which is totally representative of the population you are testing. The other good thing about statistical sampling is that it makes evaluation simple, any errors found in the sample will be netted off and the net effect transferred to the unresolved audit differences schedule in the audit work papers."

YOU ARE REQUIRED TO comment on Zeth Konti's knowledge of sampling (and auditing in general) based on his conversation with Trish Moxham.

7.10 **(22 marks 26 minutes)**

You are the auditor in charge of the audit of Screens (Pty) Ltd, a company which rents out television sets. At the financial year-end 30 April 2017, the company's records revealed inventory of 14 000 television sets on hand, valued on average at R2 500 each, of which 12 321 were out on rental. Rental payments are received monthly and are identified in the cash book, and debtors ledger by name and the rental agreement number.

The trainee on the job, Elvis Adams, decided that he should perform tests on the existence assertion relating to television sets owned by Screens (Pty) Ltd. To achieve this he selected 12 (twelve) clients from the list of rental agreements on a random basis and drafted a confirmation letter to each of them requesting that they ***positively*** confirm the existence of the TV set they had rented. The results were as follows:

1. 10 of the 12 confirmation letters were returned.
2. Of the 10 returned 9 confirmed that the television set did exist.
3. The tenth confirmation letter stated that the television set had been returned.

The workpaper presented by Elvis Adams revealed that his response had been as follows:

1. for the two confirmations not returned, he had sent a second letter but had not received any reply. Follow up by fax and phone had also not provided any response.
2. for the letter which revealed that the television set had been returned, he checked the rental agreement and established that it had expired.

The workpaper also revealed the following conclusion:

"I am satisfied with the existence assertion for television sets owned by Screens (Pty) Ltd. Of the 12 positive confirmations sent out, in effect ten of the twelve confirmed the existence of the television set. This equates to an 83% positive response which is excellent for a circularisation. No further tests are necessary."

YOU ARE REQUIRED TO:

a) explain fully why you would not be satisfied with the work performed by Elvis Adams. (12)

b) indicate and explain what further tests should be carried out in respect of the existence assertion relating to the television sets assuming that time does not allow for a full statistically based positive circularisation to be carried out and that you regard the risk surrounding the existence assertion to be high. (10)

7.11 **(20 marks 24 minutes)**

You are the senior on the 2017 audit of Egoli Ltd, a large Johannesburg based company.

Some of the junior trainees on the audit with you have learnt the principles of sampling in an audit environment from their respective universities. However they have never conducted sampling exercises in practice.

During the course of the audit, they approach you with the following practical problems that they have encountered related to sampling:

1. "I'm busy getting an understanding of the company's debtors and I have found that the debtors population is not homogeneous, i.e. there are debtors which arise from the company's wholesale operation and debtors which arise from the company's retail outlets. Further, the debtors vary from a R5.21 to R795 873. Debtors from the wholesale operations also seem to be better payers! Are we going to treat all the above debtors as one single population when doing our year end verification, or are there other alternatives?" (5)

2. "I am examining directors interests in contracts and I have found that there are only fifteen instances recorded in the register of directors interests in contracts. How can one sample such a small population when sampling is based on probability theory and large populations?" (4)

3. "I'm using a sampling plan which requires that I make an estimate of the misstatement we expect to find in the population. Obviously I will require help with this but what information must I gather for us to be able to make this estimate and what effect is our estimate likely to have on our sample size?" (7)

4. "I am going to extract a sample to perform tests of controls in the revenue cycle. The client files all the documents relating to a sale together e.g. customer order, internal sales order, delivery note, etc and I have worked out that I can test the controls I need to test using the batch of documents for each sale. My question is, can I use the same sample of batches of documents or must I extract a different sample for each control I want to test?" (4)

YOU ARE REQUIRED TO answer, with a clear, non-technical explanation, each of the above questions put to you by your junior trainees.

CHAPTER 8

THE REVENUE AND RECEIPTS CYCLE : SALES, DEBTORS, CASH AND CASH AT BANK

8.1 **(28 marks 34 minutes)**

Leadnet (Pty) Ltd is a large consumer goods manufacturing company with all the normal accounting systems such a company requires, e.g. revenue and receipts, payroll, acquisition and expenditure, etc. The chief accountant maintains a list of all the documents used within the various cycles, some of which are listed below:

1.	credit application	7.	customer's credit note	13.	receipt
2.	purchase invoice	8.	back order note	14.	purchase order
3.	delivery note	9.	costing schedule	15.	picking slip
4.	inventory requisition	10.	sales invoice	16.	goods received note
5.	clockcard	11.	cheque requisition	17.	job card
6.	internal sales order	12.	customer order	18.	salary advice

YOU ARE REQUIRED TO:

a) identify the functions you would expect to find in the revenue and receipts cycle at Leadnet (Pty) Ltd, placing them in the order the activity takes place. Do not concern yourself with the function which deals with goods returned by customers. (4)

b) select from the 18 documents listed above, only those which will be found in the revenue and receipts cycle of Leadnet (Pty) Ltd. Give a brief description of what each document selected is used for. (8)

c) indicate for each document you have selected, the department (function) in which the document is used. If you decide the document is used in more than one department (function), explain your decision. (16)

8.2 **(15 marks 18 minutes)**

The functions in a typical wholesaling company which sells on credit may be described as follows:

1.	*Order department*	*5.*	*Recording of sales*
2.	*Warehouse*	*6.*	*Receipts mailroom/cashier*
3.	*Despatch*	*7.*	*Recording of receipts*
4.	*Invoicing*	*8.*	*Credit management*

The following control procedures are in place at Wildside (Pty) Ltd, a company which wholesales a wide range of outdoor equipment.

1. A monthly age analysis of debtors is printed off the system and debtors are contacted by phone and mail if they have exceeded their credit terms.

2. Prenumbered receipts are written out for all cheques received from debtors. Most debtors pay their accounts by EFT.

3. The financial accountant, Syd Saddel inspects the daily bank deposit slips and investigates any unexpected gaps in dates.

4. Every morning one of the cash book clerks downloads the bank statements to identify and record EFTs from debtors.

5. The warehouse foreman checks goods picked to the picking slip.

6. The gate controller confirms (by counting) that the number of boxes on the delivery truck agrees to the number of boxes per the delivery notes held by the driver.

7. The order clerk compiles an on screen internal sales order (ISOs) for all orders received from customers (phone, fax or mail).

8. Every Friday the senior sales clerk follows up on the list of ISOs which have not "converted" to picking slips i.e. the goods to fill the order have not been picked.

9. The financial manager approves the credit limits (for a customer) set by the credit manager.

10. The credit manager signs the ISOs before they are sent to the warehouse.

11. If a new sales order from a customer pushes the amount owed by the customer past the customer's credit limit, the order is written to a pending sales order file.

12. The remittance register and receipts issued for debtors who have paid by cheque are reconciled to the bank deposit slips by the financial manager on a weekly basis.

13. Monthly statements are sent ***promptly*** to debtors.

14. On delivery of goods to the customer, the customer is required to sign the Wildside (Pty) Ltd delivery note.

15. After suitable investigation the credit controller will approve sales orders on the pending sales order file if he is satisfied that the debtor will pay despite being over his credit limit.

YOU ARE REQUIRED TO indicate the function under which each of the control procedures listed above is most likely to occur at Wildside (Pty) Ltd.

8.3 **(10 marks 12 minutes)**

Intersales (Pty) Ltd is a large company which wholesales a range of household products to its customers in South Africa, Namibia, Zambia and Zimbabwe. It does not sell to the general public. The company has very good internal control which addresses and is based upon the generally accepted components of internal control, i.e.

* the control environment
* the risk assessment process
* the information system, relevant to financial reporting
* control activities
* monitoring of controls.

Each of the following pieces of information relates to the ***revenue and receipts cycle***.

1. All incoming sales orders are directed to the telesales order clerks. A queuing system will direct the call to the next available clerk.

2. All journal entries for the write off of a debtor, are authorised by the credit controller and the senior financial accountant.

3. On the 25^{th} of the month a statement is produced for each of the company's debtors and emailed to them.

4. The company has an effective defined programme for developing and promoting employees.

5. The credit controller, sales director and operations director meet once a month to discuss issues or problems which may have developed with the company's products, markets or customers, and how they should be addressed.

6. When pickers in the warehouse have picked all the goods on a picking slip, they sign the picking slip.

7. The company engages the services of Inside Africa Inc to provide a six monthly report on the political, economic and consumer trends in the countries in which they do business.

8. Over the years the company has developed a reputation for ethical and honest business practice. Any employee who doesn't comply with the company's ethical code is dismissed.

9. All debtors are required to pay their accounts by electronic funds transfer (cash or cheque payments are not accepted).

10. The financial director receives a month to month report on various ratios and statistics including debtors days outstanding, debtors who have gone bad, number of customer complaints, etc.

YOU ARE REQUIRED TO identify the component of internal control to which each of the above relates.

8.4 **(10 marks 12 minutes)**

The accounting systems at Pano (Pty) Ltd are all fully computerised and are resident on the company's local area network. The following general controls and application controls relevant to the revenue and receipts cycle, are in place:

1. All programme changes are subject to approval by the internal audit department before they are implemented.

2. Before a credit sale is made, the salesperson checks the customer's account in the debtors masterfile to confirm that the customer will not exceed his credit terms if the sale is made.

3. To gain access to the local area network an employee must enter his user ID and password.

4. Write access to the debtors masterfile is restricted to two individuals in the debtors section.

5. Employees in the sales department are regularly sent on courses to acquaint them with legislation applicable to retail selling, e.g. Consumer Protection Act.

6. Before goods sold are despatched to a customer, the contents of the box to be delivered is checked against the delivery note.

7. The debtors manager scrutinises the log of debtors masterfile amendments and confirms that there is an authorised masterfile amendment form for each amendment.

8. Any employee who divulges his or her password is disciplined for breaching company policy.

9. The company has installed automatic gas release and smoke detectors in its computer facility which houses the CPU and various other computer equipment.

10. When a salesperson creates an invoice, he or she must enter the customer's account number, the account number is then validated by the computer against the debtors masterfile.

YOU ARE REQUIRED TO indicate which of the controls listed in 1 to 10 above are general controls and which are application controls.

8.5 **(12 marks 14 minutes)**

The following general and application controls are in place at Ramron (Pty) Ltd :

1. The log of amendments to the debtors masterfile is reviewed by Charly Been the credit controller on a regular basis.

2. All programme changes to the revenue and receipts application software are approved by inter alia, the financial accountant.

3. To download a daily bank statement over the internet, Thembe Zungu must in addition to entering her user ID and password, enter an additional PIN provided by the bank.

4. When pickers select items from the warehouse to fill an order, they must sign the picking slip to isolate their responsibility for having done so.

5. Employees in the revenue and receipts cycle are provided with written summaries of changes in legislation pertaining to their functions on a regular basis, e.g. changes to the Consumer Protection Act and the VAT Act.

6. For compiling an internal sales order, write access to the sales order module is restricted (by passwords and user profiles) to the two sales order clerks.

7. If the sales order clerk does not enter a "quantity" in the quantity ordered field, he cannot proceed with processing the sales order.

8. In terms of company policy, if any employee discloses his confidential password to another employee, disciplinary action is taken against the employee.

9. Ramron (Pty) Ltd is registered with Checkitout (Pty) Ltd, an online credit bureau. The password required to enter the site is known only to Charly Been and his assistant.

10. Ramron (Pty) Ltd IT systems are protected by the use of anti-virus software.

YOU ARE REQIRED TO indicate whether each of the above is a general control or an application control. Where you have chosen "general control" indicate the category of general control into which it falls.

8.6 **(25 marks 30 minutes)**

A friend of yours, Reg Park, recently purchased all the shares in Crazytimes (Pty) Ltd, a wholesaling company which sells all kinds of goods for outdoor pursuits, e.g. skateboarding, BMX, kayaking etc. The company sells only on credit. Debtors pay only by cheque or EFT. The previous owners who were also the directors, spent more time engaged in outdoor pursuits than in looking after the business, choosing to leave the running of the business in the hands of various "managers" and other employees. The goods which the company sells are popular so the business has survived this ownership neglect, and your friend (an entrepreneur) sees potential in the company. He asked you to have a look at the accounting system and internal controls which you did, only to find that, despite the design, and the documentation of the system being basically sound, the control awareness and proper operation of control activities by employees was poor. The cycle has been broken down into the usual functions for a revenue and receipts cycle and all functions are adequately staffed. On reporting to Reg Park, his response was "OK, as I am the sole director and will not be involved much in the business I want you to explain two things to me. Firstly, if we assume that the staff are honest but careless or as you say, not very control aware, what could go wrong in the revenue and receipts cycle, and secondly, if some of the staff are dishonest, including the managers, how could they be stealing from or defrauding the company?"

YOU ARE REQUIRED TO respond to Reg Park by explaining

a) what could go wrong in the revenue and receipts cycle, assuming that the staff are honest but careless and not very control aware. (15)

b) how dishonest employees (including managers) could be stealing from/defrauding the company in this cycle. (10)

8.7 **(34 marks 41 minutes)**

You have recently been requested to advise a friend of yours Joel Garnett, on certain aspects of his internal control system for sales and cash in his newly established business "The CashBox." Joel Garnett's business plan is to purchase "odd lots" of consumer goods from local manufacturers at discounted prices and to sell them from his premises in Pretoria. The CashBox will not sell a standard range of products, its range will vary according to what products he can purchase as "odd lots". He has conducted extensive research and is confident that he can source a steady stream of consumer products ranging from items of clothing to garden tools to various foodstuffs. The key to the success of his business is that he will sell items of good quality at low prices but for cash only – no cheques, no credit cards will be accepted and no accounts will be opened. His marketing research has suggested that the concept will be popular with his target market and that the outlet is likely to be very busy.

He intends to have three check-out lanes and has managed to secure three cash registers on an auction. He does not have the finance available to install sophisticated point-of-sale equipment.

The cash registers which Joel Garnett has purchased are dual roll cash registers and have the following features:

* two till rolls in a lockable compartment. The customer receipt is printed off one roll and the details of each sale are recorded on the other. This till roll is retained in the register
* the register keeps a running total of sales rung-up
* a process which calculates change to be given to the customer
* a removable lockable draw in which cash is held
* the register records any "overrides" that have taken place on the register e.g. a correction of an incorrect entry by the cashier
* the receipt produced by the register and the till roll retained in the register, record the identity number of the till.

He intends to keep "things simple" but he will employ the right number of people to run the business efficiently. Joel Garnett will be at the outlet most of the day from where he will source products from manufacturers and manage the business. The shop will be open during normal weekday business hours and on Saturday mornings.

He also intends to employ three till operators (cashiers) and one till supervisor who will also assist with the administrative functions. The three operators will sit at a different check-out lane each day. He expects to employ a bookkeeper as well as the necessary goods receiving personnel/shelf packers.

He will consider other staff if you believe it is necessary. He has also told you that proper accounting records relating to sales and cash must be kept.

YOU ARE REQUIRED TO:

a) identify the major risks which any cash based business faces. (2)

b) explain how Joel Garnett can create and maintain a sound control environment in his business. (10)

c) describe the policies, procedures and control activities which should be in place at The CashBox over the collection of cash from the cash registers, the recording of cash sales and the banking thereof. (22)

8.8 **(43 marks 52 minutes)**

PART A **(25 marks 30 minutes)**

You are a member of the internal audit department at Big Boy Manufacturing Ltd. As part of the department's regular internal control reviews you have been assigned to arranging and supervising counts of the company's cash floats. The head of internal audit believes that carrying out these counts enhances the control environment.

The main petty cash float is maintained by the chief cashier. There are, however, three other floats in operation. One is held by the secretary in the buying department, and is used to make small cash purchases. The second is kept by the raw materials storeman and is used for giving change when selling scrap materials, e.g. off cuts. Scrap is only sold to employees and only cash is accepted, no cheques, credit cards or EFTs are accepted for scrap sales. The third float is under the control of the sales director's secretary, and is used to refund occasional entertainment and travelling expenses incurred by the company's sales representatives from time to time. The approximate total amount of cash on hand at any one time is eight thousand rand, and the largest amount of cash (float and sales) is held by the raw material storeman.

All of the cash floats are maintained on an imprest basis.

YOU ARE REQUIRED TO outline the steps to be taken/procedures to be followed by members of the internal audit staff when conducting cash counts at Big Boy Manufacturing Ltd.

a) state whether you agree or disagree with the opinion of the head of internal audit that the cash counts enhance the control environment. Justify your answer. (3)

b) explain the imprest method of maintaining cash floats. (4)

c) comment on whether the counts should be conducted on a surprise basis. (2)

d) describe two precautionary measures which should be taken by an internal auditor when conducting cash counts at Big Boy Manufacturing Ltd. (3)

e) describe the controls which should be in place to ensure that all the cash sales of scrap raw materials is accounted for. (13)

PART B **(18 marks 22 minutes)**

You are in charge of the audit of "cash and bank" at Beachbreak (Pty) Ltd for the financial year-end February 2017. During the interim audit conducted during late December 2016, you had audited the bank reconciliation at 31 November and found it to be correct. All payments to trade creditors and all other payments over R20 000 made by Beachbreak (Pty) Ltd are carried out by electronic funds transfer. Amounts of R20 000 or less are paid by cheque.

During March, as part of your normal year-end procedures, you are preparing to audit the bank reconciliation prepared by Otis Redding and presented below.

Bank reconciliation at 28 February 2017 – Beachbreak (Pty) Ltd

Balance as per cashbook				R127 261.30
Add: outstanding cheques				
	49378	3 October 2016	4 446.35	
	52133	10 December 2016	15 210.65	
	52876	18 February 2017	9 316.00	
	53192	22 February 2017	943.89	
	53193	22 February 2017	47 209.11	77 126.00
				204 387.30
Add: direct EFT deposit: Note 1				18 649.30
				223 036.60
Less: bank charges and fees for February 2017				163.00
Balance as per Bank Statement 28 February 2017				222 873.60

Note 1: This represents an electronic funds transfer credited in error by the bank, to Beachbreak (Pty) Ltd's account on the 17 February 2017.

YOU ARE REQUIRED TO describe the audit procedures you would conduct on the bank reconciliation of Beachbreak (Pty) Ltd at 28 February 2017.

8.9 **(28 marks 34 minutes)**

The municipality of a popular coastal town in the Western Cape has decided that it no longer wants parking meters or unofficial car guards at its beach parking area. This has resulted from numerous complaints from beach users about having to pay fines for expired meters as well as having to pay car guards. However, revenue from parking is an important source of funds for the municipality to maintain the beach and surrounding areas. The municipality also wishes to create employment. The following system has recently been put in place:

1. The municipality employs fourteen parking attendants. Seven work on the morning shift and seven on the afternoon shift. Each shift is six and a half hours. The parking area is divided into seven sections consisting of fifty parking bays per section. Two of the parking attendants are allocated to each section for a month. One attendant will be on duty during the morning shift and the other during the afternoon shift.

2. Whilst on duty, each attendant has a small handheld device similar to a cellphone (with a keypad and display) called a "Parko'meter".

3. On parking his car, the driver is approached by the attendant and informed of the hourly cost of parking. There are also signs at the gate displaying hourly charges. The make and registration of the vehicle are then keyed into the "Parko'meter" by the attendant. The device stores this information and automatically records the time of day the vehicle was parked. Details of the vehicle entered are stored in the "Parko'meter" and can be displayed up until the vehicle is collected by its driver. Once the parking fee has been paid the details are deleted.

4. No money is paid when the vehicle is parked and no paper work is produced, i.e. no parking ticket for the driver. Hourly parking fees are reasonable to encourage people to use the facility. The minimum charge is for one hour.

5. When the driver returns from his visit to the beach, the registration number of his vehicle is keyed into the "Parko'meter" by the attendant. The parking charge is automatically calculated and displayed on the device. The "Parko'meter" also stores a cumulative total of parking fees earned. Once the vehicle has been keyed in, the attendant cannot delete the entry.

6. The driver then pays the amount owed to the attendant. No receipt is issued (too impractical) and only cash is accepted. Each parking attendant has a leather bag with his name on it in which he keeps the money.

7. For security reasons, the parking area is open every day from 6 o'clock in the morning to 7 o'clock in the evening only. The entire parking area is fenced and the entry/exit point has a boom gate which is unlocked in the morning and locked each evening. There are numerous signs indicating opening and closing times and it is very seldom that the car park is not cleared by closing time.

8. The seven attendants on the morning shift must report to the parking area by 5.45am. Here they are met by Ed Baggs, the municipal parking controller, who issues each attendant with a "Parko'meter" and a R50 float (for change) in the leather bag. The seven attendants on the afternoon shift must arrive at 12.15pm. Ed Baggs also arrives from the municipal offices at this time. He provides the afternoon shift attendants with their leather bags and floats.

9. At 12.30pm the shift changes. Each morning shift attendant hands his "Parko'meter" to the attendant who looks after their section for the afternoon shift and places his leather bag containing the cash in the boot of Ed Baggs' car. The attendant is then free to go.

10. Ed Baggs returns to the municipal offices where he counts the money in each leather bag. He deducts the float (R50) and enters the amount of parking fees received (cash) from each attendant on a "daily parking schedule" against the name and section of the parking attendant. Once he has recorded all the cash, he locks it away in his filing cabinet. He is then off for the afternoon but returns to the beach at 7pm to collect the cash and "Parko'meters" from the afternoon shift attendants. The attendants hand the devices to Ed Baggs and place their leather bags containing the cash in the boot of his car. Ed Baggs returns to the municipal offices where he again counts the cash and enters the amount on the "daily parking schedule" against the name and section of the parking attendant.

Once he has done this, he totals the cash received from each section for both shifts and compares the total per section to the cumulative total held in the "Parko'meter" used by the attendants responsible for the section. Any discrepancies are noted on the daily parking schedule. Once he has done this, he deletes the cumulative total from the "Parko'meters" memory returning it to zero so that the devices are ready for the following day. Only Ed Baggs and the municipal accountant to whom Ed Baggs reports, are able to "zero" the "Parko'meters". Parking attendants cannot tamper (e.g. change) this total. All the cash is locked away in Ed Baggs' filing cabinet overnight. In the morning he makes out a deposit slip for the cash received per the previous day's parking schedule, and deposits it in the bank. Weekend procedures are the same except that banking takes place on Monday morning.

YOU ARE REQUIRED TO:

a) indicate whether the risk of misappropriation (theft) of parking fee income by the municipal employees should be regarded as high, medium or low based on the description of the system described above. Justify your answer. (10)

b) discuss the internal controls which should be in place, or should be implemented to reduce the risk of theft of cash from parking. (18)

Note: The capabilities offered by the "Parko'meters" are restricted to those described in the question, e.g. no parking ticket/receipt can be produced, and the municipality requires that the basic system remains the same.

8.10 **(45 marks 54 minutes)**

Madgadgets (Pty) Ltd sells its products by mail order only. The company sells a range of only 10 products, none of which can be purchased by any other means. Madgadgets (Pty) Ltd advertises its products in popular magazines, such as You, Rooi Rose. Each advertisement describes the product and gives its price (prices range from R99.00 to R799.00) and includes an order coupon (order form) which customers must fill in and send to Madgadgets (Pty) Ltd. The coupon is well designed; each of the 10 products is listed and there are blocks into which the quantity required by the purchaser, must be filled. The purchaser must then multiply the quantity by the price of the item(s), entering the amounts in the blocks provided to calculate the total rand amount of the order. Customers must provide a delivery address as well as contact details.

Madgagdets (Pty) Ltd's postal address, phone and fax number and bank account details are provided and customers are required to make a direct deposit or bank transfer into this bank account. Customers are reminded on the order coupon to reference the proof of payment, to the coupon. Proof of payment and the order coupon must then be posted in an envelope or faxed to Madgadgets (Pty) Ltd. Although the coupon also instructs customers ***not*** to send cash or cheques with the coupon, some customers still do. In these cases the cash orders are "processed" but the cheque orders are returned (due to the risk of cheques not being honoured by the bank). It is also not uncommon for order forms to be incorrectly filled in.

As the company has a small range of products, which is easy to manage, inventory shortages do not occur. There is adequate staff to achieve satisfactory division of duties, and the revenue and receipts cycle is broken down into the following functions, order department, warehouse, dispatch and accounting. There is also a separate mail receiving department.

Systems are not computerised. However, Mary Bligh (who is in charge of cash records) has a facility to download the bank statement daily and prints out copies as needed. Controls over access to the bank account are good.

Madgadgets (Pty) Ltd uses a single courier service to deliver the goods to customers. Delivery costs are borne by the company.

YOU ARE REQUIRED TO describe the internal controls which should be in place at Madgadgets (Pty) Ltd to ensure the valid, accurate and complete receipt and processing of orders and the recording of the sale.

Do not concern yourself with goods returned by customers, or the controls surrounding the downloading of bank statements.

8.11 **(35 marks 42 minutes)**

You have been requested to review aspects of the revenue and receipts cycle of JenTwo (Pty) Ltd, a company which wholesales childrens clothing. The company was started a few years ago by Jenny Bird and has grown quickly. However the accounting systems and related internal controls have not kept up with the growth of the company, resulting in an increase in bad debts, incorrect goods being sent and inventory losses. Jenny Bird has asked you to carry out the review and recommend procedures and controls to address these (and other) problems in the system.

You have obtained the following information:

1. All orders from customers are handled by Mary Moore, the order clerk. Only orders through the post are accepted. (Phone orders are not accepted; if a customer phones to place an order, Mary Moore requests that the order be sent through the post. Customers are used to this and happy to comply.)

2. When Mary Moore receives an order she
   - 2.1 establishes whether it is from an approved account holder (sales are only made on credit)
   - 2.2 confirms that the customer's delivery address is on the order and
   - 2.3 that the order is made out to JenTwo (Pty) Ltd

3. If the order is from a non-account holder, Mary Moore makes out a "New Customer Form" which she completes by filling in the customer's details off the customer order, e.g. name of company, address, contact details. She then sends the "New Customer Form" to the accounting department so that the debtors clerk can open a ledger account for the new customer.

4. Once Mary Moore has carried out her checks on the customer orders (point 2 above) she signs each order, makes a photocopy of each and sends the photocopies to Eddie January, the warehouse/despatch foreman. The original customer orders are filed in the order department.

5. The warehouse/despatch department is staffed by four warehouse clerks who report to Eddie January. The photostatted orders are placed in a secure tray outside Eddie January's office and are taken one by one by the warehouse clerks for picking and dispatch.

6. As the warehouse clerk picks the items ordered from the shelves, he ticks the items off on the (photostatted) customer order and places the items picked in a suitable cardboard box. Before sealing and addressing the box, the warehouse clerk makes out

a preprinted three-part ***delivery note*** for the items which have been picked. He places the top copy of the delivery note in the box and seals the box. He then places the box on the company's delivery van (JenTwo (Pty) Ltd makes all its own deliveries) and attends to the next customer order. The remaining 2 copies of the delivery note remain in the book. (Each warehouse clerk has his own book of delivery notes.)

7. At the end of each day the four delivery note books are returned to Eddie January. He removes the second copy of each delivery note and sends them to the accounting department. The last copy remains in the book.

Jenny Bird has requested that, once you have carried out your review, you make recommendations as to how the existing system could be improved. She does not want to put in computerised systems at this stage or appoint further staff. She is prepared to incur reasonable costs, change the responsibilities of existing staff and get more involved herself if necessary.

YOU ARE REQUIRED TO describe procedures and controls which could be implemented at JenTwo (Pty) Ltd to improve those aspects of the revenue and receipts cycle given in the question. Break down your answer into the following functions:

1. Acceptance of orders and sales authorization
2. Credit Management
3. Picking of Goods and Despatch

Procedures or controls applicable to all functions should be included under a "general" heading so as to avoid repetition.

You may assume that JenTwo (Pty) Ltd always has inventory available.

8.12 **(40 marks 48 minutes)**

A friend of yours, Peter Polar, recently purchased a majority share holding in Margins (Pty) Ltd, a wholesale stationery and office supplies business in Johannesburg; he has also taken over the responsibility for the daily running of the business. However, as he does not have an accounting background, Peter Polar has engaged you to evaluate the company's systems which he believes are not up to standard. His major concern at this stage is certain functions within the revenue and receipts cycle; "the cycle seems to me to be in a mess, I'm sure that we are not filling all our orders, bad debts seem to be very high and we may even be making deliveries without raising invoices. I'm sure there are many other problems in the cycle; I need you to look into it for me and make some recommendations."

You agreed to the engagement and set about evaluating certain functions in the revenue and receipts cycle. Your discussions with Rajan Dukes, the stores foreman, and Polly Nglanya, the accountant and your own observations revealed the following:

1. *Receiving Customer orders/Sales Authorisation*

1.1 Orders are taken over the phone or are received through the post. Sometimes phone orders are followed up by a written order through the post for the same goods.

1.2 When an order is phoned through, whichever employee receives the call, jots down the details of the order, i.e. customer name, delivery address and details of goods required on a telephone message slip. If the customer wants a price, the employee reads the price off a price list.

1.3 These messages are then placed on the order clerk, Ben Chetti's desk.

1.4 Customer orders received through the post are also passed to Ben Chetti.

1.5 Ben Chetti prepares a single copy pre-printed pre-numbered picking slip for each order transferring the details on the message slips/written customer orders onto the picking slip. He writes in the selling prices for the goods but does not calculate the value of the sale, VAT, etc. Written customer orders and message slips are thrown away.

2. *Processing of Orders/Despatch*

2.1 The picking slips are placed in a wire basket at the entrance to the warehouse.

2.2 Either of the two pickers collect the picking slips from the wire basket and pick the goods from the warehouse shelves placing them in suitably sized boxes. The picking slip is placed in the box with the goods and the box is transferred to the despatch section.

2.3 The clerk in despatch

2.3.1 enters the delivery details on the box (taken from the picking slip)

2.3.2 checks the items in the box against the picking slip (see also 2.4 below) and

2.3.3 signs the picking slip after sealing the box.

2.4 If an item on the picking slip is not in the box or an order has only been partially filled, the despatch clerk writes "***not in stock***" or "***incomplete order***" next to the item.

2.5 The despatch clerk then prepares a two part pre-printed sequenced delivery note from the details on the picking slip, reflecting the ***actual*** quantities in the box. Where the quantity is less than the quantity ordered, the delivery note is marked "out of stock" to notify the customer. The picking slip is then thrown away.

2.6 The boxes are loaded onto the company's small delivery vehicle by the despatch clerk and both copies of the delivery note for each delivery are handed to the driver. The driver is given a list of delivery notes, and he ticks off each box as it is loaded onto the vehicle. He and the despatch clerk sign the list.

2.7 On delivery of the goods to the customer, the driver obtains the customer's signature on both delivery notes, leaves the top copy with the customer and on return to Margins (Pty) Ltd's premises, hands the second copy of each delivery note to Grace Face, the bookkeeper. Grace Face files each delivery note in date order.

2.8 If the customer collects an order from Margins (Pty) Ltd's despatch area, the customer signs both copies of the delivery note and keeps one copy which must be shown to the guard at the exit to the company's premises. The second copy goes to Grace Face.

Around the 25th of each month, Grace Face prepares invoices to be sent to customers on her computer using a simple software package. Details of sales are taken from the delivery notes returned by the driver. Where an invoice must be made out to a customer who does not appear on the debtors masterfile, Grace Face makes the required addition to the masterfile.

Once you had looked into the system, you asked Peter Polar whether there were any constraints or specific requirements of which you should be aware, before making your recommendations. He responded as follows:

1. the company should continue taking orders over the phone without written customer orders,

2. the company should continue to make only credit sales i.e. no cash on delivery sales,

3. due to his tight budget having just purchased the business, no costs are to be incurred on new computers or software or on hiring of additional staff, but that if necessary new or redesigned documentation (stationery) could be purchased, (only Polly Nglanya and Grace Face have computers). If necessary Sarif Keito, a competent clerical assistant could be transferred to the warehouse,

4. invoicing of customers should become much more frequent to improve cash flow.

YOU ARE REQUIRED TO:

a) identify and explain briefly, the weaknesses evident in the revenue and receipts cycle of Margins (Pty) Ltd based on the information given above. (14)

b) recommend improvements to the company's business processes and control procedures/activities which should be introduced to address the weaknesses, taking into account the constraints and specific requirements listed above. (26)

8.13 **(30 marks 36 minutes)**

A friend of yours, Matthew Miller, recently came to see you for some advice. His business, Screen Aids (Pty) Ltd, sells a range of television and computer related products such as computer games, spares etc. The business has grown quickly and Matthew Miller feels that certain systems require improvement if efficiency and customer service is to be maintained. His initial concerns relate to the revenue and receipts cycle.

Currently customers (account holders only) phone orders through to Screen Aids (Pty) Ltd, using the product catalogue which they are given by Screen Aids (Pty) Ltd. Order clerks take down the details of the order by writing out a multipart internal sales order/picking slip which is then processed through picking and dispatch. As the business has grown, this manual system has proved inefficient and more and more mistakes in deliveries etc, have occurred. Matthew Miller sought the advice of a computer expert who suggests that Screen Aids (Pty) Ltd put a telesales system into operation. This would involve the existing sales order clerks being trained in the use of computers. Each clerk would be allocated to a terminal and would create the necessary documentation on the computer. Customers will still be given up to date catalogues as in the past. The order could then be printed out in the warehouse for picking and dispatch purposes. Matthew Miller likes the idea but wants to clear up some matters with you. He tells you that the computer expert's explanations were too technical and that he didn't want to look stupid by asking the expert too many questions!

However, he has asked you the following questions:

1. If we give each of the three buying clerks their own terminals, surely it increases the risk of unathorised orders being placed and our other system applications on the network being accessed by unauthorized people. How do we control this? (10)

2. If the order is being taken over the phone how are we going to check on inventory availability and the credit worthiness of the customer, before we dispatch the goods?(4)

3. The computer expert used a number of terms I did not understand in particular, "least privilege", "minimum entry" and "mandatory fields". What do these mean? (6)

4. As far as I can understand, errors could still occur whilst taking orders, for example:
   4.1 orders could be taken from customers who aren't approved.
   4.2 the sales order clerks may type in incorrect quantities, or product codes, or could even type in the wrong description, and leave out the quantities. Am I correct? (10)

YOU ARE REQUIRED TO respond to Matthew Miller's questions.

8.14 **(28 marks 34 minutes)**

PartTime (Pty) Ltd is a wholesaler of car parts to the local trade. The company operates out of large premises in Port Elizabeth. PartTime (Pty) Ltd does not deliver and does not take orders through the mail or over the phone. Sales are only made to customers who come to the premises. Most of the building is taken up by the inventory warehouse. Parts are laid out in logical locations on shelving and in bins. Each different part has a unique part number which is entered on the inventory database with other details of the part, inter alia, quantity on hand, description, selling price and location in the warehouse. All parts carried by the company are also listed in catalogues which are placed on the sales counter. Generally customers know exactly what parts they require but will not necessarily know the part number and are thus able to refer to the catalogues. The sales counter is one long counter behind which the eight parts sales personnel are seated. Due to the risk of having cash on the premises, PartTime (Pty) Ltd does not make cash sales. The company sells only on credit to approved account holders, e.g. garages, workshops, panel beaters as well as a number of car accessory outlets.

Customers will approach the counter when a salesperson is available and must produce a customer purchase order. The company's accounting systems are all resident on a local area network. Each salesperson has his own workstation on the network. Applications on the system are menu driven.

Before creating an invoice, the salesperson and customer confirm by reference to the inventory masterfile and parts catalogue on the counter that the part numbers for goods required are correct. The salesperson also confirms the availability of the parts by reference to the inventory masterfile "quantity on hand" field. (The inventory masterfile is updated immediately as sales are made and when deliveries are received from suppliers).

If the parts are available (usually the case) the salesperson enters the necessary details, e.g. customer account number, part number, quantity, onto the system via his keyboard to produce a computer generated three part invoice. On keying in the data a number of programme controls are carried out, prices are "fetched" from the inventory masterfile and casts and calculations are carried out by the computer. The programme checks include a check to determine whether the sale being entered will result in the customer's credit limit being exceeded. If so, the sales person cannot proceed with the sale unless the credit controller is called and agrees to override the control which she is able to do by entering her password and activating a command via the keyboard.

The customer is given two copies of the invoice (the third remains in the sales department) and the customer is directed to "warehouse dispatch". A warehouse clerk picks the parts listed on the invoice from the shelves, and hands the parts to the customer who leaves the premises through a designated security area. From time to time there are discrepancies between the theoretical inventory and actual inventory on hand which results in the clerk not being able to pick the parts as listed on the invoice.

As part of an internal audit review of PartTime (Pty) Ltd's systems you, a member of internal audit, have been asked to evaluate the application controls in those aspects of the system described above. The company is generally regarded as having well designed and implemented internal controls.

YOU ARE REQUIRED TO:

a) discuss the controls which should be in place to prevent unauthorized access to the sales application. (8)

b) describe the controls which should be in place to ensure that only ***valid*** overrides of the control which prevents an invoice being generated for a sale which will result in a customer's credit limit being exceeded, are made. (5)

c) explain the following programme controls ***in the context of the creation of a sales invoice by PartTime (Pty) Ltd's sales personnel***
   (i) minimum keying in of information (3)
   (ii) mandatory fields (3)

d) describe the control procedures/activities which should be in place over the dispatch of parts sold, from the time the customer is directed to "warehouse dispatch" until he leaves the company's premises. Your answer should include controls over instances where the warehouse clerk is not able to pick the goods as listed on the invoice. (9)

8.15 **(34 marks 40 minutes)**

Dan Dare the former sales manager of Velocity (Pty) Ltd, has recently been appointed as the credit manager at the company as part of his career development. The company's revenue and receipts cycle is computerised and resident on the company's local area network. Software is well designed and kept up to date. Being familiar with the policies and procedures relating to extending credit to new customers, following up on slow payers, etc., he has fitted into his new role quickly but is concerned about a few of the computer related aspects and has asked you to explain some of these. His first concern is control over the debtors masterfile and he has asked you what controls are in place to prevent an employee at Velocity (Pty) Ltd from invalidly deleting a debtors record of say, a friend or family member, from the debtors masterfile.

YOU ARE REQUIRED TO :

a) explain the principle of ***defence in depth.*** (2)

b) explain to Dan Dare how invalid deletions of a debtors record from the debtors masterfile is prevented. (10)

Dickie Jeeps the owner/manager of Cooldrinkz (Pty) Ltd, wishes to computerise his sales order function. His business, which manufactures and sells a range of soft drinks, has grown considerably and his existing system which is manual is not working effectively. He is finding more and more that sales are being made to his customers when they are over their credit limits, which in turn is negatively affecting his cashflow. He tells you that his customers phone in their orders to the sales order clerk and he wants to keep it this way, but he wants a system which allows him to authorise or reject a sale from a customer who is over his credit limit. He does not want to automatically deny the customer the sale as he feels that this is not good customer relations. Dickie Jeeps also understands that he will need to upgrade/computerise the rest of the revenue and receipts cycle (and integrate it with other cycles), train staff including the debtors clerks and sales order clerk, and is quite prepared to incur the expenditure. However for now he wants to get "sales ordering right as this is where it all starts".

YOU ARE REQUIRED TO describe to Dickie Jeeps, a sales ordering system which would meet his needs and ensure that only orders from approved customers are accepted and that they are entered into the system accurately and completely. Your answer should list the controls which should be put in place and you can assume that Dickie Jeeps understands computer terminology. Do not concern yourself with inventory availability. (22)

8.16 **(24 marks 29 minutes)**

Jobfixers (Pty) Ltd, a company which supplies a range of tools, has a fully integrated computerised accounting system resident on its local area network. The following activities/procedures take place at some point in the revenue and receipts cycle :

Sales orders (email, phone or fax) are entered into the system. Ben Bolt the sales order clerk, accesses the sales order module and completes an on-screen sales order. This process is subject to a range of application controls which ultimately result in the order which has been taken, being written to a ***pending sales order file*** or a ***sales order file***. All pending sales orders must be approved by Clarence de Wet the credit controller, before the order can be accepted. Clarence de Wet performs this function on the system (i.e. not manually). Processing of sales orders is in real time.

At various times of the day Foster Grove the warehouse administration clerk, accesses the sales order file from his terminal in the warehouse. He selects the sales order he wants to have picked and prints out a copy of the sales order in the form of a picking slip. When Foster Grove selects a sales order for "picking", the system allocates (attaches) a status code to the sales order (on the system) which indicates that it has been selected for picking and is now at the picking slip stage. (The sales order selected is not transferred to a separate picking slip file). Once the tools have been picked, they are moved to the picking control area of the warehouse with the picking slip. At this point, one of the two picking control clerks, checks the tools picked against the picking slip to identify incorrect tools or incorrect quantities picked. The control clerk is then responsible for correcting and approving the picking slip on the system.
Once the picking control clerk has completed his duties, the tools and the hardcopy picking slip are transferred to the despatch area where Joe Hart the despatch controller, performs a final check of the goods before creating the invoice on the system. (Jobfixers (Pty) Ltd sends a copy of the invoice with the goods). Loyiso Gwala is in charge of the warehouse.

YOU ARE REQUIRED TO :

a) give two reasons why a sales order might be placed on the pending sales order file. (2)

b) explain how approval on the system by Clarence de Wet of pending sales orders, would be successfully carried out. (8)

c) indicate what access privilege to the sales order file should be given to each of the individuals listed below. Explain your reason for selecting the access privilege you believe should be given:
   (i) Foster Grove, the warehouse administration clerk (2)
   (ii) The picking control clerks (4)
   (iii) The pickers (2)
   (iv) Joe Hart, the despatch controller (3)
   (v) Loyiso Gwala, the warehouse manager. (3)

8.17 **(15 marks 18 minutes)**

You are the senior on the 28 February 2017 audit of Prizm (Pty) Ltd a retailer of glassware. You enquired of a junior trainee as to the assertions pertaining to the following account headings.

Accounts Receivable (trade debtors)	R2 297 141
Sales	R8 863 219

Her response was as follows

Accounts Receivable: The assertions are

Existence:	All debtors making up the balance of R2 297 141 actually exist; they are not fictitious.
Accuracy:	The amount of R2 297 141 is accurate i.e. no mistakes are included in the balance.
Completeness:	Only debtors who can pay the complete amount owed by them are included in the balance.
Obligation:	Debtors included in the amount are obliged to pay within the company's credit period.

Sales: The assertions are

Materiality:	The sales figure of R8 863 219 is material in relation to the other figures in the financial statements
Cut-off:	The figure of R8 863 219 includes only sales made in the financial year being audited.
Validity:	All sales included are valid sales, e.g. they are not fictitious.

YOU ARE REQUIRED TO discuss your junior trainee's understanding of the assertions. Justify.

8.18 **(12 marks 14 minutes)**

You are on the audit team of Jingle Bells (Pty) Ltd a company which manufactures a large range of conventional door bells, electronic buzzers and security alarms. During the course of the current audit the following procedures were undertaken.

1. Enquired of the sales director as to whether the company had expanded into any new markets.

2. Conducted subsequent receipts testing on payments from debtors.

3. Extracted a sample of debtors from the aged list of debtors and reperformed the aging of each debtor.

4. Scrutinised the internal control procedure manuals to gain an understanding of how credit notes should be processed and authorised.

5. Enquired of the credit controller as to whether, as recommended by our firm at the previous year's audit, the company had abandoned the practice of pre-invoicing.

6. Extracted a small sample of sales invoices, and by reperformance, confirmed the mathematical accuracy of each invoice including the VAT calculations.

7. Scrutinised the company's loan agreements for loans raised during the financial year for evidence of any loan covenants.

8. Reviewed the debtors control account in the general ledger for any unusual entries.

9. Discussed changes to the company's credit terms/limits with the credit controller and financial accountant.

10. For each of the sample of sales invoices selected in (6) above, traced the sale back to its supporting documentation, i.e. customer order, picking slip, delivery note, etc.

YOU ARE REQUIRED TO state whether each of the procedures would be classified as a "risk assessment procedure" or a "further" audit procedure. Where you selected "further" audit procedure, indicate to which assertion the procedure relates.

8.19 **(16 marks 19 minutes)**

You are currently doing a vacation job at a firm of auditors. As you have virtually no experience, you have not been given much responsibility. However, one of the audit seniors has asked you to go and conduct a petty cash count at Dreamshop (Pty) Ltd, a retail outlet which sells bedding, blankets, etc. The shop has two floats (kept in lockable petty cash boxes), one for petrol and other minor expenditures for the company's delivery truck (NPN 3297), and the other for sundry shop expenses, e.g. stationery, tea, coffee, cleaning equipment.

He informs you as follows:

1. The count must be conducted on a surprise basis.

2. You must conduct the count in the presence of Dolly Duvet, the custodian of the cash floats.

3. Both petty cash boxes should be present when the count takes place and should be counted one immediately after the other.

4. You must prepare a workpaper detailing your count.

5. Dolly Duvet must check and sign the workpaper once it has been prepared.

YOU ARE REQUIRED TO:

a) explain the reason for each of the instructions given to you by your senior. (8)

b) prepare a detailed workpaper for the motor vehicle petty cash count, assuming that the petty cash is kept on the imprest system with an original float of R500. Use your imagination to supply the detail and record the procedures you would have conducted. (8)

8.20 **(25 marks 30 minutes)**

PumpIt (Pty) Ltd is a wholesaler of industrial pumps of all shapes and sizes. It is a subsidiary of a listed company and is required to have its annual financial statements externally audited. The financial year end is 31 March. The audited financial statements must be lodged with the holding company twelve working days after the year end. To address this tight audit deadline, your team's audit strategy was to conduct as much work as possible at an interim audit at the end of January, and then perform roll forward procedures on the two months prior to year end.

At the interim audit you spent some time on verification of the debtors balance at 31 January 2017. This included a positive debtors circularisation. This circularisation produced satisfactory results but resulted in a small number of adjustments to the debtors ledger and debtors control accounts becoming necessary. The client was in agreement with these adjustments. You have now returned for the final audit and are about to commence procedures on the debtors control account for the months of February and March 2017. The debtors control account appears in the general ledger as follows:

Date	Account	Ref	Amount	Date	Account	Ref	Amount
1/02	Balance	b/d	5 472 915	28/02	Cash	CRJ73	2 187 840
28/2	Credit Sales	SJ47	2 531 804	28/02	Credit Notes	CNJ17	104 145
25/3	Credit Sales	SJ52	2 183 727	28/02	Special discount	J43	81 000
31/3	Mightyflow CC	SJ44	92 150	15/3	Note 2		
	Note 1			31/3	Adjustment	J45	87 200
31/3	Credit Sales	J47	352 214	31/3	Note 3		
	Note 4			31/3	Cash	CRJ79	2 946 906
					Bad debts	J49	225 413
					Note 5	c/d	5 000 306
			10 632 810				
					Balance		10 632 810
	Balance	b/d	5 000 306				

James Jett the debtors controller at PumpIt (Pty) Ltd, has supplied you with the following information:

Note 1. A pump to the value of R92 150 was loaned to Mightyflow CC in March on trial with the understanding that if the pump met Mightyflow CC needs, the CC would purchase the pump.

Note 2. This was a special discount given to Maxipressure (Pty) Ltd. The discount of 25% of the unit sale price of the pump was granted because the pump was damaged.

Note 3. This amount represents the adjustments arising from the debtors circularisation conducted by the auditors at the end of January 2017.

Note 4. This journal entry raises the sales made between 25 and 31 March 2017. The sales journal was closed off on 25 March. The last invoice number on 25 March was X3792 and the last delivery note D4918.

Note 5. This represents a write off of the full amount owed by Waterworx (Pty) Ltd. The company has gone into liquidation and the liquidator has informed PumpIt (Pty) Ltd that creditors are unlikely to receive any more than 25% of the amount owed to them. The financial director of PumpIt (Pty) Ltd is of the opinion that the company will receive nothing.

YOU ARE REQUIRED TO describe the procedures you will conduct relating to the debtors control account of PumpIt (Pty) Ltd at 31 March 2017.

8.21 **(23 marks 28 minutes)**

You are engaged on the audit of Flaggs (Pty) Ltd, a company which manufactures a range of flags and banners. The company has a good internal control system including documentation which is well designed and comprehensive.

The financial year-end was 30 April. You were responsible for conducting a positive debtors circularisation and towards the end of May you are following up on a number of responses which have been returned to your office. These are detailed below:

Name	***Amount***	***Response***
Eventz CC	R11 413	We are not paying this amount. The banners which Flaggs (Pty) Ltd supplied us (invoice 4932) had spelling mistakes and were unusable. We are waiting for Flaggs to collect the banners and refund us. (4)
The Flagman (Pty) Ltd	R14 291	This balance is not correct as it does not reflect a cheque payment sent to Flaggs on 24 April for an amount of R4 301 (cheque no 1473, see remittance advice). (3)
Bills Bags CC	R29 250	This amount is not for us, we do not buy flags or banners and have never heard of Flaggs (Pty) Ltd! (8)
Mall Managers Ltd	R96 750	This balance is incorrect. The purchase was for flags made for one of the shopping malls we manage. In terms of our agreement with Flaggs a 10% discount is given on all flags purchased by us for our malls. The discount has not been granted. (5)
Triathlete CC	R7 702	This balance is correct but it is most unlikely that we will be able to pay due to circumstances beyond our control. The event for which these unique banners were purchased was washed out and the organiser made a loss. We would appreciate a credit note. (3)

YOU ARE REQUIRED TO describe the procedures you will carry out/actions you will take resulting from each of the above debtors responses.

8.22 **(35 marks 42 minutes)**

Instant Energy (Pty) Ltd is a wholesaler of industrial and vehicle batteries. You are a member of the team working on the audit for the financial year-end 28 February 2017. You have been assigned to the audit of trade debtors and in preparation for a meeting to discuss the audit with your manager you have obtained the following information:

1. Trade debtors at R8 487 030 is a material balance in the financial statements (2016 – R6 187 294). All sales are made on credit to approved customers only.

2. The company divides its debtors into 4 categories. An analysis of debtors which you extracted from the debtors masterfile using your software revealed the following:

Category	***Description***	***Number of Debtors***	***Rand Value***
1	Industrial	40	1 057 595
2	Vehicle Manufacturer	6	3 217 815
3	Chain Stores	9	728 401
4	Spares Outlets	486	3 483 219
	Total	541	8 487 030

3. The "debtors days outstanding" ratio at 28 February 2017 is 75 days (2016 – 61 days). Debtors are given credit terms of 60 days.

4. During the year the directors decided to expand their customer base, in the "spares outlets" category, and to achieve this they implemented the following:
   - 4.1 creditworthiness checks for the new account holders became less strict and payment terms were extended.
   - 4.2 the "***cashback***" incentive scheme. In terms of this scheme, customers will receive a cash payment from the company of between 5% and 15% of their total purchases from Instant Energy (Pty) Ltd for each three month period i.e. four times a year. The debtors masterfile contains a "sales to date field" for each customer, as well as a field into which each debtor's cashback percentage can be entered. The percentage allocated to each customer is decided upon by the credit controller and sales director of Instant Energy (Pty) Ltd. The masterfile also contains a category field for each debtor (see chart above).

5. The credit controller has provided you with an age analysis of debtors (30 days, 60 days, 90 days and over) which revealed that at 28 February the following number of debtors, representing the amounts shown below, had gone beyond their credit limits (the amount of credit).

Category	***Description***	***Number***	***Rand Amount***
1	Industrial	2	96 314
2	Vehicle Manufacturer	0	-
3	Chain Stores	0	-
4	Spares Outlets	73	465 224

At the meeting with your audit manager he posed the following questions to establish whether you understood your responsibilities:

a) Can you identify the two assertions relating to debtors which you consider are most at risk for this audit and, how would you justify your choice? (7)

b) I have read your notes on the "***cashback***" incentive scheme and it strikes me that the controls over the percentage field in the debtors masterfile are very important. For example, an unauthorised change from 5% to 25% could be made, which would significantly increase the cash payment to the customer. I know that Instant Energy (Pty) Ltd generally has sound internal controls, but what controls are you expecting to find relating to this potential problem? (10)

c) I agree with your decision to conduct a positive debtors circularisation as it is our firm's policy not to carry out negative circularisations. Can you give me an indication of which debtors you will include in your sample to be positively circularised, and why? (8)

d) Can you discuss with me the procedures you intend carrying out in respect of the allowance for bad debts? (10)

YOU ARE REQUIRED TO respond to your manager's questions.

8.23 **(48 marks 56 minutes)**

Broadmans (Pty) Ltd is a large company which sells a wide range of household goods, furnishings, crockery etc. You have worked on the audit team for the last two years, and for the current audit (financial year-end 31 March 2017) you have been put in charge of the audit of accounts receivable. The company has neither an internal audit department nor an audit committee but does have a company secretary. The following information pertains to accounts receivable.

1. All financial systems are fully computerised. On two interim visits to the client during the year under audit your firm's computer audit division performed some tests of controls on Broadmans (Pty) Ltd's systems and found them to be well maintained and effective.

2. The majority of the company's debtors are members of the general public. However, also included in accounts receivable, are a significant number of corporate customers such as hotels and time share resorts.

3. Amounts owed to Broadmans (Pty) Ltd range considerably.

4. Broadmans (Pty) Ltd relaxed its credit control policies early in the year under audit. Credit limits were increased and payment terms extended in an attempt to stimulate sales. This resulted in a significant number of new debtors accounts being opened.

5. The accounts receivable balance in the statement of financial position is very material.

6. Veejay Singh, the credit controller and Mariah Julio, the financial manager, are responsible for accounts receivable. Their responsibilities include submission of a

monthly report on accounts receivable to the directors which includes an analysis of relevant ratios, lists of doubtful debtors, etc.

7. Broadmans (Pty) Ltd obtained a long term loan from Cityfin Ltd during the year under audit. The loan agreement contains a number of clauses relating to the current ratio as reflected in the annual financial statements. Contravention of these clauses could have negative consequences for Broadmans (Pty) Ltd.

Your audit firm saves all important client information onto memory sticks thereby creating a "databank" for each client. These memory sticks are kept in the firm's client library along with prior year hardcopy audit files.

At the commencement of each year's audit, information can be downloaded from the memory sticks onto the audit team's laptops to assist in numerous audit activities, e.g. considering audit strategy, conducting risk assessment procedures, reviewing prior year schedules etc. This system has worked very well except that on occasion memory sticks have been mislaid or lost, resulting in the permanent loss of client information. Fortunately the memory sticks containing the information for the previous five audits of Broadmans (Pty) Ltd, including information relating to accounts receivable, are available for your use.

In addition to having this information downloaded onto your laptop, arrangements have been made to download the debtors masterfile at 31 March 2017 onto your laptop in order for you to make use of your audit software.

The following fields are included on the debtors masterfile:

account number
name
address and contact details e.g. telephone numbers, email etc
total amount owed
aging of total amount owed: current, 30 days, 60 days, 90 days, 120 days and over.
credit limit: e.g. R5000
credit terms: e.g. 60 days
credit rating - category A (low risk, regular payer)
category B (slow but regular payer)
category C (erratic payer)
type of customer - gen (general public) cor (corporate)

After discussing the year-end audit of accounts receivable with your manager, it was decided that you would conduct a limited positive debtors circularisation supplemented by other appropriate tests to obtain evidence of the existence of debtors included in the accounts receivable balance. He also requires extensive procedures relating to the allowance for bad debts assertion.

There is no strict audit deadline but it is anticipated that the audit will be concluded about 15 June.

YOU ARE REQUIRED TO:

a) describe the risk assessment procedures you would carry out in respect of the audit of accounts receivable for the financial year end 31 March 2017. (14)

b) identify two factors which are likely to increase your assessment of the risk of material misstatement in the accounts receivable balance at 31 March 2017 as compared to the prior year assessment. Explain why you believe each factor will increase your assessment. (4)

c) define detection risk and explain how it relates to audit risk. (4)

d) identify two factors which should reduce the risk that your firm expresses an inappropriate opinion on the accounts receivable balance as reflected in the financial statements at 31 March 2017. (4)

e) identify controls which should be in place at your audit firm to minimise the risk of memory sticks on which client information is stored, being lost or mislaid. (6)

f) explain how you would conduct subsequent receipts testing to gather evidence pertaining to the existence of debtors included in the accounts receivable balance at 31 March 2017. (4)

g) describe the procedures you would carry out in respect of the allowance for bad debts set for the financial year end 31 March 2017. (12)

8.24 **(35 marks 42 minutes)**

Your firm holds the appointment of auditor of Paperwait (Pty) Ltd, a company which sells paper (of all kinds) to printers, companies, stationery shops etc. You have been assigned to the audit of the revenue and receipts cycle for the year end 31 May 2017. This will be the third year that you have worked on this audit and revenue and receipts in particular, and you have come to respect Monty Zuma, the accounts receivable manager, as well as the other financial staff for their hard work, honesty and competence.

All of the company's financial systems are computerised. Interim audit work carried out during the year has confirmed that the systems are well designed and that they operate effectively.

The company has a large customer base. It does not export, selling exclusively to the local market, but on a national basis.

Although the company is financially sound, with a strong customer base, competition in the market has become very fierce within the last 12 months. Paperwait (Pty) Ltd has responded to this by improving its service, e.g. prompt delivery, frequent calls on customers, and by increasing customer credit limits and extending payment terms.

Current assets in the draft financial statements are as follows:

	2017	2016
	R'000	R'000
Inventory	5 876	4 486
Accounts Receivable	7 921	6 729
Bank	497	268
	14 294	11 483

The debtor's masterfile consists of the following fields:

debtor's account number	:	e.g. Mul 303
name	:	e.g. Multicopy
address and contact details	:	4 Press Way, Pinetown, 3016 etc
total amount owed	:	R426 013
age of total amount owed	:	current, 30 days, 60 days, 90 days and over
credit limit	:	e.g. R500 000
credit terms	:	e.g. 60 days
status of account	:	the letter "h" (for hold) is entered in this field if there is a problem with the account.

The company's software also has an enquiry facility which enables a user to print out a detailed account reflecting all the transactions with the debtor for the preceding twelve months.

For a number of years the company has set its allowance for bad debts at year end by applying the same percentages each year to the aged breakdown of the total amount owed by debtors. The percentages used in prior years are as follows:

Current	-	0%
30 days	-	2%
60 days	-	5%
90 days and over	-	15%

Once the allowance has been calculated, it is approved at the monthly directors' meeting.

In discussion with your manager at a planning meeting, you decided that to test existence of debtors at year end, you would not obtain direct confirmation of balances from debtors by circularisation or other means, but would adopt other procedures to test existence.

Your firm has excellent audit software which you and your audit team are able to make use of. Included in your workpapers from the prior year's audit, is a list of Paperwait (Pty) Ltd's debtors and their balances at 31 May 2016 held on a memory stick.

During October 2016, Marcel Roux, the financial director of Paperwait (Pty) Ltd decided that the company should connect to its bank (Stanwest Bank) via the Internet to enable it to obtain "up to the minute" information about its bank account, download bank statements and make electronic funds transfers. The major reason for this decision was that Paperwait (Pty) Ltd had requested its debtors to pay their accounts by making payments directly into Paperwait (Pty) Ltd's bank account and not to send cheques through the post. In late October, Stanwest Bank installed the necessary software onto Paperwait (Pty) Ltd's local area network. This menu driven software is used with success by many of the bank's clients.

YOU ARE REQUIRED TO:

a) identify the controls which you would expect to find in place at Paperwait (Pty) Ltd to prevent the unauthorized downloading of bank statements via the Internet. (7)

b) discuss the risk of material misstatement pertaining to accounts receivable as reflected in the 31 May 2017 financial statements based on the information given above. (8)

c) describe the audit procedures you would carry out in respect of the verification of the accounts receivable balance at 31 May 2017. You are only required to consider the ***existence***, and ***accuracy, valuation*** and ***allocation*** assertions. You are not required to concern yourself with the audit of disclosures related to the accounts receivable balance. (20)

8.25 **(45 marks 54 minutes)**

Having been on the audit team of The Clotheshorse (Pty) Ltd for the past two years, you have been placed in charge of the audit of accounts receivable for the financial year-end 30 June 2017. The Clotheshorse (Pty) Ltd is a wholesale company which imports clothing from a number of countries for sale locally. The company has a customer base consisting of large retail businesses and specialist clothing shops. It sells only on credit to approved customers.

The audit does not have a tight deadline. In early July you are reviewing the work papers of work carried out during the year on the audit, and conducting risk assessment procedures for the year-end audit. You have noted the following:

1.

	June 2016	June 2017
Debtors balance	R2 546 215	R3 762 935
Debtors days outstanding	65 days	84 days
Debtors as a % of current assets	33%	41%
Number of debtors	398	529

2. The company's accounting systems are fully integrated and run on a local area network. All customers are supplied with a hardcopy product catalogue from which they can select the goods to be purchased from The Clotheshorse (Pty) Ltd. Orders must be placed by phoning the company's toll free number. Calls are automatically directed to one of the four order clerks who enters the order directly into the system.

3. In April 2017 your firm's computer audit division had conducted an evaluation, including tests of controls, on the revenue and receipts cycle and found that information produced by the system was valid, accurate and complete.

4. The accounts receivable department is headed by Benni Goles the credit manager, and is staffed by three debtors clerks. Benni Goles reports to Lewis Figo, the financial manager.

5. For the financial year-end 30 June 2016 (previous year), the audit team conducted a debtors circularisation as part of the year-end verification procedures but the conclusions recorded on the work paper suggest that the circularisation had not really reflected efficient use of audit resources due to the time spent on following up on non-responses. Although the prior year accounts receivable audit was ultimately successfully concluded, the audit manager has decided that for the 2017 financial year-end a circularisation will ***not*** be carried out but alternative procedures will be conducted to test the existence of debtors.

6. The debtors masterfile contains the following fields

Fields		Example
account number	:	S2468
name	:	Smartypants (Pty) Ltd
address and contact details	:	10 Brix Road, Jacobs 3120. (031) 260 1234
date account opened	:	October 2006
total amount owed	:	R8 241.53
aging of total amount owed	:	i.e. 30 days, 60 days, 90 days, 120 days and over
credit limit amount	:	R10 000
credit terms	:	60 days
account status*	:	e.g. Handed over to attorneys for collection

*Note: This field remains blank other than where important information about the debtors status is entered.

7. To determine the bad debts allowance at year end, the company extracts an age analysis of the total amount owed by debtors at year end and applies the percentages shown below to the age analysis e.g. 7% of amounts in the 60 days column, and adds the amount calculated for the four age categories together to give the total allowance.

30 days - 3%   60 days - 7%   90 days - 20%   120 and over - 30%

As in past years Lewis Figo is quite prepared to allow you to interrogate the debtors masterfile using your firm's generalized audit software and you intend to do so.

YOU ARE REQUIRED TO:

a) conclude on whether the risk of material misstatement in respect of accounts receivable at 30 June 2017 should be classified as low, medium or high. Provide reasons for your conclusion. (6)

b) describe the application controls, both manual and automated, which your computer audit division would have found to be in place to ensure
   i) all orders are valid orders from approved customers and that details of the order are accurately and completely recorded, and (15)
   ii) that only new customers who have been approved are added to the debtors masterfile, and that additions are accurate and complete. (10)

c) describe the procedures you will conduct to test the existence of debtors at year-end.(5)

d) identify the information which you would extract from the debtors masterfile to assist you in the audit of the allowance for bad debts. Explain how you would use the information. Do ***not*** give audit procedures. (9)

CHAPTER 9

PAYROLL AND PERSONNEL CYCLE

9.1 **(22 marks 26 minutes)**

Goingup (Pty) Ltd a manufacturer of forklifts, currently operates a manual wage system. The functions within the cycle at Goingup (Pty) Ltd, are divided as follows:

1. personnel (human resources)
2. timekeeping
3. payroll preparation
4. payment preparation and payout
5. deductions: payments and recording

YOU ARE REQUIRED TO:

a) describe, briefly, each function in the payroll cycle and (10)

b) describe briefly, the risks faced by each function. (10)

c) comment on whether the functions listed above would change if Goingup (Pty) Ltd computerised its payroll cycle. (2)

9.2 **(15 marks 18 minutes)**

The functions within the payroll cycle for a company with a reasonably large workforce will be as follows:

1. personnel
2. timekeeping
3. payroll preparation
4. payment preparation and payment
5. deductions: payment and recording

The following actions/policies/controls are procedures carried out at Hastings (Pty) Ltd, a manufacturing company with a large number of hourly paid employees:

1. The factory security personnel observe the clocking in and out of factory workers each day. Employees must insert their clockcard into a timing device to record their times of entry or exit.

2. Background checks are carried out and interviews are conducted with prospective employees.

3. The head of the payroll section reviews the period-to-period wage reconciliation.

4. Before entering their unique passwords to affect the electronic transfer of amounts into employees' bank accounts, the senior members of management who authorize payments scrutinize the supporting documentation carefully.

5. The financial accountant confirms by inspection of the documentation, including payment records that deductions (such as PAYE) have been paid to the correct bodies (e.g. SARS) timeously.
6. To enter (key in) the hours worked from the clockcard, the wage clerk must first key in the individual's employee number.
7. The factory foreman authorizes all overtime by signing the clockcards before they are sent to the wage section.
8. A copy of all warning letters given to employees arising out of disciplinary hearings is filed in the employee's personnel file.
9. A clockcard is prepared for each employee for the wage period (two weeks); each card is carefully checked to the masterfile of employees before being handed to the factory administration clerk to be placed in racks at the entry/exit point.
10. At the end of the wage period the factory administration clerk divides the clockcards into batches, creates various control totals e.g. record count, and enters the details onto a batch control sheet.

YOU ARE REQUIRED TO:

a) identify the function within which each of the above (1 to 10) will take place. (5)

b) explain briefly the risk(s) which each of the above (1 to 10) is implemented to address. (10)

9.3 **(12 marks 14 minutes)**

Metalmade (Pty) Ltd is a manufacturing company with a labour force which is hourly paid. It is located in rural KwaZulu Natal. There is one entry/exit point to the factory and on arriving or leaving work, each employee must "swipe" his identity tag through the access machine situated at the entry/exit point. The access machine which is linked into the company's computer network, records the times of arrival and departure of each employee and calculates daily, normal and overtime hours worked for each employee. At the end of the wage period, the transaction file of hours worked is processed against the masterfile to produce the payroll. Wages are paid every two weeks. Wages are still paid in cash as the labour force requires this.

Each of the procedures, practices or policies listed below (1 to 10) is related to one of the components of internal control: i.e.

* control environment
* risk assessment
* information system and related business processes
* control activities
* monitoring of controls.

1. The payouts are conducted by StrongArm Security, the company which draws the cash from the bank, makes up the paypackets and transports the made up paypackets to Metalmade (Pty) Ltd's premises.

2. Access to the computerised employee records is restricted to the human resource manager and her senior administration clerk by user ID and password. All changes are logged by the computer.

3. The factory manager is responsible for checking and authorising overtime hours. Each morning he accesses the previous day's overtime report and, after checking the hours worked, approves the hours on the system. The ability to approve the overtime is restricted (by user profile) to the factory manager. He cannot however, alter the overtime hours reflected on the report.

4. The company operations manager receives a detailed monthly report on crime in the region from the local police station commander.

5. The paymaster (senior manager) reviews the payroll as well as the reconciliation of wages paid for the current wage period to the previous wage period. When he is satisfied, he signs the document as part of the authorization to transfer funds to StrongArm Security.

6. The company uses a suite of payroll software called Payout, which is compatible with SARS efiling.
7. Before an administrative employee is offered employment in the payroll section, he must undergo testing to determine whether he can work under deadline pressure and whether working in an isolated rural environment will suit his personality.

8. At the end of every six month period a report is produced for the board of directors which deals with a number of matters pertaining to the payroll, for example:
   8.1 production hours lost due to strikes and labour unrest
   8.2 employee turnover in the payroll section
   8.3 disciplinary matters relating to all employees
   8.4 incorrect wage payments.

YOU ARE REQUIRED TO identify the component of internal control to which each of the above (1 to 10) relates. Where you have identified a control activity, indicate the type of control activity which has been implemented, e.g. approval, authorisation. Note: Information given in each sentence (1 to 10) may relate to more than one component and more that one type of control activity.

9.4 **(13 marks 15 minutes)**

1. List three benefits of having wages paid by electronic funds transfer directly into employee's bank accounts. (2)

2. Material misstatement of the wage expense is more likely to arise from fraudulent financial reporting than from misappropriation of assets. True or false? Explain. (2)

3. Give two terms which are used to describe "fictitious employees". (1)

4. Identify three advantages which a company will derive from changing from a clockcard system to a biometric reader to record the time worked by hourly paid employees. (3)

5. Physical verification of salaried employees is a test of controls. True or false? Explain. (1)

6. When an auditor performs a physical verification of wage employees, evidence pertaining to the existence assertion is being obtained. True or false? Explain. (1)

7. If a company pays wages below the minimum wage rate, is it fraud? Explain. (2)

8. Why would an auditor conduct a reverse physical verification, i.e. from employee to wage records? (1)

9.5 (16 marks 19 minutes)

You are on the audit team of Blooms (Pty) Ltd, a large seedling nursery. Where a client's wage expense is material your firm's approach to the audit of wages is to carry out risk assessment procedures followed by conducting tests of controls and (usually) some substantive tests of detail and analytical procedures. The following procedures were carried out during the current audit of wages:

1. observed the supervision of the clocking in procedure one Monday morning on a surprise basis. Nursery workers are required to insert their clockcards into a clocking device when entering or leaving the nursery area.

2. inspected a sample of clockcards for the signature of a nursery foreman (there are 4 of them), authorizing the overtime hours reflected on the clockcards.

3. enquired of the company's human resource officer as to the disciplinary process followed by the company.

4. traced the overtime hours on a sample of clockcards to the schedule of planned overtime, prepared by the nursery production manager.

5. reviewed the prior year audit workpapers to gain an understanding of the payroll system and discussed changes with the financial accountant.

6. selected a sample of wage payments made and confirmed, by reference to the relevant tables e.g. PAYE that the correct deductions had been made.

7. reperformed the calculation of net wages for a small sample of wage payments selected for detailed testing.

8. inquired of the financial accountant as to whether any wage frauds had occurred during the year being audited.

9. performed a comparison of wages for the current year to prior year wages, by section (e.g. planting, pruning, etc) and by wage period.

10. inspected the half-yearly wage rate increase schedule for evidence of the human resource manager's signature authorising the schedule.

11. inspected the company's communication with the nursery staff relating to the recently introduced performance bonus scheme.

12. attempted to process a test pack of clockcards through the system, some of which contained invalid data, e.g. 85 hours of normal time for the two week wage period.

YOU ARE REQUIRED TO

(a) indicate whether each of the procedures above (1 to 12), is a risk assessment procedure, substantive procedure or a test of controls. (8)

(b) where you have selected "test of controls" in (a), indicate which control objective (validity, accuracy or completeness) the control is designed to address, and where you have selected a substantive test, indicate the assertion you are testing. (8)

9.6 **(20 marks 24 minutes)**

You are currently a member of the team on the audit of JumboFeeds (Pty) Ltd, a company with a large labour force. The following controls/policies/procedures have been implemented at the company.

1. For an employee to be successfully entered on the employee masterfile, a valid income tax number and identity number for the new employee must be entered in the designated field.

2. Programme changes to the payroll software must be authorized, inter alia, by the internal audit section.

3. To gain access to the company's local area network, an employee must enter his user ID and password.

4. The company has a computerized (biometric scanner) timekeeping system; every morning the factory manager reviews an on-screen report which lists the name and section of any employee who is absent from or late for work.

5. The company's network is linked to its bank via the internet; the bank's software which enables this access and facilitates, inter alia, the payment of wages and salaries by EFT, is loaded on only two terminals at JumboFeeds (Pty) Ltd.

6. All new employees in the payroll section are required to write a computer literacy test and demonstrate their computer skills.

7. Rigby Bedlington the human resource manager, frequently reviews the log of amendments to the employee masterfile.

8. To effect any EFT payment, the transfer must be "authorized" by a senior employee and "released" by a second senior employee (two signatory principle). Ziggi Puli, the financial director has the sole authority to "release". Before he releases the salary EFT, he carries out a comprehensive review of the payroll, particularly in respect of the effects of masterfile amendments.

9. At the monthly directors meeting, a report on various statistics pertaining to the labour force is presented. This includes month to month comparisons of such things as, time lost to labour disruption disciplinary hearings, hours lost to sick leave etc. The report is discussed by the directors and any action required is minuted.

10. Before the payroll is processed, the factory manager approves the schedule of overtime hours recorded.

YOU ARE REQUIRED TO:

a) indicate whether each of the controls/policies/procedures listed above is a general control or an application control. Where you have selected ***general control***, indicate the category of general control into which it falls. (10)

b) explain briefly whether each of the controls is a preventive or detective control. (10)

9.7 **(12 marks 14 minutes)**

On the current audit of Peroxaid (Pty) Ltd the balance on the wages expense account for the year amounted to R3 936 124. You asked a junior trainee on the audit team to explain the assertions applicable to this account heading.

He informs you that the shareholders are making the following assertions relating to this expense.

Valuation:	the value of wages paid for the year is R3 936 124.
Completeness:	all wages actually earned for the year are included in the amount.
Existence:	all employees who earned these wages exist at reporting date.
Rights:	Peroxaid (Pty) Ltd has the right to pay wages at hourly rates it sees fit, provided it complies with labour law.

YOU ARE REQUIRED TO state, giving reasons, whether you agree with your fellow trainee accountant.

9.8 **(40 marks 48 minutes)**

You are the auditor of Pretty Petals (Pty) Ltd, a company which manufactures artificial flowers for the export market. The company has three directors but none of them actually lives anywhere near the factory. Generally they concentrate on marketing the flowers and sourcing raw materials from a small office in Durban, and do not visit the factory very often. The company is situated in an isolated area of rural KwaZulu Natal. As the flowers are hand made, the company is labour intensive. Over the last few years, increases in orders from the Far East have resulted in the growth in the number of employees at Pretty Petals (Pty) Ltd to about ninety. The workforce is divided into 6 production areas, each of which manufactures a specific range of flowers e.g. beadwork flowers, feather flowers. There are three foremen, each in charge of 2 production areas, as well as a production manager, Primrose Zondi . With the rapid growth in production and employee numbers, the original internal control system for wages has become ineffective. You have pointed this out to management in the previous audits but they have shown little concern. Your audit manager has now requested that you compile a report identifying and explaining the weaknesses in the internal control over wages to be submitted to Pretty Petals (Pty) Ltd.

One of your audit team has prepared the following notes:

1. The production foremen hire and dismiss staff as they feel necessary. There is an abundance of labour in the area.
   1.1 When a new employee is hired, the foreman completes a prenumbered "employment form" by filling in the employees name, personnel details, production area code, and rate of pay. This form is then sent to Ruby Dooh, a clerk in the wage office, who opens a personnel file for each employee. (If an employee is not registered with SARS as a taxpayer, Ruby Dooh assists the employee to register as soon as possible.)

   1.2 When a foreman decides to dismiss an employee (or an employee resigns) the foreman completes a "dismissal/resignation form" and sends it through to Ruby Dooh.

2. Each employee sits at his/her own workbench to manufacture the artificial flowers.

3. During the course of the day, the foremen walk through the two production areas for which they are responsible and tick off the employees present on a "daily attendance sheet". The names of employees are pre-entered by Ruby Dooh onto the daily attendance sheets from the employees' personnel records which she maintains. On Thursday mornings each foreman receives two sets of 5 "daily attendance sheets" for the coming week (one set for each production area, one sheet per work day.)

4. Each employee who is ticked off on the sheet is credited with 8 working hours for the day.

5. Any overtime worked is also entered by the foremen onto the daily attendance sheet.

6. The company works only on weekdays and a working week runs from Thursday to the following Wednesday. Preparation of the payroll (see pt 9) and wage packets takes place on Thursday and wages are paid out on Friday.

7. Early on a Thursday morning the foremen collect up the five "daily attendance sheets" for the week for each production area and send them through to Scooby Dooh, (Ruby Dooh's brother) in the wage office.

8. Scooby Dooh totals all the hours on the daily attendance sheet for each employee and obtains totals for normal hours worked as well as overtime hours worked.

9. He then enters each employee's details which he obtains from Ruby Dooh e.g. rates of pay, deductions, onto the daily attendance sheet and performs all the casts, extentions and other calculations. In effect the daily attendance sheet becomes the payroll.

10. Scooby Dooh then draws a cheque for the amount of the net wages and passes it to Ed Africa, the financial manager for his signature.

11. The payroll is filed in weekly order and the wages cheque is cashed at the nearest bank which is about 70 kilometres away by Pretty Petals (Pty) Ltd's security section by lunchtime on Thursday. The money is passed to Scooby and Ruby Dooh for preparation of the paypackets on Thursday afternoon.

12. The paypackets are kept overnight in the company safe and on Fridays at 12 o'clock they are handed to the foremen who conduct the payouts for their production areas at 1 o'clock.

13. Copies of the payroll are not given to the foremen but each paypacket has a "tear off" slip which is signed by the employee on receipt of his or her wages. The "tear off slip" is retained by the foreman. Employees present identification before receiving their paypacket.

14. The signed "tear off" slips and any unclaimed wages are returned to the wage office.

15. The signed "tear off" slips are filed with the weekly payroll and the unclaimed wages placed in a strong box to be paid out once the employee returns to work. (Once again on collection, the employee is required to sign the tear off slip).

16. Employees do not belong to a union.

17. Wages constitute the company's largest expense.

18. The company does not wish to computerise their wage system or to use a wage security company as they have their own security department.

19. As banking facilities are limited in this isolated area, employees do not want their weekly wages paid into bank accounts; they require that their wages be paid in cash. They also wish to be paid weekly and not every two weeks or monthly.

YOU ARE REQUIRED TO explain the weaknesses in the above system and recommend improvements.

9.9 **(38 marks 46 minutes)**

Tie-a-Fly CC manufactures flies for fishing as well as fishing rods and accessories which are exported around the world and sold locally.

The business has expanded rapidly over the last few years and as a result of increased demand for the company's product, there has been a significant increase in the number of hourly paid employees. Most of the business's products are made by hand and there are currently approximately sixty hourly paid employees. There are also fifteen salaried staff including the three members of the CC.
Although most of the accounting systems at Tie-a-Fly CC are computerized (resident on a local area network) the wage cycle has always been manual due to the relatively small number of hourly paid employees.

Until his recent departure to Mexico to run a fishing lodge, John Santana, formerly a member of the CC, was responsible for all computer (IT) aspects of the business. This responsibility has now been delegated to Morcom Wallis another of the members. However, by his own admission, Morcom Wallis does not have sufficient computer knowledge or skills and as a result the CC has decided to engage a small IT consultancy firm, Whizzkids Inc, to keep the LAN "up and running" and assist Morcom Wallis with IT matters.

The members have also decided that the payroll cycle, both salaries and wages, should be computerized and to get this underway Morcom Wallis arranged a meeting with Whizzkids Inc to discuss various IT matters.

At the meeting Morcom Wallis took detailed notes of what was discussed, firstly for record purposes and secondly because of his lack of knowledge. Not wanting to appear too stupid he chose rather to write down anything he didn't really understand! He has now come to you with the following queries.

1. In our discussions the consultant mentioned general controls and application controls several times and emphasized that we must maintain a strong control environment. Can you explain the difference between general controls and application controls as well as what maintaining a strong control environment means and how we do it at Tie-a-Fly? (8)

2. During the course of the discussion I wrote down a number of procedures which the consultant mentioned, but I don't know whether they are general controls or application controls. Can you help please?
   - 2.1 Management at the CC must carry out background checks on any new staff we employ to work in the payroll section.
   - 2.2 The clocking in and out of the hourly paid employees should be supervised.
   - 2.3 All staff involved in the payroll section must be sent on a course to learn how to use the new software.
   - 2.4 An exception report will be generated for any employee who has recorded more than 10 hours of overtime a week.
   - 2.5 The factory manager must approve all overtime before it is worked.
   - 2.6 Whizzkids Inc's responsibilities in respect of Tie-a-Fly CC network must be laid down in a contract.

2.7 A disaster recovery plan must be put in place and tested, e.g. if the LAN goes down and the payroll cannot be run, how will the CC pay wages?

2.8 Amendments to the wage employee masterfile must be authorized by myself and another senior member of staff.

2.9 If an employee is dismissed, his or her user ID and password should be deleted from the system on dismissal. This is very important for employees in the payroll section.

2.10 The computer will generate a reconciliation of the current wage period to the prior wage period for the number of employees as well as net wages and deductions. (10)

3. The consultant also said that the payroll cycle software would be placed on the LAN and will be menu driven. I think I understand what this means, but I don't quite understand how we are going to keep salary and wage information on the system confidential and protected from all the employees who work with other accounting systems which are on the LAN or in fact, other individuals who may be in the offices. Can you explain? (12)

4. It seems to me that one of the risks we run by computerising our wages system is that it will be easier for employees to commit fraud. I understand that all employee details will be kept in an "employee masterfile" and that when the computer calculates the gross wages for an employee it will read the employees hourly rate of pay category from this masterfile – but how do we know that someone hasn't made an unauthorised change to the pay rate category in the masterfile? (8)

YOU ARE REQUIRED TO:

a) respond to Morcom Wallis's queries as laid out in points 1 to 3 above. (30)

b) describe to Morcom Wallis, the controls that will need to be put in place to ensure that unauthorised (invalid) changes to the pay rate category are not made on the employee masterfile. See his query 4. (8)

9.10 **(35 marks 42 minutes)**

Your firm has recently been appointed as auditor of Folozifeet (Pty) Ltd, which is situated in Empangeni. The company manufactures shoes and outdoor footwear. Because all of the company's footwear is handmade, manufacturing is labour intensive.

As part of conducting your risk assessment procedures you are in the process of evaluating the company's systems and have gathered the following information about the company's payroll and personnel cycle:

1. The cycle is computerised and the payroll software which the company uses, is reputable and well supported.

2. Staff involved in the payroll cycle are:
Olga Olifant – human resource manager (she has two clerical assistants)
Ben Buffel – the factory wage and administration clerk

Louis Lyon and Tiger Singh – the wage clerks responsible for payroll preparation
Ryno White – the wage department supervisor who has overall responsibility for the operation of the wage department.

3. Because of the threat of having cash on the premises, employee's wages are paid directly into their bank accounts every two weeks. Hence no wage payout takes place; all wage earners are provided with a payslip detailing the amounts paid into their bank accounts. These are handed to employees by the factory foreman, Jacques Jakkals, once the payroll has been authorised. On receiving their payslips, employees must sign a payslip distribution sheet to acknowledge having received their payslips.

4. Employee hours worked are recorded on clockcards (which are designed to record employees' work hours for two weeks). Every second Wednesday afternoon after the factory has closed, Ben Buffel collects the clockcards for the just completed wage period and, having carried out sound internal control procedures, delivers the cards to the wage clerks.

5. On Thursday mornings, Tiger Singh prepares the payroll. He accesses the relevant module of the wage application software which is resident on the local area network from his terminal, and keys in the necessary information from the clockcards.

6. As a result of a suitable range of programme controls and careful checking and review by Ryno White and Louis Lyon, a complete, accurate and valid payroll is produced.

7. In addition to the payroll, a reconciliation of the wages from one wage period to the next, is produced. This reconciliation identifies, inter alia, the changes in wage employee headcount from one wage period to the next, e.g.

Number of employees at the end of wage period 1	154
Less: Resignations/Dismissals	(6)
Add: Appointments	8
Number of employees at the end of wage period 2	156

All resignations/dismissals and appointments reflected on the period-to-period reconciliation are supported by authorised masterfile amendment forms. Your firm's approach to the audit of wages includes the selection of a very limited number of wage periods. The wage expense for these wage periods is audited in detail and then used as a basis for analytical procedures to be conducted on the wage expense for the year.

YOU ARE REQUIRED TO:

a) describe the control activities, both manual and computerized (automated), which you would expect to find in place to ensure that the hours captured by Tiger Singh, are valid, accurate and complete. Your answer should commence with controls over the issue of clockcards at the start of the wage period (2 weeks) and end with the controls over keying in of the hours. Do not concern yourself with general controls. (25)

b) describe the procedures you would conduct to satisfy yourself that employees included on the payroll for the wage periods selected for audit, are not fictitious (e.g. dummy workmen). (10)

9.11 **(40 marks 48 minutes)**

Times (Pty) Ltd is a manufacturer of timing devices. In addition to a large salaried staff, the company employs about 100 skilled and semi-skilled wage earners. As part of the planning for the audit, you obtained the following information:

1. The 100 employees are spread evenly over three sections.

2. Each section is headed by a foreman. The foremen report to Reagon Seconds, the factory manager.

3. The three sections are located in a single factory building and to enter or leave the building, hourly paid employees must pass a clock card through a clocking machine to record their time of entry or exit and to activate the control gate. The clock is located at the control gate. There is only one point of entry/exit.

4. The clocking procedure is observed by Ben Bigg the factory administration clerk who has a glass fronted office overlooking the clocking area.

5. Employees work Monday to Friday and are required to "clock-in" by 7am and "clock-out" at 4pm. Any additional time worked is regarded as overtime. Overtime work is carefully planned and scheduled by the section foreman. Reagon Seconds authorizes the schedule of overtime.

6. Wages are paid every two weeks and the clockcards for each wage period are prepared in the human resources department and sent to Ben Bigg with a listing of each employee for whom there is a card. Ben Bigg agrees the cards to the list, signs the list and retains a copy.

7. The wage period runs from Thursday morning until Wednesday afternoon two weeks later. Early on the Thursday morning Ben Bigg collects all the clock cards for the wage period just completed from the racks next to the clocking machine, and replaces them with the clockcards for the two week wage period commencing that morning.

8. Once the previous period's cards have been collected, various batch controls and other procedures are carried out before the clockcards are taken to the wage office by Ben Bigg.

9. The wage office is staffed by the paymaster, Jerome Jantjies, and his assistant, Preston Ngcobo. The wages are processed using application software developed and maintained by the company itself. Enhancements to the software are made from time to time by Times (Pty) Ltd's small information technology (IT) section to keep the application up to date with tax requirements and to provide management with better information for controlling wages, which is a major expense. The company runs all of its accounting applications on a local area network and the IT department is headed by Shakira Maharaj.

10. Preston Ngcobo is responsible for preparing the payroll. Once he has received the clockcards, he selects the "enter hours worked" module and then captures the employee number, as well as the normal and overtime hours from each clockcard.

Once he is satisfied that the hours captured are accurate and complete, he selects the “process payroll” option to effect the processing of the payroll. The software is well designed and includes a number of programme (automated) controls to provide valid, accurate and complete capture and processing of data.

YOU ARE REQUIRED TO:

a) explain the internal control objectives of validity, accuracy and completeness in the context of the payroll cycle. (5)

b) describe the batch controls and other procedures which should be in place from the time Ben Bigg collects the completed wage period’s clockcards from the racks, to the time Preston Ngcobo accepts the clockcards from Ben Bigg. (12)

c) identify and explain the controls which should be in place to prevent unauthorized access to the wage application and its various modules on Times (Pty) Ltd’s local area network. (8)

d) briefly explain the following programme control and give an example of how each control could be used to assist Preston Ngcobo in capturing valid, accurate and complete data

    * mandatory field check
    * verification check
    * limit check (3x2) (6)

e) describe the internal controls which should be implemented over enhancements to the wage application software. (9)

9.12 **(45 marks 54 minutes)**

Your firm holds the appointment of auditor of Rubix Ltd, an industrial company. In the management letter resulting from the previous year’s audit, you raised a number of concerns with the directors relating to the company’s salaries system. Your evaluation of the salaries application suggested to you that the controls over amendments to the employee masterfile were not adequate. You were also concerned that the controls over payments of salaries were inadequate, (signed salary cheques were generated by the system and distributed with a pay slip to all employees through the internal post). In response to your report the Human Resources director, Nate Frisk, had at the time, concurred with your concerns and explained that the payroll system which the company had been using had become unsuitable as the total number of salaried employees had increased significantly. He had informed you that the company intended installing a new software package for the salaries application and introducing payment of salaries direct into employees’ bank accounts by electronic funds transfer. On your return to Rubix Ltd for the current year’s audit you discovered that during the course of the year the new software package and the electronic fund transfer system has been successfully installed.

At Rubix Ltd the payment of salaries to the approximately three hundred salaried employees is the responsibility of the salaries section within the human resources division. The section is headed by Morgan Govind, who has a team of six administration clerks. Morgan Govind reports to Sias Reyneke, the Human Resources manager, who in turn reports to Nate Frisk.

Your enquiries into the new salaries application revealed, amongst other things, the following:

1. controls over masterfile amendments have been significantly improved.

2. to facilitate the payment of salaries by EFT the banking details of each salaried employee are entered in the employee's record on the employee masterfile.

3. the electronic funds transfer is effected over the internet. The necessary software has been installed by Rubix Ltd's bankers and as one of the controls initiated by the bank, the senior personnel who authorise transfers have been issued with random number generating devices.

4. Mary Topper the financial manager, Sias Reyneke and Nate Frisk have been issued with random number generators to effect an EFT. Morgan Govind approves the final payroll which has been prepared by his staff. Approval is given on the system.

YOU ARE REQUIRED TO:

a) describe the conversion controls which would have been put in place by Rubix Ltd when converting to the new salaries application. (8)

b) explain how random number generator devices are used and why they are issued. (5)

c) describe the controls which should be in place to ensure that changes to employees' banking details on the employee masterfile are valid, accurate and complete. (12)

d) describe the controls which should be carried out with regard to the payment of salaries from the point where Morgan Govind approves the payroll on the system. Your answer should include a description of applicable access controls. (20)

9.13 **(38 marks 46 minutes)**

Your firm recently accepted the appointment of auditor of ConCwest (Pty) Ltd, an environmental consultancy. Up until the current financial year the company's public interest score required only that the company's annual financial statements be reviewed. However, growth in the company and the related increase in its public interest score requires that the company's AFS be externally audited. The firm which previously conducted the review, resigned the appointment as they did not wish to accept the audit appointment. The managing director, Con Masters who formed the company some years ago is an environmentalist with little interest in administrative matters. You have been assigned to the audit and as part of the risk assessment procedures, are gaining an understanding on the company's business processes and related controls within various cycles. You have established that the accounting systems are resident on a local area network but were surprised to find that the salary system was the only system not on the network. You raised this matter with Con Masters who responded as follows:

"We have good reasons for this and they are mainly about confidentiality. Our accountant, Jerry Holland who reports to me, tells me that if we put the salaries application on the network too many employees will have access to sensitive salary information and that the risk of employee dissatisfaction and fraud is increased. The existing salary system works just fine. It is, and has been for some years, operated and managed by Jerry Holland himself. There are never any problems, employees are paid promptly on due date every month. Jerry never misses a month and even if he is ill, which is not often, he makes sure he gets to work to ensure salaries are paid. If he takes time off, it is for short breaks which are never over month end. The three directors of ConCwest (Pty) Ltd are all environmentalists and we are away working a lot. We have an administration manager as well as Jerry our accountant and there is no need for us to have a financial director or other senior financial personnel.

I don't know much about the salary system other than that we are paid by electronic funds transfer and that Jerry handles the entire process himself. I do know that we have a separate salaries account at the bank but I don't know much more than that. Nobody else is involved, so confidentiality is maintained and I don't have to worry about fraud."

You have gathered the following information:

1. The company has around seventy five employees of differing levels from research staff, junior consultants and administration/accounting personnel. Personnel (human resources) are handled by Marco Grant and his assistant. If a position needs to be filled Con Masters gives approval to personnel to recruit a suitable candidate (advertising the post, interviewing etc), and make the appointment. Where there is a resignation/dismissal Marco Grant ensures that the law is complied with and effects the resignation/dismissal. Marco Grant also notifies Jerry Holland of all the necessary details he requires to commence or stop salary payments. This enables Jerry Holland to make the necessary amendments to the employee masterfile (nobody else, including the directors has read or write access to the masterfile). Jerry Holland also makes it his business to pay over all deductions to third parties, e.g. PAYE and reconciling these payments where necessary, e.g. PAYE with SARS as well as issuing IRP 5's to employees when they are due.

2. Jerry Holland has two terminals in his office, one which is part of the LAN and another which is "stand alone" and on which he runs the salaries application.

3. The company has a standing instruction with the bank to transfer a set amount from ConCwest (Pty) Ltd's main account to the salaries account on the 22nd of each month. In his capacity as accountant, Jerry Holland has the sole authority to change the amount transferred from the main bank account but seldom does so because the salaries amount paid for the month is less that the amount transferred into the salaries account each month.

4. Other than a few monthly petty cash expenditures, all payments are by EFT. The company has a small number of creditors so these payments are minimal, and are left up to the administration manager who has the bank's software on his terminal. He will prepare a schedule of payments but cannot effect an EFT payment without the input of Jerry Holland who must enter his password to "release" the payment once he is satisfied that all is in order. The transfer of funds from the salaries account is carried out slightly differently. Salary EFTs can only be made from Jerry Holland's computer

once a “dongle” supplied by the bank and unique to Jerry Holland is inserted in the USB port of his computer (on which the bank’s software is loaded). In addition Jerry Holland must enter an additional password to effect the EFTs. Subsequent to the payment of salaries each month, Jerry Holland downloads a copy of the salaries account bank statement and reconciles it to his salary records.

YOU ARE REQUIRED TO:

a) comment on whether the practitioner who conducted the review of ConCwest (Pty) Ltd’s annual financial statements in previous years should have identified the risk of fraud. (8)

b) discuss fully, based on the information above, whether the risk of fraud in the salary system should be regarded as low, medium or high. (18)

c) explain to Con Masters why, including the salaries application on the network will not necessarily compromise the confidentiality of salaries information. (12)

9.14 **(37 marks 44 minutes)**

HippoHyde Lodge is a large resort situated in Mpumalanga. It consists of 100 accommodation units, reception area and offices, as well as various facilities for visitors to enjoy. The resort is entirely fenced for security purposes. Besides a number of salaried staff, the resort employs approximately 75 hourly paid personnel which includes housekeeping maids, cleaners and garden staff. The following information pertains to the (wage) payroll system.

1. The payroll system is computerised and the payroll application is resident on the lodge’s local area network. The network is maintained by Frans Kruger the IT manager.

2. Hours worked by hourly paid personnel are recorded by a biometric scanner/timing device situated at the main gate to the resort. To gain access and record hours a worker must place his thumb on a scanner. The same procedure must be carried out at the end of the day when workers leave the resort. If the scanner identifies a valid thumbprint, the turnstile will be activated and the time of entry or exit will be recorded against the employee’s name on a file on the system. The biometric scanner/timing device is linked to the system which enables the device to compare the scanned thumbprint to the wage employee masterfile and to download the entry/exit times for each employee onto the system instantly.

3. Prieur du Plessis the estate operations manager can access this file at any time and generate various reports relating to employee attendance. All hourly paid employees, including the sectional supervisors report to Prieur du Plessis.

4. Wages are processed every two weeks, by Anne Mann who works in the accounting section. As described above the hours worked by each employee for the two week period are already in a file on the system awaiting processing against the employee masterfile (which contains, inter alia, the employee’s hourly rate of pay). Prior to

commencing processing, Prieur du Plessis is required to authorise "on screen", a schedule of normal and overtime hours worked for each employee. Once hours have been approved, Anne Mann can proceed with preparations of the payroll.

5. To commence processing Anne Mann selects the "prepare payroll module". On accessing the module, her screen will come up formatted as the employment record of the first employee on the employee masterfile. The majority of fields on the record will already be "populated" e.g. all employee standing data, cumulative earnings and deduction fields as well as the fields containing the current two week periods normal and overtime hours worked. Blank fields into which Anne Mann will enter data if necessary, include fields for extra earnings due to the employee e.g. a performance bonus, and fields for additional deductions e.g. loan repayment deductions.

6. Once Anne Mann has entered any additional data and satisfied herself that the employee payment record is correct, she selects the "accept" option and the employment payment record for the next employee on the masterfile appears on the screen. Anne Mann repeats the process for each employee on the masterfile.

7. Once all employee payment records have been updated (amended) and completed, Anne Mann selects the "confirm" option and the processing of the payroll commences. During this process a number of programmed (automated) controls will take place. The output from processing will include the detailed payroll and a number of supporting schedules. These are printed out (hardcopy) and reviewed by Max Boyce, the human resource manager.

8. Wages are paid by electronic funds transfer via the internet, directly into the employees' bank accounts. A payment advice which shows exactly how the payment is made up as well as cumulative totals for earnings, PAYE, etc, is printed out and distributed to each employee.

9. The accounting and administration functions are headed by Linda Basson, the financial manager.

YOU ARE REQUIRED TO:

a) briefly describe three reports which Prieur du Plessis the estate manager, could download on a daily basis pertaining to the hours recorded by hourly paid employees. Indicate how each report would be useful. (6)

b) explain briefly the controls and procedures which must be implemented for on-screen approval to be carried out effectively. (6)

c) describe the controls which should be in place to ensure that invalid amendments, including the entry of unauthorised extra earnings or deductions, ***cannot*** be made to the employee payment records (see point 5 above) before processing to create the payroll takes place. (6)

d) briefly describe four output controls which should be implemented to promote the ***confidentiality*** of the wage payroll and its supporting documentation. (4)

e) discuss each of the following aspects of control over EFT wage payments in the context of HippoHyde Lodge. Deal ***only*** with the following:

* access to the payment facility on the bank's website. (6)
* additional authentication devices issued by the bank. (5)
* the "two signature" principle (authorise and release) (4)

CHAPTER 10

THE ACQUISITION AND PAYMENTS CYCLE

PURCHASES, CREDITORS AND ACCRUALS

10.1 **(10 marks 12 minutes)**

The following lists identify a number of the departments and documents at Steelworks (Pty) Ltd, a supplier of steel products.

	Departments		*Documents*
1.	Receiving (Warehouse)	1.	Purchase Invoice
2.	Despatch (Warehouse)	2.	Internal Sales Order
3.	Marketing	3.	Purchase Order
4.	Administration (Warehouse)	4.	Payroll
5.	Buying/Ordering	5.	Delivery Note (company)
6.	Accounting	6.	Delivery Note (supplier)
7.	Human Resources	7.	Goods Received Note
8.	Wages	8.	Cheque requisition
		9.	Inventory Requisition

YOU ARE REQUIRED TO:

a) identify, in order, the departments which would be involved in the acquisition of and payment for credit purchases in this company. (2)

b) for each department identified, indicate which documents, if any, would be used/generated. (4)

c) indicate, with a brief explanation, the sequence in which the documents would be used. (4)

10.2 **(10 marks 12 minutes)**

Brackets (Pty) Ltd is a large manufacturing company. Its acquisitions and payments cycle is broken down into the following functions:

1. ordering
2. receiving
3. recording of acquisitions (purchases)
4. payment preparation
5. payment and recording (of payment)

The following control procedures take place within the cycle:

1. on arrival of goods from a supplier, a clerk signs the supplier delivery note after counting the goods.

2. the senior financial officer and the creditors' accountant scrutinise the schedule of "payments to creditors" prior to "authorising" and "releasing" the file of EFT payments to creditors.

3. the senior buying officer confirms that the details on the order to be sent to the supplier, agree with the purchase requisition submitted by the stores manager.

4. purchase orders are cross-referenced to goods received notes on a regular basis to identify unfilled orders.

5. on transfer of goods from the receiving bay to the warehouse, the stores clerk signs the goods received note to acknowledge acceptance of the goods.

6. all casts, extentions, discount and VAT on suppliers invoices are carefully checked.

7. creditors statements and the creditors ledger are reconciled on a monthly basis.

8. to release an EFT creditors payment file, the senior financial officer must enter an additional "password" provided by a random number generator registered to him.

9. purchase invoices received from suppliers are matched to the goods received note, supplier delivery note and purchase order.

10. goods short delivered (ie. 10 ordered only 5 received) are clearly marked on the supplier delivery note.

YOU ARE REQUIRED TO identify the function in which each of the controls listed above (1 to 10), will take place.

10.3 **(26 marks 32 minutes)**

1. Describe the overall objectives of a company with regard to the acquisition of goods and the payment of the goods acquired. (3)

2. Provide two examples of how the misappropriation of company assets might be achieved in the acquisition and payments cycle. (3)

3. Distinguish between a "re-order level" and a "re-order quantity". (3)

4. Knightclubs (Pty) Ltd imports golf equipment. At the financial year end you selected a small number of foreign creditors as part of your accuracy, valuation and allocation testing. Describe the procedures you would carry out to verify that the foreign creditors' balances have been included at appropriate amounts. (4)

5. Omni (Pty) Ltd has a computerized ordering system but does not make use of all the facilities offered by the software. Currently the order clerk creates a batch of purchase orders (based on requisitions from the stores controller) on his computer. He prints out the purchase orders and takes them to the senior buyer to be approved. However, on a fair number of occasions the senior buyer deems it necessary to make changes to the orders. This means that the purchase order must be cancelled and a new order created and printed out. It has been suggested to the senior buyer that he could approve the purchase orders (on screen) on the system which would be much more efficient. However, he is skeptical. In particular he doesn't see how the ordering clerk can be prevented from creating and approving an order or how any changes he wants to make will be executed in a controlled manner. Explain to the senior buyer how on

screen approval would work and how his concerns would be addressed. You may assume that the software has been designed to facilitate on screen approval. (7)

6. Joe Powder an employee at Greenstem (Pty) Ltd is being trained for a supervisory position in the creditors section. He has asked you the following question:
"What controls should be in place to prevent an employee calling up the creditors masterfile and simply reducing the balance owed by say, a friend, or in fact deleting the creditors entire record from the file? " (6)

10.4 **(21 marks 25 minutes)**

1. State the two major activities of the acquisitions and payment cycle and describe what each of the activities sets out to achieve. (3)

2. List three ways in which a company might pay its creditors. (2)

3. Describe two important divisions (segregations) of duty in the acquisition phase of the cycle. (2)

4. The acquisitions and payment cycle links with the inventory and production cycle. True or false? Justify. (2)

5. If a company has an "approved supplier" list from which they make purchases, what should a supplier be evaluated for, before being placed on the "approved supplier" list? (2)

6. What is the most common method of fraudulent financial reporting relating to the acquisitions and payments cycle? (1)

7. List three different ways in which the assets of a company may be misappropriated in the acquisitions and payment cycle. (3)

8. Which assertion(s) is affected by each of the following:
   8.1 omitting certain creditors balances at the year end.
   8.2 recording the purchase of goods on credit for the personal use of the directors as company expenditure just before year end.
   8.3 using the wrong conversion rate on a foreign creditor's balance at year end. (3)

9. Categorise each of the following procedures as a test of controls or a substantive test:
   9.1 observed the receiving clerk counting goods delivered to the company.
   9.2 inspected the supporting documentation for a payment to a creditor to confirm that the documents had been stamped in some manner so that they could not be used to support another payment.
   9.3 reperformed a creditors reconciliation. (3)

10.5 **(12 marks 14 minutes)**

The following amounts appear in the general ledger of Bankers (Pty) Ltd a trading company, at the year end:

Purchases	R8 721 864
Trade accounts payable	R2 890 214

An inexperienced first year trainee informs you that the assertions relating to both these account headings, are as follows:

Validity :	All purchases made by the company are for the type of goods sold by Bankers (Pty) Ltd
Valuation:	The amount of R8 721 864 represents the total value of purchases made by the company, less any returns to suppliers.
Existence:	The creditors (accounts payable) exist at the year end (reporting) date; they are not fictitious.
Rights:	Bankers (Pty) Ltd have the right to make purchases in terms of the powers included in the Memorandum of Incorporation.
Accuracy:	All accounting records underlying these two balances have been accurately kept.

YOU ARE REQUIRED TO indicate whether your trainee has a good understanding of the assertions. Justify your answer.

10.6 **(36 marks 43 minutes)**

You are a member of the team on the audit of Officestuff (Pty) Ltd, a company which manufactures office furniture. You have been assigned to the audit of the acquisitions and payments cycle. The company has a small number of suppliers but the rand value of purchases is reasonably substantial.

As part of your "on-the-job" training, your audit senior has asked you to familiarize yourself with the cycle at Officestuff (Pty) Ltd by compiling some notes on which he could question you to establish your understanding of the cycle.

In preparation for your meeting with him, you compiled the following notes:

1. The acquisitions and payments cycle at Officestuff (Pty) Ltd is divided into the following functions, ordering, receiving, recording of acquisitions, payment preparation and payment and recording. The extent of computerisation varies from function to function.

2. Internal documents used in the cycle are: stores requisitions, purchase orders and goods received notes, remittance advices and cheques. All documents are multi-part (other than cheques), sequenced and well designed.

3. External documents used in the system are: suppliers delivery notes, suppliers invoices and suppliers statements.

4. Clerks within the various functions, key information into their terminals to generate the necessary document i.e. stores requisition, purchase order and goods received notes. A copy of each of these documents (as well as the suppliers delivery note) is sent to Mary Merson in the creditors section. She files the documents in pending files to await the arrival of the suppliers invoice. At the beginning of the last week of each month, Mary Merson performs the necessary control procedures on the documentation before capturing the purchase details into the system to produce the monthly purchase journal and to update the creditors masterfile.

5. Officestuff (Pty) Ltd runs its accounting system on a small local area network which links all administrative and accounting staff. Senior members of the accounting section include Tim Cruise the financial manager and Sterling Dorlock the creditors accountant. The software used by the company, although not very sophisticated, is reputable, well designed and menu driven for ease of operation and to enhance division of duties.

6. Once Mary Merson has completed her duties, the documentation is passed to Claude Pule who is responsible for payment preparation. Before preparing cheques for creditors, he reconciles the balances per the creditors masterfile with the creditors statements. He then compiles a list of payments to be made to creditors and prepares a remittance advice and cheque, for each creditor on the list. Controls over cheque payments are sound.

7. Officestuff (Pty) Ltd does not post cheques to creditors, choosing rather to deposit the cheques directly into creditors' bank accounts. The company purchases only from approved suppliers who must supply their banking details, e.g. bank, branch code and account number. This information is stored on the creditors masterfile. Controls over amendments to the masterfile are sound. Once the cheques have been signed, they are returned to Claude Pule who makes out the relevant bank deposit slip for each payment, obtaining the creditors banking details by accessing the creditors masterfile.

8. Paying creditors by electronic funds transfer is under consideration.

At the meeting with your senior, he posed the following questions:

1. If sound control activities are not implemented in the acquisitions and payments cycle, the risk of the company being subjected to fraud by employees is significantly increased. Do you agree with this statement? Justify your answer. (5)

2. In note 4 you state that Mary Merson performs the necessary control procedures on the documents before capturing the purchase details into the system. What control procedures is she performing? (5)

3. In note 5 you mention that the software used in the cycle is designed "to enhance

division of duties".

3.1 can you explain how the ***design*** of the software used in the cycle enhances division of duties, provide an example to illustrate your explanation. (3)

3.2 how division of duties is achieved in a computerised accounting system. (5)

4. In note 6 you state that "controls over cheque payments are sound" Can you describe the controls which led you to this conclusion? (5)

5. You have indicated that controls over amendments to the creditors masterfile are sound, but if the company decides to pay by EFT in the future the company needs to be sure that creditors' bank account details are not changed to perpetrate fraud or that non-approved creditors are not added to the masterfile. Essentially what are the controls which ensure that amendments to the masterfile are valid, accurate and complete? (10)

6. What would the advantages be to Officestuff (Pty) Ltd of paying creditors by EFT? (3)

YOU ARE REQUIRED TO respond to each of your senior's questions listed above.

10.7 **(35 marks 42 minutes)**

You have recently been appointed to the newly created position of internal auditor at Streetwheels (Pty) Ltd, a wholesale company which supplies vehicle accessories to auto shops. Your first assignment was to review the acquisitions and payments cycle at Streetwheels (Pty) Ltd as part of an ongoing project to improve the accounting systems at the company. A systems description prepared by the company accountant was presented to you for your review. The systems description is as follows:

1. The company's inventory is held in a single warehouse. The different products sold by the company are stored on shelves and in bins which are clearly marked with a description of the item and an inventory code. Percy Garmin is in charge of the warehouse. He is very knowledgeable and maintains the warehouse in a neat and organised condition.

2. Each week Percy Garmin works his way through the shelves and bins to identify "out of stock" items and items which appear to be running low on quantity. Having completed this exercise he prepares a warehouse requisition, (a pre-printed, numerically sequenced document) by listing the inventory code, description and quantity of each item to be ordered. Percy Garmin decides on the quantities to be ordered based on his experience in the vehicle accessories market. Once he has completed the requisition he signs and dates it, and drops it off with Arnold Image, the buying clerk.

3. The company makes use of pre-printed, properly designed sequentially numbered purchase order forms. Each order form consists of three parts (the original and two copies) which are distributed as follows:

Original	-	sent to the supplier
1st copy	-	sent to the accounting dept
2nd copy	-	filed in numerical sequence in the buying office.

4. On receiving the weekly requisition from Percy Garmin, Arnold prepares orders for each item on the requisition. Where more than one item can be ordered from the same supplier, a single purchase order is made out to that supplier. The purchase orders are cross-referenced to the requisition.

In choosing the supplier, Arnold Image refers to his list of regular suppliers which he has built up over his seven years at Streetwheels (Pty) Ltd. Once he has completed a purchase order, he signs it and faxes it to the supplier. He then stamps the original "confirmation of faxed order" and posts it to the supplier. At the end of the week he sends the first copy of each of the purchase orders to the creditors clerk in the accounting department who files the purchase orders in a temporary file to await the supplier invoice. Arnold Image files the second copy in his office in numerical sequence so that he can follow up on any queries from suppliers. Preparing and placing orders (and following up on any queries from suppliers) takes up most of Arnold Image's time, but when he is not busy he helps out in the receiving department or in the warehouse.

Streetwheels (Pty) Ltd's warehouse has a separate receiving area adjoining the warehouse. When a supplier arrives, a goods receiving clerk obtains a copy of the supplier delivery note from the driver making the delivery. He then checks the description and condition of the boxes being delivered as they are offloaded into the receiving bay, against the supplier delivery note. Once this control has been carried out he signs two copies of the supplier delivery note and retains one copy. The other copy is returned to the driver. All errors in delivery are clearly marked on both copies of the supplier delivery note and signed by the goods receiving clerk and the driver. The goods receiving clerk then moves the goods into the warehouse where the boxes are unpacked and the items placed on shelves or in bins.

A photocopy of the supplier delivery note is made and retained in the receiving bay and the original (supplier delivery note) is sent to the creditors clerk in the accounting department.

YOU ARE REQUIRED TO *identify* and ***explain*** the weaknesses in the acquisition of inventory by Streetwheels (Pty) Ltd based on the information given above.

Note: Your explanation should convey the reason why you believe the weaknesses identified are, in fact weaknesses. You are ***not*** required to make recommendations to address the weaknesses.

10.8 (30 marks 36 minutes)

Jane Martins worked for a number of years, for SkweeG (Pty) Ltd, a small company which sells cleaning materials. Due to her enthusiasm and charm, she soon became the key member of accounting and administration. Her duties included deciding on which creditors should be paid, preparing all cheques, maintaining the cash book and reconciling certain general ledger accounts and the bank account, as well as a host of other activities.

The directors have just discovered purely by chance, that Jane Martins has over the past two years, defrauded the company of an estimated R350 000, in the following manner :

1. She identified that one of SkweeG (Pty) Ltd's major suppliers was Action Chemicals (Pty) Ltd, which supplied the company every month.

2. Jane Martins' husband then opened a bank account in the name of Reaction Chemicals (Pty) Ltd with the small business division of Standard Bank. All the necessary documents which were received by Standard Bank to ensure the account was FICA compliant, were produced.

3. SkweeG (Pty) Ltd pays is creditors each month and the system worked as follows :
   3.1 Jane Martins would write out cheques for creditors on two consecutive days at month end, batch one on the first day and batch two on the second.
   3.2 When she had written out the first batch, she would take the cheques with supporting documentation, to Allen Archer and Billy Bugwandeen, both of whom were directors, for signature. (The other authorised signatories were Chris Chetty and Delron Ruckley, and any two of the four could authorise cheques).
   3.3 When she had written out the second batch of cheques the following day, she would take this batch to two authorised signatories, sometimes Allen Archer and Billy Bugwandeen but sometimes to a different pairing of signatories.
   3.4 When having the cheques signed, Jane Martins would chat away to the signatories, usually about topics she knew they were interested in such as Bulls rugby, fishing or their families.
   3.5 All cheques were handwritten by Jane Martins and she would write out the payee's name in capital letters, and make sure that all details were correct and that the amounts to be paid, agreed with the invoices to be paid.
   3.6 Most of the time the signatories would simply sign the cheques without looking at the supporting documents but not always, and when they did look at the supporting documents, they would either initial or sign them or simply put a line through them.
   3.7 Jane Martins would then take the cheques etc. back to her office and mail them or send them with the company's driver if the supplier was close by.

4. To perpetrate the fraud, Jane Martins would :
   4.1 Prepare a cheque made out to ACTION CHEMICALS (Pty) Ltd, carefully, for the exact amount owed. She would always include this cheque in the first batch which she would take to Allen Archer and Billy Bugwandeen for signature.
   4.2 If ***neither*** of the signatories initialled, signed or otherwise marked the supporting documentation for payment to Action Chemicals (Pty) Ltd, Jane Martins would proceed with the fraud.
   4.3 She would take one or two of the Action Chemicals (Pty) Ltd's invoices which had been presented in batch 1 as supporting documentation, and make out a second cheque to the supplier for the amount of the invoices. (She would be careful that this amount was not unreasonable). This cheque would always be presented in batch two on the second day and the batch would be taken to the two signatories who had not signed the cheques on the previous day.
   4.4 When writing out the name of the payee, ACTION CHEMICALS (Pty) Ltd, she would use capital letters as normal but would leave a gap between the word "pay" and ACTION on the cheque.
   4.5 On returning to her office, Jane Martins would alter the payee on the cheque from ACTION CHEMICALS (Pty) Ltd, to REACTION CHEMICALS (Pty) Ltd, and deposit this cheque into her husband's "business" account.

5. To conceal the fraud, Jane Martins would :
   5.1 When the bank statement and paid cheques were sent to SkweeG (Pty) Ltd, extract the cheque made out to REACTION CHEMICALS (Pty) Ltd and destroy it.
   5.2 When she wrote up the cashbook, enter this cheque as a payment to some other company (never using the same company twice), and allocate the payment to an expense account which she knew was never reviewed or reconciled by anyone at SkweeG (Pty) Ltd.

Subsequent to the discovery of this fraud, the directors of SkweeG (Pty) Ltd were informed by the police that Jane Martins had been convicted of a similar offence and jailed for a period prior to being employed by SkweeG (Pty) Ltd.

YOU ARE REQUIRED TO:

a) identify and discuss the weaknesses in SkweeG (Pty) Ltd's internal control which contributed to Jane Martins being able to perpetrate this fraud. Structure your answer in terms of the components of the internal control process. (25)

b) comment on whether, had SkweeG (Pty) Ltd paid its creditors by electronic funds transfer, Jane Martins could have perpetrated a fraud of this nature. (5)

10.9 **(22 marks 26 minutes)**

You are the auditor of Smelloil Ltd a large oil refinery situated in Durban. Whilst conducting analytical review procedures during the planning of the audit, you identified a large increase in purchases for the laboratory which monitors the quality of Smelloil Ltd's products. Expenditure on quality control at Smelloil Ltd is relatively high as the materials used in quality control are expensive. As preliminary discussions with management revealed no obvious explanation for the increase, you proceeded with detailed investigations.
Your investigations revealed the following:

1. Because of the special nature of the products required by the laboratory, the central buying department does not place orders for these products. Nikki Noodle, the chief laboratory technician is responsible for this function.

2. Besides Nikki Noodle, the laboratory is staffed by 10 technicians, two of whom have additional responsibilities: Earl Slick is responsible for receiving goods and Shelley Kohl is responsible for running the laboratory store.

3. The purchases system is fully computerised. Salient details are
   3.1 the system will only allow orders to be placed with approved suppliers listed on the suppliers' masterfile.
   3.2 access for placing orders for the laboratory purchases is restricted to Nikki Noodle. However, it has now transpired that Nikki Noodle occasionally asks her assistant Earl Slick, to place the orders due to her heavy workload and provides him with her password.

3.3 once the details of the order have been entered and an approved supplier selected, the computer generates a prenumbered order form which is sent to the supplier.

3.4 once again because of the specialised nature of laboratory requisites, purchases are delivered directly to the laboratory (rather than the central receiving depot) where they are received and checked by Earl Slick who signs and retains the delivery note before passing the goods to Shelley Kohl.

3.5 Earl Slick then updates the computer records to reflect the receipt of the goods by entering the suppliers delivery note number against the order held on the "orders pending file".

3.6 when the suppliers invoice is received by the accounts department, the payments clerk checks on his terminal that the delivery note number quoted on the suppliers invoice, matches the one entered by Earl Slick. If so, payments are processed.

4. An analysis of laboratory purchases by supplier, revealed that the large increase in purchases was due, almost entirely, to purchases from a supplier, Scitech (Pty) Ltd, who was not on the masterfile of approved suppliers in previous years. Further investigation revealed that Scitech (Pty) Ltd had never formally been approved as a supplier and turned out to be owned by Grace Slick, Earl Slick's sister.

The above investigations had led you to suspect that the large increase in purchases for the laboratory is due to fraud perpetrated by Earl Slick.

YOU ARE REQUIRED TO:

a) discuss briefly the auditor's responsibilities relating to fraud in general. (4)

b) identify the weaknesses in the above system and explain how they may have been exploited by Earl Slick. (18)

10.10 **(16 marks 19 minutes)**

You are in your final year of study for your BComm (honours) degree on your way to becoming a chartered accountant. As a part of your course you are required to act as a tutor to a group of students who are taking an undergraduate auditing course. After a recent test on the acquisitions and payments cycle, a student, Ronald Rubbio, asked you to go through his answers as he had done very poorly. In the test, students were required to state whether they agreed or disagreed with given statements. They were not asked to explain their answers and were not provided with solutions after the test.

In respect of the following statements Ronald Rubbio answered "agree" when the correct answer is "disagree":

Statement 1. Each week the purchase order clerk should generate a purchase requisition report from the inventory masterfile, listing each item which has reached its pre-set re-order level and should immediately generate a purchase order for the quantity designated as the item's re-order level.

Statement 2. If a purchase order clerk can obtain items listed on a purchase requisition report provided by the inventory controller at a better price than the approved supplier's price, he should make the necessary amendments to the creditors (approved suppliers) masterfile before compiling the file of purchase orders on the system.

Statement 3. Once the purchase order clerk has created the file of purchase orders on the system, the chief buyer should access the file, make any changes he deems necessary, and approve the file on the system before the file is transferred back to the purchase order clerk to execute the orders.

Statement 4. Once the chief buyer has approved the purchase order file on the system, the purchase order clerk must retain his write access to the approved purchase order file.

Statement 5. When goods are delivered by a supplier, the goods receiving clerk should enter the purchase order number (taken from the supplier delivery note) onto the system. If the purchase order number is rejected by the system, or there is no purchase order number on the supplier's delivery note, the goods receiving clerk must refuse to accept the delivery from the supplier.

Statement 6. The major preventive control used to maintain the integrity of the creditors masterfile is the review of all creditors masterfile amendment logs by a senior official.

In respect of the following statements Ronald Rubbio answered "disagree" when the correct answer is "agree":

Statement 7. Only the purchase order clerk(s) should have write access to the "create purchase order" module.

Statement 8. A company pays its trade creditors by electronic funds transfer. To effect an EFT payment, the company's bank requires that a physical device called a "dongle" be inserted into the USB port of the computer from which the transfer will be made. Use of such a device is in fact an additional authentication procedure.

YOU ARE REQUIRED TO provide Ronald Rubbio with an explanation as to why the answers he provided to each of the statements listed above is incorrect. Consider each statement individually.

10.11 **(15 marks 18 minutes)**

The following procedures relating to the acquisitions and payments cycle were carried out on the audit of Nitemoves (Pty) Ltd, a manufacturer of security equipment including certain items which are subject to government legislation (controlled substances are used in manufacture).

1. Inspected a sample of inventory (purchases) requisitions for the authorising signature of the production foreman.

2. Discussed the stages and methods of production of the company's products with the production manager.

3. Observed the goods receiving clerk as he counted and checked a delivery of goods from a supplier.

4. Inspected a sample of supplier invoices to determine whether orders are placed with approved suppliers only.

5. Enquired of the operations director as to any amendments to the regulations pertaining to the purchase of controlled substances used in production by the company.

6. Inspected the same sample as used in 4 above to confirm that the invoices were all made out to Nitemoves (Pty) Ltd.

7. Identified any debit balances on the list of creditors at year-end and by enquiry of the financial controller, established the reason for the debit balance.

8. Enquired of the financial manager as to whether any of the company's purchase requirements were put out to tender.

9. Reperformed the reconciliation of the creditors control account in the general ledger to the creditors ledger.

10. Inspected the workpapers for attendance at the year-end inventory count to identify any instances of physical inventory materially exceeding recorded inventory per the perpetual inventory.

11. Enquired of the financial manager as to whether any purchases were made from related parties.

12. Positively circularised a selection of creditors.

13. Evaluated a detailed description of the newly implemented EFT system for the payment of creditors.

14. Selected a sample of purchases from the purchase journal for the month after year-end and by inspection of the date on the corresponding supplier delivery note and goods received note, confirmed that the goods were received after year-end.

15. Obtained a comprehensive list of all employees who had access privileges to the EFT facility and the extent of the privileges given to each.

YOU ARE REQUIRED TO indicate whether each of the procedures listed above is a risk assessment procedure, a test of controls or a substantive test.

10.12 **(45 marks 54 minutes)**

Toy-Toy (Pty) Ltd is a wholesaler of toys. The company purchases its inventory from local companies which either manufacture or import toys. Little attention has been paid to the accounting and related internal control systems at Toy-Toy (Pty) Ltd over the last few years and evidence of this has started to show. You have been asked by the financial controller to review the company's systems commencing with the acquisitions and payments cycle.

Ordering of goods
The buying department consists of five buying officers and the senior buyer, Goliath Booysen. The toys which the company sells are broken down into five product categories, i.e. boardgames, balls, dolls, video games and model cars. Each buying officer is allocated to a product category and is responsible for purchasing inventory for his or her category. Goliath Booysen is responsible for monitoring and analysing the toy market and working with the sales department in deciding on new toy lines which should be purchased.

All the company's applications are resident on a local area network. To access the network employees must enter their user ID and a general password. However, access to the modules on the acquisition application is restricted to "ordering" and "receiving" employees by the use of a password known only to employees in these departments (and one or two senior personnel).

The inventory masterfile is divided into the five product categories. Each morning the buyers access the category for which they are responsible and based on the quantity on hand per the masterfile, decide whether to place an order. The inventory masterfile contains details of the company's preferred supplier and the buyers will normally place the order with that supplier. However, if the preferred supplier is "out of stock" the buyer will source the item from another supplier. If this is the case, the buyer will add the new supplier's details to the inventory masterfile. A supplier code must also be entered so that a computer generated purchase order can be printed.

To create the purchase order the buyer accesses the "create purchase order" module of the acquisitions software. The screen comes up formatted as a purchase order which the buyer completes by entering the details of the supplier and of the goods to be ordered, quantity, description etc. The supplier code must also be entered. Once all the details have been captured, a two-part sequenced order is printed out. The buyer mails the top copy to the supplier and files the second copy numerically in a lever arch file. Each buyer's purchase orders have their own numerical sequence. To ensure that they do not duplicate an order once it has been placed, the buyer updates the inventory masterfile by entering a date in the "pending order field".

Receiving of Goods
Goods ordered by Toy-Toy (Pty) Ltd are delivered in boxes which display the quantity and description of the contents of the box on the outside of the box, e.g. ten Leggo sets. Each delivery is supported by a supplier delivery note which lists the quantities and description of the goods being delivered.

All goods delivered are directed to the "Receiving Department", a physically secure area attached to the warehouse. Any one of the three receiving clerks will accept a delivery. The clerk will determine the validity of the order for the goods being delivered by entering the purchase order number (taken from the supplier delivery note) into the computer via a terminal in the receiving department. If the purchase order is valid, the words "accept delivery" appear on the screen.

The receiving clerk then agrees the number of boxes delivered and the quantity and description of the goods as per the details recorded on the boxes, to the supplier delivery note. If there are any discrepancies, the receiving clerk changes the delivery note accordingly. He and the person delivering the goods will sign both the copies of the delivery note to acknowledge the changes.

The boxes are placed in a secure area until the warehouse packers have time to move them into the warehouse, unpack them and place the toys on their respective shelves in the warehouse.

At 3pm each working day, one of the receiving clerks (they rotate this function on a weekly basis) accesses the "create goods received note" module. The screen comes up formatted as a goods received note which the receiving clerk then completes taking the information from the supplier delivery notes. Once the goods received notes have been completed, the quantities on the inventory masterfile are automatically updated and the date in the "pending order field" is deleted to convey that the order has been received. The receiving clerk prints out one copy of the goods received note which is attached to the supplier delivery note and is filed sequentially and retained in the receiving department. (The goods received notes remain on the system to be accessed and printed out by the creditors/accounting department where they are matched to the supplier invoice when it arrives.)

YOU ARE REQUIRED TO *identify* and ***explain*** the weaknesses in the internal controls over those functions of the acquisitions cycle at Toy-Toy (Pty) Ltd described above.

10.13 **(36 marks 42 minutes)**

You are a member of the team on the audit of Lighttime (Pty) Ltd a manufacturer of a range of torches, lamps, light fittings etc. You have been assigned to the audit of the acquisitions and payments cycle. The following information pertains to the cycle:

1. All employees in the company are issued with strict ethical guidelines pertinent (relating) to their functions. In respect of the acquisitions and payments cycle this includes guidelines for the purchase order clerk and the purchasing manager on how to react if they are offered bribes or kickbacks by suppliers. Appropriate action is taken against any employees who transgress the guidelines, but no such action has been necessary during the year under audit.

2. Ongoing training is also provided to all employees in the cycle.

3. To initiate a purchase order, the factory clerk identifies materials required for manufacture from production schedules. If the required materials are not available in Lighttime (Pty) Ltd's warehouse, he completes and signs a hard copy purchase requisition form for the materials not "in stock". The requisitions are sent to Pete Peters the factory manager, who carefully checks that the goods are required, and that all the details on the requisition are accurate. He then approves the requisition by signing it. The requisition will reflect the approved supplier code as well as the supplier's inventory code for the items to be ordered.

4. The purchase requisitions are then sent to Clive Crawley the order clerk. He accesses the "prepare purchase order" module on the system and compiles the purchase order. Before Clive Crawley emails the orders to suppliers, the orders are approved "on screen" by Dave Parker the creditors manager. Orders are only placed with approved suppliers (on the creditors masterfile). The ability to approve the purchase orders on screen is restricted to Dave Parker.

5. When the ordered goods are delivered (to a secure, separate receiving bay) Marcos Masters checks the goods against the supplier delivery note and relevant purchase order which he accesses on the system. The purchase order is displayed on his terminal screen as a goods received note and before he approves the GRN, Marcos Masters will check the goods delivered and amend quantities on the screen GRN if necessary. Goods which have not been ordered will not be accepted. Marcos Masters then prints out a GRN in duplicate. One copy is filed numerically in the receiving bay and the second copy goes with the goods when they are transferred to the warehouse. When Marcos Masters selects the "approve" option, the inventory masterfile is automatically updated.

6. Invoices from suppliers are sent direct to the accounting department where they are filed by Norman Anderson the creditors clerk. To determine whether the supplier invoice is valid and accurate, Norman Anderson accesses the purchase order file on the system relevant to the supplier invoice, and if a valid purchase order number has been entered, all the details of the relevant purchase will appear on screen, formatted as an invoice. Norman Anderson will then confirm that the detail of the on-screen invoice agrees exactly with the supplier invoice. The on-screen invoice is approved by a second creditors clerk. Once the approve option is "clicked on", the file of unpaid invoices and the creditors masterfile are updated.

7. Creditors are paid by electronic funds transfer. A schedule of payments is compiled in the creditors section by the creditors clerk and approved after meticulous scrutiny by Dave Parker the creditors manager. Once he has approved the schedule, he notifies Jake Lekota the chief accountant that the schedule is ready for payment to be made. From this point Dave Parker has nothing further to do with EFT payments to creditors, as he has no authorization privileges.

8. EFT payments are made over the Internet from the company's bank account. The company's bank has loaded the necessary software onto the terminals of Jake Lekota and Cyril Regis the financial director. A full range of controls over EFT payments have been implemented including the use of "dongles" which are issued to certain employees to effect EFT payments.

YOU ARE REQUIRED TO:

a) discuss the control environment within the acquisitions and payments cycle at Lighttime (Pty) Ltd based on the information provided above. (8)

b) identify two examples, one manual and one programmed (automated) of each of the control activities listed below, evident from the description of the cycle provided above.
   (i) isolation of responsibility
   (ii) segregation of duties (4)

c) explain how effective "on-screen" approval of purchase orders is achieved. (8)

d) explain why, with regard to paying its creditors by electronic funds transfer, control over the creditors masterfile is very important. (4)

e) explain how access to the function which allows EFT payments to be made from Lighttime (Pty) Ltd's bank account on the internet will be protected. (12)

10.14 **(30 marks 36 minutes)**

You are currently engaged on the 30 April 2017 financial year-end audit of Homethings (Pty) Ltd. As part of your substantive testing of year-end creditors you have selected the following creditors reconciliations for detailed testing shortly after year end.

Creditors Reconciliation : Perfect Pots (Pty) Ltd

Balance as per Perfect Pots (Pty) Ltd statement at 25 April 2017		R181 250
Less: payment not recorded.	Note 1	66 455
Less: goods short delivered.	Note 2	26 440
		88 355
Add: goods received	Note 3	R33 111
Balance as per creditors ledger at 30 April 2017		R121 466

Note 1: Payment made by electronic funds transfer on 28 April 2017.

Note 2: This relates to an order for forty two waterless cooking pots, twenty four were delivered. See purchase discrepancy report No. CDR372. The supplier is unable to supply the outstanding eighteen pots due to inventory shortages.

Note 3: This relates to goods delivered by Perfect Pots (Pty) Ltd on 27 April, see GRN 4572.

Creditors reconciliation: Zebro Publishing (Pty) Ltd

Balance as per Zebro Publishing (Pty) Ltd statement 23/04/2017	R236 910
Less: incorrect invoice (Note 1)	62 105
Less: payment not reflected (Note 2)	72 400
	R102 405
Add: undercharge on Zebro invoice (Note 3)	18 000
Add: purchase not reflected (Note 4)	60 555
Balance as per creditors ledger at 30/04/2017	R180 960

Note 1: This invoice is for goods never ordered or received by Homethings (Pty) Ltd and invoiced by Zebo in January 2017.

Note 2: This payment made on 22/04/2017 by cheque (cheque No 43219) was not reflected on the suppliers statement.

Note 3: This undercharge resulted from no VAT being charged by Zebro Publishing (Pty) Ltd on invoice XT1339

Note 4: The supplier invoice reflecting the charge for the goods received in respect of GRN MM691 (dated 25 April) was only received on 10 May.

YOU ARE REQUIRED TO describe the substantive tests of detail you will conduct on Perfect Pots (Pty) Ltd and Zebro Publishing (Pty) Ltd creditors reconciliations at 30 April 2017.

10.15 **(45 marks 54 minutes)**

Part A **(30 marks 36 minutes)**

You are a member of the team on the audit of Sporting Life (Pty) Ltd, a wholesaler of a large range of sports goods purchased from both local and foreign suppliers. You have been assigned to the 30 April 2017 year-end audit and are currently (late May) assisting with the audit of various aspects of the acquisitions and payments cycle. You have obtained the following information, inter alia, whilst assisting with risk assessment procedures.

1. The company has had a successful trading run for the last few years and with the current high level of interest in sport, the board of directors has decided to build an additional warehouse. This warehouse will be used exclusively for receiving, storing and dispatching imported sports goods. The company's bankers will supply the necessary finance, provided that the 30 April 2017 financial statements satisfy certain existing loan covenants relating to working capital ratios.

2. Sporting Life (Pty) Ltd is a "family owned" business and most management positions/directorships are held by members of the Clarkson family. Accounting systems are sound and a strong control environment exists. Your manager has been in charge of the audit for some years and has got to know the company's business very well.

3. The balance on the trade creditors account at 30 April 2017 was R9 267 914 (2016 – R11 900 418), a material amount in the context of the business.

4. The company's systems are all computerized and are resident on a local area network. Applications are menu driven.

5. Purchase orders are generated on the system by the buying clerks and approved on the system by the senior buyer, Polly Clarkson.

6. The creditors masterfile is an extremely important component of the system (all purchases). Purchase orders can only be generated for suppliers listed in the masterfile, and payments to suppliers (made by electronic funds transfer) can only be made to suppliers (creditors) on the creditors masterfile.

YOU ARE REQUIRED TO:

(a) comment on the risk of material misstatement at financial statement level for the 30 April 2017 audit. (6)

(b) comment on the risk of material misstatement in the trade accounts payable account in the 30 April 2017 annual financial statements. (6)

(c) explain the process of online approval of purchase orders. Include in your answer the application controls which should be in place. (9)

(d) describe the internal control procedures you would expect to find in place at Sporting Life (Pty) Ltd to ensure that the additions of new suppliers to the creditors masterfile are ***valid***. (9)

Part B **(15 marks 18 minutes)**

As part of your duties on the Sporting Life (Pty) Ltd audit you have been requested to audit a sample of the client prepared creditors reconciliations at 30 April 2017. You extracted a sample of reconciliations for audit, one of which appears below

Creditors reconciliation : Racketman (Pty) Ltd : 30 April 2017

Balance per creditors statement at 25 April 2017		R592 876
Less : payment : electronic transfer on 28 April 2017		R134 533
		R458 343
Less : invoice number 7493	*Note 1*	R 76 913
		R381 430
Less : Goods returned note 1017	*Note 2*	R 46 290
		R335 140
Add : Invoicing error	*Note 3*	R 13 320
Balance as per creditors ledger 30 April 2017		R348 460

Note 1 The goods relating to this invoice were only received by Sporting Life (Pty) Ltd on 7 May 2017 due to a strike at the Racketman (Pty) Ltd warehouse.

Note 2 The consignment of tennis racquets relating to this invoice was delivered to Sporting Life (Pty) Ltd on 15 April 2017. However on unpacking the racquets in May, it was discovered that they were cracked. Racketman (Pty) Ltd acknowledged that the damage was caused in its warehouse and have agreed to take back the entire consignment and credit Sporting Life (Pty) Ltd. Racketman (Pty) Ltd's invoice number 7216. This is expected to be resolved in July 2017.

Note 3 Racketman (Pty) Ltd undercharged on its invoice number 7001. 100 rugby balls were charged at R14.80 each instead of R148.00 each, inclusive of VAT.

YOU ARE REQUIRED TO describe the audit procedures you would conduct in respect of the reconciliation presented above.

10.16 **(40 marks 48 minutes)**

You are the newly appointed internal auditor of Massbuild (Pty) Ltd, a construction company, which builds low cost housing complexes. The head office of the company is in Johannesburg and building sites are spread around Gauteng. You are currently evaluating the acquisition and payments system and have established the following in discussion with Brin Gigg, the newly appointed financial manager.

Purchases

1. Quantity surveyors at head office compile a detailed list of materials (materials list) for each new project. This is then approved by the construction manager. A copy is sent to the site administration office (see below) and the original is filed away to be used in the event of any query.

2. It is Massbuild (Pty) Ltd's policy not to work on any more than four projects concurrently. This enables the company to employ four administration teams each consisting of 3 clerks, who, as one project is completed, move to a new project. The administration teams are responsible for purchasing and receiving materials from local suppliers, paying wages and maintaining inventory records, whilst the site managers and site foremen (one at each project) are responsible for construction and physical protection of building materials held in stock. From a building efficiency perspective, it is necessary for these functions to be carried out at the project site.

3. All purchases are made on credit. The senior administration clerk will, on arrival at a new project site, open accounts with whichever additional suppliers in the area he considers necessary i.e. because the project sites are sometimes geographically spread, it is not efficient or cost effective to use existing suppliers.

4. As materials are required, the site foreman will request the senior administration clerk at the site to purchase them. After checking the details of the materials requested to the materials list, the clerk places a phone order with the relevant supplier. If the materials requested by the foreman are not on the materials list, the administration clerk asks the foreman to submit a written, signed request.

5. When the materials are delivered to the site, the senior administration clerk checks them against the suppliers delivery note and signs and retains a copy to await the suppliers invoice. (Some suppliers send the invoice with the delivery.)

6. When the suppliers invoice is received at the site, details on the invoice are matched to the delivery note by the senior administration clerk and filed.

7. The only part of the acquisitions and payments cycle which is computerized is the payment of creditors. All creditors are paid by electronic funds transfer from head office.

Payments

8. At the end of each month, the senior administration clerk (at each site) compiles a list of amounts to be paid to creditors according to the invoices on file. The list contains the name of the supplier, the supplier's bank account details, the document numbers of the invoices being paid and the amount to be paid.

9. This list is faxed to head office and the original filed in month order, at the site.

10. Ansi Jansen an assistant accountant at head office is responsible for EFT payments
    10.1 Massbuild (Pty) Ltd pays its creditors over the internet but does not have its bank's software loaded onto its system, i.e. it has no "bank certificated"

terminals. When Massbuild (Pty) Ltd decided to set up EFT payment of creditors, Ansi Jansen was sent to the bank to arrange the EFT facility on the company's bank account with the necessary documentation and authority from the company. The cell phone number which she provided to the bank (as required) was her own cell phone number as she was to be responsible for making EFT payments. The bank provided Ansi Jansen with a PIN number. Ansi Jansen also set up the initial list (profile) of suppliers on the system.

10.2 On receiving the lists of suppliers to be paid from the four sites, Ansi Jansen accesses the bank's website from her terminal by entering the required account number, PIN and password.

10.3 By checking the names of suppliers on the four lists against the list of beneficiaries on the bank's system, Ansi Jansen identifies which suppliers must be added to the list of beneficiaries on the system. To do this she selects the "add beneficiary" option and following the prompts and entering the "once-off" password sent to her cell phone by SMS.

10.4 To actually pay the beneficiary (supplier) Ansi Jansen accesses the bank in the normal manner (PIN, passwords) and following the prompts, selects each supplier to be paid, enters the amount and selects the proceed option.

11. If Ansi Jansen is too busy to pay suppliers, she asks one of her two assistants to do it. Both know the PIN and passwords and are given Ansi Jansen's cell phone so that any once-off passwords will be available.

12. EFTs to suppliers are usually made in the first week of the month. At the end of the month when the bank statement sent by the bank arrives, Ansi Jansen enters up the cash book from the bank statement.

YOU ARE REQUIRED TO:

a) identify and explain the weaknesses in the internal control procedures for purchases as described in points 1 to 7 above, and to recommend improvements which should be made. The company does not wish to computerize the site office but temporary telephone/facsimile lines are always installed in the site offices. (25)

b) identify and explain the weaknesses in the internal control procedures for payments to creditors as described in points 8 to 12 above. You are ***not*** required to recommend improvements. (15)

10.17 **(39 marks 46 minutes)**

You are the senior in charge of the audit of Crowded House (Pty) Ltd, a large wholesaler of household furnishings and interior decorating requisites. The company imports many of its inventory lines from foreign companies but does not take forward cover on these purchases. The company has numerous creditors and the amount owed to creditors is substantial. At 30 April 2017, the financial year-end, the balance reflected in the financial statements for

"Trade Accounts payable and Accruals" was R14 372 810 (2016 - R18 291 630). The year-end substantive work is being carried out in June.

You have obtained the following information:

1. Crowded House (Pty) Ltd's purchases system is computerised. Hard copy purchase documents are printed out, e.g. orders and GRNs, and are attached to suppliers delivery notes, invoices and statements and filed by month alphabetically by supplier name.

2. When goods are delivered to Crowded House (Pty) Ltd, one of the receiving clerks accesses to the "Receive Goods" module of the purchases application, and calls up details of the delivery by keying in the Crowded House (Pty) Ltd order number reflected on the suppliers delivery note. The details are displayed on the terminal screen. Once the delivery is completed, a two part goods received note is printed, one of which is sent to the accounting department to await the suppliers invoice. Creditors are paid by electronic funds transfer.

3. All correspondence with creditors in respect of disputed amounts is filed in date order in a "Disputes" file.

4. Tim Finn, the accountant responsible for looking after creditors, reconciles the creditors masterfile to the creditors control account in the general ledger on a monthly basis, whilst his two clerks reconcile individual creditors accounts in the creditors masterfile with creditors statements.

5. At each month end, Tim Finn produces a list of creditors off the creditors masterfile split into two sections, namely local creditors and foreign creditors. (Each creditors record on the masterfile contains a field designating the creditor as "foreign" or "local".) The total of the two sections is reconciled to the creditors control account. (You have the necessary audit software and expertise to interrogate files on the system and you have copies of all important prior year masterfiles stored on a memory stick and kept with the working papers.)

6. Your audit team has carried out some work on internal controls in the acquisitions cycle and has concluded that controls are reasonably sound. The team is satisfied that purchases are properly authorised and accurately recorded. No work has been done on "cut-off" at 30 April 2017, but your audit team, when attending the inventory count, did record the last document numbers for the year and also made a list of unmatched GRNs (i.e. those filed and awaiting the arrival of the supplier invoice) at year-end.

7. Tim Finn and the financial accountant are responsible for identifying and listing accruals at year-end.

YOU ARE REQUIRED TO:

a) discuss the risk of material misstatement of the "Trade Accounts Payable and Accruals" account at 30 April 2017. (5)

b) describe the application controls, (both manual and computerised) which would be in place to ensure that deliveries in respect of valid orders only, are accepted and accurately recorded by the receiving department. (9)

c) describe the substantive procedures which you will carry out to verify "the Trade Accounts Payable and Accruals" balance at 30 April 2017. Do not concern yourself with related disclosures. (25)

CHAPTER 11

INVENTORY AND PRODUCTION CYCLE

11.1 **(15 marks 18 minutes)**

The following documents may play a role in the inventory and production cycle:

1. goods received note
2. production schedules
3. materials issue note
4. inventory sheets
5. inventory adjustment forms
6. job cards
7. inventory tags (for inventory counts)
8. transfer to finished goods note

YOU ARE REQUIRED TO briefly describe the use to which each of the above documents is put.

11.2 **(20 marks 24 minutes)**

YOU ARE REQUIRED TO select the correct answer(s) for each of the following questions. Note, there may be more than one correct answer.

1. Which of the following is (are) ***not*** normally a function(s) of the inventory cycle of a wholesale company?
   a) timekeeping in respect of warehouse personnel.
   b) receiving of goods from the receiving bay into the warehouse.
   c) safekeeping of inventory in the warehouse.
   d) authorising purchase requisitions to be sent to the buying department.

2. Which of the following is normally a function of the inventory and production cycle of a manufacturing company?
   a) placing orders for raw materials with suppliers.
   b) controlling and recording the costs of manufacture.
   c) timekeeping in respect of hourly paid factory personnel.
   d) authorising capital expenditure on plant and equipment.

3. Which of the following documents will ***not*** be relevant to the inventory cycle of a company which purchases goods for resale?
   a) goods received note.
   b) picking slip.
   c) components issue note.
   d) inventory adjustment form.

4. The document which tracks the stages of production of a unique job in a manufacturing company and on which costs can be recorded as they are expended is called a
   a) costing schedule.
   b) process report.
   c) job card.
   d) cost transfer record.

5. The ongoing comparison of the physical quantities of inventory on hand to the theoretical quantities on hand per the perpetual inventory records is referred to as conducting
   a) periodic counts.
   b) comparative counts.
   c) inventory reconciliations.
   d) cycle counts.

6. Access to the warehouse of Hi-end Sound (Pty) Ltd, a wholesaler of quality sound equipment, is restricted (by key pad) to warehouse personnel only. This control is categorized as
   a) an application control.
   b) a general control.
   c) neither (a) nor (b).

7. To minimize damage to the company' (very) expensive inventory, forklift drivers at Hi-end Sound (Pty) Ltd are sent on regular short driver skills courses. This control is categorized as
   a) a general control.
   b) an application control.
   c) neither (a) nor (b).

8. When inventory at Hi-end Sound (Pty) Ltd is moved from the warehouse to the dispatch area it is accompanied by a warehouse issue note which is signed by the dispatch controller to acknowledge the transfer of the inventory. This control is categorized as
   a) a general control.
   b) an application control.
   c) neither (a) nor (b).

9. Rihanna Mda, the inventory controller has read access to the inventory masterfile but no write access. This control would be categorized as
   a) preventive application control.
   b) detective general control.
   c) detective application control.

10. Hi-end Sound (Pty) Ltd conducts frequent inventory cycle counts. Any amendments which must be made to the perpetual inventory records are recorded on an inventory adjustment form which must be signed (authorised) by Rihanna Mda and Nick Numbers the company accountant. This would be categorized as a
    a) preventive general control.
    b) detective application control.
    c) preventive application control.

11. Subsequent to each cycle count, a log of all inventory adjustments made is reviewed by Ben Booysens the operations manager. This would be categorized as a
    a) preventive general control.
    b) detective application control.
    c) preventive application control.

12. Which of the following costs may ***not*** in terms of IAS 2, be included in the cost of Hi-end Sound (Pty) Ltd's inventory at reporting date?
    a) import duties on imported sound equipment.
    b) the salary of Rihanna Mda, the inventory controller.
    c) VAT.
    d) a non-reclaimable tax (duty) payable on luxury goods.

13. Which of the following is/are ***not*** an assertion(s) which applies to inventory?
    a) obligation.
    b) accuracy, valuation and allocation.
    c) completeness.
    d) occurrence.

14. If the auditor assesses that the risk of a client including fictitious inventory is high, he is likely to pay particular attention to further audit procedures which provide evidence relating to
    a) completeness of inventory.
    b) accuracy, valuation and allocation of inventory.
    c) existence of inventory.
    d) rights to inventory.

15. If the auditor assesses that the risk that a client will attempt to understate the allowance for obsolete/damaged inventory is high, he is likely to pay particular attention to further audit procedures which provide evidence relating to
    a) completeness of inventory.
    b) accuracy, valuation and allocation of inventory.
    c) existence of inventory.
    d) rights to inventory.

16. Hi-end Sound (Pty) Ltd holds material quantities of inventory in its warehouse on consignment for a number of international brands. This would have an effect on our assessment of the risk of material misstatement in the inventory account relating to which assertion
    a) completeness.
    b) accuracy, valuation and allocation.
    c) existence.
    d) rights.

17. At the year end inventory count at Hi-end Sound (Pty) Ltd, the audit team selected a sample of items from the warehouse, counted the number of items on hand and agreed the quantities counted to the quantities reflected on the inventory count sheets. This procedure provides evidence relating to which assertion?
    a) classification of inventory.
    b) accuracy of purchases.
    c) completeness of inventory.
    d) existence of inventory.

18. On the audit of Hi-end Sound (Pty) Ltd, the audit manager is considering whether it is necessary to make use of an expert who is not an employee of the audit firm to assist in gathering evidence relating to the saleability of certain very expensive sound

systems which have been "in stock" for a long period of time. Should the audit manager decide to engage an expert it would

a) require the consent of the audit committee.
b) not be chargeable as part of the audit fee.
c) be part of the audit strategy.
d) breach the auditor's compliance with the fundamental principle of professional competence i.e. the auditor must have the necessary knowledge and skills to carry out the audit.

19. On the audit of Hi-end Sound (Pty) Ltd, the auditor enquired of the chief financial officer as to the detail of the company's insurance policy for inventory, e.g. what risks were addressed, what conditions the company had to keep the policy effective. This procedure would be
    a) a test of controls.
    b) an "other" procedure.
    c) a substantive procedure.
    d) a risk assessment procedure.

20. Hi-end Sound (Pty) Ltd records the cost of imported inventory at the current exchange rate ruling on the date of the transaction. For financial reporting purposes, the cost of any imported inventory on hand should
    a) be adjusted to the spot rate for the foreign ruling on reporting date.
    b) remain unchanged.
    c) be adjusted to reflect the amount which was actually paid for the inventory taking into account any currency fluctuations.
    d) be converted at the average exchange rate of the applicable foreign currency for the financial year to which the financial statements relate.

11.3 **(12 marks 14 minutes)**

You are the auditor of Pacman (Pty) Ltd, a company which sells home entertainment goods. Your evaluation of the company revealed that the following controls had been implemented in the inventory and production cycle.

1. Pickers sign the picking slip after they have selected the goods from stores.

2. The company has a receiving supervisor, a despatch supervisor, and a stores controller who is responsible for the custody of inventory.

3. The stores controller has read access to the computerised perpetual inventory, but not write access.

4. The company has a full inventory count every three months which is attended, inter alia, by the financial controller, and external auditors.

5. All warehouse personnel, pickers, receiving clerks etc, are sent on regular training courses to ensure that they are kept up to date with the company's products.

6. One of the warehousing section's objectives is to keep theft of inventory below 1% of the total cost of inventory on hand. This is monitored monthly.

7. Entries to and exits from the warehouse are monitored 24 hours a day by surveillance cameras.

8. After a cycle count, the warehouse manager follows up on every inventory adjustment before he authorizes, (by signing the inventory adjustment form), that the adjustment to the inventory records may be entered.

9. Stores requisitions are numerically sequenced.

10. Warehouse personnel who are caught stealing inventory, are dismissed immediately.

Two of the components of internal control in terms of ISA 315 (Revised) are ***control environment*** and ***control activities***. Five control activities are listed below:

(i) division of duties (segregation of duties)
(ii) isolation of responsibilities
(iii) access/custody controls
(iv) performance review
(v) comparison and reconciliation.

YOU ARE REQUIRED TO indicate for each of the above whether it relates to the control environment or control activities component of internal control. Where your answer is control activities, indicate into which category (or categories) of activity, it falls ((i) to (v)).

11.4 **(25 marks 30 minutes)**

1. If a company maintains perpetual inventory records there is no need to conduct any physical inventory counts. True or false? Justify. (2)

2. Which of the following costs can be included in the cost of purchase of inventory by Capespin (Pty) Ltd, a large wholesaling company?
   * transport costs between the sea port and the company's ten warehouses
   * financing costs due to extended payment terms
   * VAT
   * sales promotion costs on a specific item of inventory. (2)

3. Inventories must be valued at year-end at the lower of cost or net realisable value. True or false? (1)

4. Explain why the inventory balance presents the directors with an effective opportunity to manipulate the financial statements. (2)

5. Identify four factors, with brief explanation, which may directly affect the likelihood of a company's inventory being misappropriated (stolen) from the company's warehouse. (4)

6. With which two cycles does the inventory and production cycle interface? (1)

7. Provide six examples of inventory which illustrate the diversity of inventory in respect of its nature, location, permanence and stage of development. (4)

8. Which assertions relating to inventory is the auditor normally most concerned about?(1)

9. It is sometimes thought that when auditors attend clients' inventory counts, they are only concerned with the existence assertion. However auditors are usually concerned to some extent with all the assertions relating to inventory at the time of the inventory count. Explain. (4)

10. With regard to inventory, auditors often find it more difficult to obtain sufficient assurance in respect of the accuracy, valuation and allocation assertion than in respect of the existence assertion. Explain. (2)

11. Explain the principle of "two-directional testing" in the context of attendance at an inventory count. (2)

11.5 **(20 marks 24 minutes)**

Soundwaves (Pty) Ltd wholesales a large range of hi-fi equipment, e.g. amplifiers, speakers, mixers, etc. The company holds a considerable quantity of high value inventory in its central warehouse.

1. The warehouse is monitored by close circuit television twenty four hours a day.

2. Sam Most, the warehouse supervisor has read only access to the inventory masterfile.

3. Warehouse personnel carry out inventory cycle counts on an ongoing basis.

4. When items are transferred from the goods receiving bay to the warehouse, the warehouse foreman signs an "inventory transfer note" which accompanies the goods.

5. Senior warehouse personnel are sent regularly on product training courses to make them more knowledgeable about the products the company sells.

6. The company's insurance company visits Soundwaves (Pty) Ltd every six months to assess the adequacy of the warehouse security conditions and to discuss with the senior personnel whether the company is adequately insured.

7. Any employee at Soundwaves (Pty) Ltd who is caught attempting to steal inventory is dismissed immediately.

8. Adjustments needed to the inventory records arising from cycle counts must be authorised by the warehouse supervisor and the financial accountant.

YOU ARE REQUIRED TO:

a) indicate whether each of the above actions/policies/procedures (1 to 8) is a general control or an application control. (8)

b) describe the purpose (objective) of each of the actions/policies/procedures (1 to 8). (12)

11.6 **(26 marks 31 minutes)**

Fabric (Pty) Ltd is a very large company in the textile sector. The risk assessment procedures you have carried out revealed that the company imports fabric from many countries and purchases from local suppliers. Fabric (Pty) Ltd sells the fabric and manufactures garments for both the mass market and the fashion market.

The company leases warehousing facilities in Durban, East London and Cape Town and owns a warehouse in Johannesburg. The manufacturing plant is also situated in Johannesburg.

The company's fabrics and garments are sold through approximately two thousand outlets, some of which are part of the company, but most of which are independent retailers of varying sizes i.e. ranging from national chain stores to small sole traders. Inventory is purchased from Fabric (Pty) Ltd by the larger outlets. The approximately 500 small outlets make purchases from Fabric (Pty) Ltd but also hold certain fashion lines on a consignment basis. The small outlets are also allowed to return any out-of-fashion or slow moving inventory. This inventory is then sold by Fabric (Pty) Ltd by auction to the highest bidder.

The internal control system for inventory has not always proved to be reliable due mainly to the volume of business and the constant movement of inventory between warehouse, consignment inventory holders and the outlets in general.

The statement of financial position for the year-ended 31 March 2017 shows inventory to be valued at R28 million.

YOU ARE REQUIRED TO:

a) explain to the junior trainee who is on the audit with you why auditors conduct risk assessment procedures. (8)

b) assess the risk of material misstatement in the inventory balance in the financial statements of Fabric (Pty) Ltd at 31 March 2017. Structure your answer in terms of the assertions, but do not concern yourself with the risk of material misstatement applicable to ***related disclosures*** or the ***presentation*** assertion. (18)

11.7 **(32 marks 38 minutes)**

The risk of material misstatement in a company's inventory balance, will vary considerably depending on the nature, location and other characteristics of the inventory itself. Consider the following companies:

Treeline Ltd - This company owns thousands of hectares of plantation. When matured, the trees are felled and transported to the company's mills where they are turned into paper, chipboard and a number of lesser by-products.

Dazzling Diamonds (Pty) Ltd - This company purchases diamonds which have already been cut and polished, and sells them to manufacturing jewellers.

Shu-Shu (Pty) Ltd – This profitable company sells popular locally manufactured shoes. It has five outlets located in shopping malls in Gauteng.

Borro-Brick Ltd - This company manufactures bricks at its Pretoria brickyard. Bricks are baked in 20 kilns (baking ovens). Finished bricks and pavers are held at the Pretoria depot and on consignment by the company's agents around the country.

Modern Interiors (Pty) Ltd - This company sells upmarket, imported furniture and home décor items. The company is experiencing financial difficulties and the pending financial statements will be submitted to the bank in support of a loan application.

All of the above companies are large, and inventory is material.

YOU ARE REQUIRED TO, based solely on the information given above, categorise the above companies, as follows:

* high risk of material misstatement in the inventory balance
* medium risk of material misstatement in the inventory balance
* low risk of material misstatement in the inventory balance.

Fully justify your answer.

11.8 **(35 marks 42 minutes)**

You are on the audit of EagleEye (Pty) Ltd a company which manufactures security devices, e.g. burglar alarm units, surveillance cameras, etc.

Some months prior to the audit, the company appointed Simon Brown as the internal auditor of the company. He reports to Krishen Vather the financial manager. Prior to his appointment as internal auditor, Simon Brown had been an administration clerk in the creditors section. However, due to a restructuring of the creditors section, his position had become redundant, and his options were either to leave the company or accept the newly created post of internal auditor. Although he has no formal training in auditing, Simon Brown is regarded as a competent and enthusiastic staff member who could develop into a satisfactory internal auditor.

It has also been decided that, as internal auditor, he could be used effectively if staff members in the accounting department are absent, on annual or sick leave, to carry out their responsibilities.

You had considered the possibility of relying on some of the work which Simon Brown had carried out relating to the inventory and production cycle and using him to assist with certain aspects of the year-end inventory audit, but decided at this stage it was not appropriate to do so.

In addition to your audit responsibilities, Krishen Vather has requested that you evaluate certain aspects of the production cycle and make recommendations for improvement where necessary. He believes that improvements are required and that the Board would be receptive to reasonable recommendations. He has provided you with the following narrative description:

Systems description – production

1. The company manufactures a standard range of products, each of which has its own product code.

2. Manufacture is carried out by ten technicians who each have their own workstation in the factory. The workstation consists of a bench and all the necessary equipment the technician requires to build and test the products.

3. The factory foreman, Frans Flinthoff, is in charge of the factory and reports to the production manager.

4. The sales department notifies the production manager of demands for the company's products on a weekly basis. (This procedure works well).

5. A large "production blackboard" is positioned at the entrance to the factory. This blackboard displays each workstation number and the name of the technician assigned to that workstation. Below these headings are columns to enter the date, product code and quantity of the product to be manufactured.

6. Each Monday morning the production manager assigns work to the technicians by updating the date, product code and quantity columns on the blackboard.

7. All of the technicians are trained to manufacture all of the company's products and have an assembly manual to which they can refer if necessary.

8. Components for manufacture are kept in a warehouse adjoining the factory. As technicians generally know what components are needed to manufacture each product (they can also refer to the assembly manual), they will personally select the components from the warehouse shelves as they require them.

9. Once the technician has constructed and thoroughly tested a batch of items, he loads them onto a trolley and takes them to the finished goods warehouse.

10. On arrival at the finished goods store he unloads the items in the receiving area and returns to his workstation.

11. Before the end of each working day a warehouse clerk who is responsible for keeping the components warehouse and finished goods warehouse clean and tidy, takes the items manufactured from the receiving area and places them on the allocated shelves in the warehouse. No perpetual inventory records are maintained.

YOU ARE REQUIRED TO:

a) fully justify your decision not to rely on the work of Simon Brown, the internal auditor, on the audit of EagleEye (Pty) Ltd. (15)

b) identify the weaknesses in those aspects of the production cycle described above, and for each weakness make suitable recommendations for improvement. (Do not concern yourself with the costing of manufactured items). (20)

11.9 **(20 marks 24 minutes)**

You are in charge of the audit at Toytown (Pty) Ltd, a manufacturer and wholesaler of toys. The company imports both raw materials and complete toys. The following audit procedures were carried out at some stage during the year end audit.

1. Observed the client's count teams perform the year end inventory count.

2. Undertook a guided tour of the production facility with the production manager.

3. Selected a sample of toys in the warehouse during the year-end inventory count and traced them to the inventory count sheets.

4. Inspected the draft annual financial statements for compliance with the disclosure requirements of IAS 2 – Inventories.

5. Enquired of the warehouse manager as to whether Toytown (Pty) Ltd held inventory on consignment for other companies.

6. Inspected the supporting documentation pertaining to various consignments of toys in transit from Taiwan at year-end, to determine whether or not the risks and rewards of ownership had passed to Toytown (Pty) Ltd.

7. Inspected a sample of sales invoices for sales made after year-end to establish the selling price of the toys sold, as part of establishing whether inventory has been valued at the lower of cost or net realizable value at year-end.

8. Discussed the prior year audit of inventory with the senior in charge of the prior year inventory audit and scrutinized the prior year workpapers.

9. Enquired of the financial accountant as to whether any events had occurred in the post reporting period relating to inventory.

10. Reperformed the costing exercise on a sample of costing schedules for consignments of imported toys held at year-end.

11. Reviewed the minutes of directors meetings to determine whether inventory had been encumbered in any way.

12. Reviewed the contracts between Toytown (Pty) Ltd and two major chainstores pertaining to replacement of damaged toys and obsolescence of fashionable toy lines.

13. Inspected a sample of raw material requisitions from production to the warehouse for the authorizing signature of the production foreman. The sample was drawn from the complete population of material requisitions for the year.

14. Obtained a letter from various toyshops confirming that they held inventory on consignment on behalf of Toytown (Pty) Ltd. The letters listed all inventory they had held at year end.

YOU ARE REQUIRED TO:

a) indicate whether each of the procedures listed above is a risk assessment procedure or a “further” audit procedure. For each procedure you identified as a “further” audit procedure, indicate whether it is a test of controls or a substantive procedure. (15)

b) for each procedure you identified as a substantive procedure, indicate the assertion pertaining to inventory which is being addressed. (5)

11.10 **(35 marks 41 minutes)**

You are the manager on the audit of Firezone Ltd. The company is a wholesaler of numerous products related to domestic and industrial heating, fire extinguishers and other fire fighting chemicals and equipment. The company’s year-end is 31 July. The senior on the audit was taken ill shortly before the financial year-end and you had no choice but to put a far less experienced trainee Ted Mitton, in charge of the audit.

Pertinent information about the company’s inventory is as follows:

1. Inventory is kept in a single warehouse in Durban.

2. The warehouse is divided into six sections according to the type of goods stored e.g. domestic heaters, chemicals etc, and is neatly stacked.

3. The majority of items are packaged in sealed boxes or cartons.

4. Some of the chemicals have a limited shelf life. Where this is the case, the expiry date is stamped on the container.

5. Firezone Ltd holds inventory on consignment from Bushblaze Inc, an Australian firefighting company.

You asked Ted Mitton to submit a report to you on his attendance at the year-end inventory count. The report contained the following information.

1. The inventory count took place over two afternoons, from 1pm to 5pm on 30 and 31 July. This was to enable the company to receive and dispatch goods during the morning.

2. The count was carried out by the six warehouse employees who usually pick the goods to fill orders. This worked well because they are familiar with the nature of the inventory and where everything is stored.

3. The pickers decided amongst themselves which section of the warehouse to count. Maggie Motolo, the warehouse administration clerk, printed a list off the computerised perpetual inventory system (inventory sheet) of each item (description and quantity) in the section chosen by the picker. The numerically sequenced inventory sheets were handed to the pickers who then counted each item in their section of the warehouse, ticking off the quantities on the inventory sheets once they had counted the item.

4. If the count quantity differed from the quantity on the inventory sheet, the counter (picker) highlighted the item and quantity and wrote in the number he had counted.

5. At the conclusion of the count on the second day, the counters returned the inventory sheets to Maggie Motolo who identified the highlighted items and amended the quantities on the perpetual inventory records to reflect the actual quantities on hand.

6. Prior to the count, I confirmed with the financial accountant that we would be attending the inventory count. He confirmed the dates and times with me.

7. I was assisted at the count on both days by Zane Mulla (also a second year trainee) and we carried out the following procedures:

   7.1 accompanied each picker for a short period of time on each day to observe them counting.
   7.2 allocated the six sections between us, compiled a count workpaper by selecting inventory items (on a random basis) from the counters' inventory sheets, and performed a physical count of the items selected.
   7.3 we entered the count quantity for each item counted on our workpaper (which is attached).
   7.4 observed Maggie Motolo adjust the quantities on the perpetual inventory records.
   7.5 I initialed each of the inventory sheets and left them in the custody of Maggie Motolo.

YOU ARE REQUIRED TO:

a) discuss the weaknesses in the year-end inventory count, based on the information given above. (17)

b) state whether you would be satisfied with the procedures conducted by the trainee accountant in connection with the year-end inventory count at Firezone Ltd. Fully justify your answer. (18)

11.11 **(35 marks 42 minutes)**

Recently, your firm was appointed as auditor of Shades (Pty) Ltd, a wholesaler of inexpensive eyewear. The company's financial year ends on 31 March 2017.

Lars Lens was also recently promoted to the position of financial manager of Shades (Pty) Ltd and has, for the first time, taken on the responsibility for the annual inventory count. He has drafted a memorandum to his staff but has asked you to comment on it before it is distributed to staff.

MEMORANDUM

To:	All staff involved in the inventory count
From:	Lars Lens
Date:	3 February 2017
Subject:	Inventory count

1. The inventory count will take place somewhere between 27 and 31 March 2017. As we expect to be very busy at this time with the receipt and despatch of the new winter lines of eyewear, we will hope for a quiet day to do the count.

2. The following staff members from the accounting department should count the inventory in the identified section of the warehouse:

Staff member	***Style category***	***Section***
Tiny Temple:	fashion	north section
Ben Vision:	sport	west section
Squincy Johnson:	prescription	south section
Ivan Malemah:	novelty	east section

3. Mia Osman, please do not forget to record last document numbers for goods received notes and delivery notes on Thursday, 31 March 2017. (I suggest you do it early in the morning on 31 March 2017.)

4. Iris Lash, will you please order four examination pads from stationery to use as inventory sheets.

5. Will those responsible for counting inventory (see 2 above) do so in the following manner:
   5.1 write down the details from the labels on the boxes and the quantity of identical boxes, and
   5.2 sign your inventory sheets on completion of the count.

   I know that the warehouse is still in a bit of a mess due to the installation of the new sprinkler system, but the inventory is roughly in its correct location by style category. Just move through your section systematically when you are counting.

6. Mia Osman will be away between 27 and 30 March. Should you decide to come in early to count inventory on either of those days, you can obtain the keys from security, but I must warn you, no overtime will be paid.

7. As you all know I have been extremely busy settling in to my new position. Unfortunately I will not be able to involve myself much in the inventory count but I have no doubt that you will all do a good job.

This memorandum will be my last official communication concerning the inventory count but if you wish to discuss any aspect of the count, please see me.

Your "understanding the entity (risk assessment)" procedures conducted earlier, revealed that:

1) Shades (Pty) Ltd has a reasonably large warehouse. The eyewear is stored in boxes which are placed on shelves arranged in parallel rows.

2) Eyewear is received from manufacturers in labeled, sealed boxes. The label contains details of the manufacturer, style category, frame colour, and a unique inventory number (for reorder purposes) and the number of units in the box. There are four style categories of eyewear and each is located in a different section of the warehouse as described in pt 2 above.

   Shades (Pty) Ltd supplies only full boxes of eyewear to its retailers.

3) The company accounts for inventory on a periodic basis. However Mia Osman, the warehouse controller, does keep a simple "quantities only" cardex system which she writes up manually from pre-numbered goods received notes and delivery notes.

4) Mia Osman who is the most senior employee in the warehousing function, has a staff of five warehouse clerks reporting to her.

5) During December 2016 all inventory in the warehouse had to be moved due to the installation and testing of a new fire extinguisher sprinkler system. Unfortunately when the inventory was put back on the shelves, many boxes were returned to the incorrect sections.

6) The previous senior in charge informed you that a properly organised and conducted inventory count should be completed in about eight hours and that the "tag system" is not necessary or recommended.

7) The financial director will not approve an inventory count to be held on a Saturday or Sunday, as this will result in what he regards as "unnecessary overtime having to be paid to staff". He has also instructed that no orders be despatched on inventory count day but that all deliveries from suppliers be accepted.

YOU ARE REQUIRED TO:

a) write a letter to Lars Lens detailing those matters which should be brought to his attention to ensure a successful inventory count. (25)

b) describe the audit procedures you will conduct when you attend the inventory count at the end of Shades (Pty) Ltd's financial year, assuming that Lars Lens follows your advice. (10)

11.12 **(30 marks 36 minutes)**

Farmer Joe (Pty) Ltd manufactures various items of machinery for the agricultural sector. The company manufactures items such as irrigation pumps and small trailers as required by its customers.

All raw materials and parts for manufacture, are held in the raw material and component store, a separate warehouse adjoining the factory and are issued to production as required. Once manufactured, the items move from the factory to the finished goods warehouse which also adjoins the factory. Each warehouse is controlled by its own warehouse foreman.

After consultation with the farmer, the product development department designs the item required and draws up a "Build Schedule" which identifies each and every part required to manufacture the item. Build schedules are pre-printed and numerically sequenced.

Farmer Joe (Pty) Ltd has good internal controls including sound departmental division of duties within each cycle. The only function within the acquisitions cycle which is not computerized is ordering which is still carried out manually.

The company also has an internal audit department. It is headed by Murree Turner, a chartered accountant and is well staffed.

Murree Turner who reports to the Board of Directors ensures that his department does not involve itself with operational matters. The department concentrates its efforts on a well planned schedule of risk and control evaluations, compliance testing and similar activities.

The annual inventory count for the financial year-end will take place on 30 April (the last day of the financial year). No manufacturing will take place on this day and management requires that the entire inventory count, including work-in-progress, be completed on this day. You believe that if proper planning takes place, this can be achieved.

As part of your planning activities, you assessed the work papers of internal audit's recent evaluation of a number of cycles. You found the work papers to be comprehensive and well prepared and the internal control systems to be sound.

YOU ARE REQUIRED TO:

a) describe the internal controls which should be in place at Farmer Joe (Pty) Ltd in respect of the:
   i) ordering of raw materials and parts for manufacture (10)
   ii) transfer of raw materials and parts from the raw material and component store to the factory. (9)

b) state, giving reasons, whether it would be appropriate for you to work with the internal audit department on the year-end inventory count to be held on 30 April. (11)

11.13 **(24 marks 29 minutes)**

You are the auditor of Households (Pty) Ltd, a retailer of home appliances, e.g. fridges, stoves, televisions. The financial year-end of the company is 28 February and you are currently planning attendance at the inventory count which is scheduled for 28 February, as well as the subsequent inventory procedures you will conduct.

Households (Pty) Ltd operates out of a large warehouse/outlet in Port Elizabeth and also holds inventory at outlets in Grahamstown and Port Alfred. The majority of the appliances sold by the company are manufactured in South Africa but certain more expensive lines are imported from Austria and the United States. In addition to their regular products, the company also sells a very expensive range of technologically advanced audio equipment which is also imported. All imported goods are shipped in containers to the Port Elizabeth warehouse. At year end there are likely to be a number of containers which have been delivered to the warehouse but not unpacked.

Households (Pty) Ltd is well managed with sound systems of internal control and is profitable.

In addition to its inventory of new appliances, Households (Pty) Ltd also has a large inventory of second-hand appliances for sale at its Port Elizabeth warehouse. These are taken as “trade-ins” on new appliances and repaired/repainted in Households (Pty) Ltd’s workshop. Each of these "trade-ins" is given a job number and costs of repair are recorded on a job card. A computerised inventory ledger of second-hand goods is maintained, each item having a unique record of its details including item serial numbers, date of trade-in and sales agreement number, trade-in value, and repair costs.

YOU ARE REQUIRED TO:

a) assess the risk of material misstatement of the inventory account balance in the financial statements at 28 February 2017. Consider each of the assertions relating to inventory. Do not concern yourself with the assertions relating to classification and presentation. (12)

b) describe the further audit procedures you will carry out to verify the ***valuation*** of second hand appliances on hand at the year end having satisfied yourself as to the existence of second-hand appliances by attending the annual inventory count. (12)

11.14 **(30 marks 36 minutes)**

You are working on the audit of Playboy (Pty) Ltd, a company which wholesales computer play stations such as Nintendo and Sony. The company’s business model is simple and effective. It imports four different types of play station; these are stacked in their sealed boxes in four designated areas of the warehouse. As orders come in from retailers, the play stations are promptly shipped out in their sealed boxes. At year-end there were roughly fifteen thousand units on hand. Of the fifteen thousand units held, approximately ten thousand were the expensive Sony and Nintendo play stations, (about five thousand of each make) with the balance being made up of the cheaper Creativ and Blaster play stations also in approximately equal quantities.

One of the procedures which your firm has carried out each year at the annual inventory count has been to carefully open a small sample of sealed boxes to confirm that each box contains a play station. The box is then resealed. In prior years no instances of empty boxes had been found; internal controls in the receiving and issuing of inventory and physical controls over inventory are sound. The company has a strong control environment.

However, at the year-end inventory count which is currently underway the same procedure identified a box stacked with the other boxes which was empty but had been carefully resealed. This was the only empty box from a non-statistical sample of thirty boxes randomly selected from the fifteen thousand units.

The members of the audit team are divided on what should be done about this and the following conversation takes place:

Peter Dean: We can ignore it – one empty box in fifteen thousand hardly makes a difference – it's not material.

Roy Sidhu: No, I think we should open another thirty boxes and if we find no empty boxes in that sample, we can ignore it.

Bob Boon: I agree with Peter, one out of thirty is a tolerable error rate.

Creedence Ndlovu: How can you have a tolerable error rate for a test like this? Obviously there has been theft here which is serious. If we think there is theft we have to do something about it. If it comes out later that there has been major theft, the company can sue us for not picking it up. If necessary every box will have to be checked.

Peter Dean: You know the warehouse manager is very fussy about us being careful when opening the boxes so let's just record our finding and move on.

YOU ARE REQUIRED TO:

a) state the assertion to which the procedure of checking the contents of the boxes relates. (1)

b) comment on the size of the sample selected for this procedure. (7)

c) comment on the opinions of the audit team based on the conversation recorded above. (12)

d) comment on whether the warehouse manager should be notified of the empty box. (3)

e) describe, giving reasons, how you would go about increasing/carrying out your tests on the contents of boxes. (7)

11.15 **(30 marks 36 minutes)**

You are engaged on the 31 March 2017 audit of Formweld (Pty) Ltd a company in the light engineering sector. You have been assigned to the audit of inventories. Towards the end of the financial year, the company was involved solely in the manufacture of 20 pivot irrigation systems for Turnerfarms Ltd, a commercial farming company. At year-end, four of the twenty systems ordered had been completed and were awaiting collection. Six were "work-in-progress" and manufacture of the balance of 10 had not commenced.

All materials used in the manufacture of the systems are purchased locally, with the exception of the high pressure pumps which were imported as a batch of twenty from Speck Pumps Inc in Germany.

The company operates a job costing system. Each unit is treated as a separate job and costs and other information are recorded on a numerically sequenced "job card" on which costs are recorded.

Prior to the commencement of the manufacture of the units, a "materials and labour schedule" is prepared by the company's engineer and cost accountant. This document details the estimated manufacturing hours for the different grades of employee working on the unit and the description and estimated costs of materials to be used.

At year-end the chief engineer, John Graham, estimated the stage of completion of the six units in progress and provided you with the six job cards updated to the 31 March 2017. The year-end inventory count took place on the last day of the year.

Prior to the year-end, you evaluated the underlying internal control systems and conducted tests of controls. You have concluded that the accounting system and related controls at Formweld (Pty) Ltd are sound.

The job card for the seventh unit (unit 7) which is included in work in progress at 31 March appears below (see next page).

YOU ARE REQUIRED TO:

a) describe the further audit procedures you would have conducted at the year-end inventory count in respect of work-in-progress. (5)

b) describe the further audit procedures you will conduct in respect of the costs relating to the seventh irrigation system (unit 7) included in work-in-progress at 31 March 2017. (25)

Note job card on next page.

Formweld (Pty) Ltd Box 10, Willerton Pietermaritzburg. Customer : Turnerfarms Ltd Product : Pivot Irrigation System Unit 7					Job Card no: 3276
Employee	Grade	Wage week	Hrs	Rate	R
Preston	skilled	49-52	136	R80	10 880
Dhlamini	skilled	49-52	136	R72	9 792
Clark	skilled	52	16	R90	1 440
Costas	unskilled	49-52	136	R25	3 400
John	casual	51	40	R10	400
					R25 912
Materials					
Description		Requisition	Amount		
Speck Pump V32791		SR 2891	54 292		
Pivot Arm		SR 2782	18 610		
Piping & Joints		SR 2798	21 839		
Consumables		SR 2781	4 923		R99 673
Overheads					R14 200
Additional Costs		Pivot Arm. This pivot arm fell off the forklift whilst being transported to the workshop from stores. Damaged beyond repair.			R18 610
Stage of Completion		At the 31 March 2017 unit 7 was 80% complete			
Signed: *John Graham*					
			Total		R158 395

11.16 **(36 marks 43 minutes)**

You are a member of the team on the audit of X-Bike (Pty) Ltd, a company which wholesales motorbikes, parts and accessories, to motorbike dealers. The company's administration offices and warehouse are situated in Durban. It has no other storage facilities and goods are shipped direct to their customers from the warehouse. The company does not hold inventory on consignment on behalf of others, and does not own any inventory which is held by others on consignment.

The company maintains a computerised perpetual inventory system. All motorbikes are imported either from the East or from America. Motorbikes arrive in complete kits each in its own box. Dealers are responsible for the minor assembly which is required to get the motorbike on the road. Parts and accessories are purchased from both local and overseas suppliers.

Imported goods are brought into the country by sea in containers at a rate of approximately two containers a month and are cleared through customs at Durban harbour. Goods in the container are usually from a number of suppliers. X-Bike (Pty) Ltd makes use of Clearforward (Pty) Ltd to arrange the forwarding and clearing of its imports.

The company conducted its inventory count on 31 July 2017 and you and your team were in attendance. The warehouse was closed for the day and no inventory was dispatched on the day of the count. However, a number of deliveries from local suppliers were received. These goods were not placed in the warehouse but were stored securely in the receiving bay. (The relevant goods received notes were made out but, as the goods were not included in the count, the perpetual inventory/inventory masterfile was not updated).

During the inventory count, besides observing the count controls, your audit team:

1. performed test counts in both directions and recorded the results in the working papers.

2. made notes of all items which appeared to be damaged or slow moving, including pre-2017 models of motorbikes.

3. followed up with the clients warehouse personnel and resolved all instances where actual quantities on hand differed from the perpetual inventory quantities.

4. obtained and confirmed a list of all GRNs made out on the day of the count.

During the evening of the 31st July, the inventory masterfile quantities were adjusted for the differences arising out of 3 above and, having satisfied yourself that all the adjustments were correctly made, you arranged for the download of the complete inventory masterfile onto a memory stick to enable you to make use of your firm’s audit software when performing subsequent audit procedures on inventory. Your firm’s audit software is very powerful and enables you to extract an extensive range of reports for audit purposes.

The company provides for obsolete/slow moving inventory by using the following percentages of total cost at financial year-end for each category:

Motorbikes	-	5%
Parts	-	10%
Accessories	-	20%

An extract of a selection of records from the inventory masterfile as well as some explanatory notes appears in the appendix on the next page.

YOU ARE REQUIRED TO:

a) explain the term “direction of testing” in the context of the auditor’s attendance at a client’s inventory count. (4)

b) describe the additional procedures you will conduct in respect of the verification of the ***rights*** assertion and the ***accuracy***, ***valuation*** and ***allocation*** assertion relating to the inventory balance reflected in the statement of financial position of X-Bike (Pty) Ltd at 31 July 2017. (32)

(see appendix on the following page)

Appendix

Item code	***Description***	***Cost reference***	***Supplier***	***Quantity on hand***	***Cost R weighted average***	***Value R***	***Selling price R***	***Date of last sale***	***Date of last purchase***	***Quantity sold year to date***
B 0332	KTM 20002D	CR/141	KT Japan	3	78 375	235 125	186 500	4/2017	09/2016	18
B 0437	KTM 5000Z	CR/187	KT Japan	10	72 450	724 500	182 500	7/2017	03/2017	30
B 0461	KTM 6000X	CR/214	KT Japan	4	81 515	326 060	190 500	-	07/2017	0
A 1321	Headbanger Helmet	LS	Brainz (Pty) Ltd	35	1 745	61 075	3 162	12/2016	6/2016	2
A 0792	Leather off road boots	CR/091	Toestubbers Inc	24	1 300	31 200	4 850	5/2017	12/2016	16
P 0063	Harley disc brake kit Part no. HB6817	CR/173	Harley USA	4	1 812	7 248	4 285	11/2016	4/2017	3
P 0111	Michelin P200 tyre	LS	Tyreman CC	40	1 375	55 000	1 850	3/2017	4/2017	120

Note 1: Every item of inventory has its own alphanumeric item code, e.g. B 0332. The alphabetic digit denotes the category of inventory B = Bikes, P = Parts, A = Accessories, and the numbers are a simple numerical sequence which started at 0001 for each category. When an item of inventory is purchased by X-Bike (Pty) Ltd for the first time it is allocated the next numerical number for that category of inventory. When an item is no longer carried by the company its code number is removed from the inventory masterfile but is not re-used for another item. LS denotes a local supplier.

Note 2: The company uses the weighted average cost formula. Weighted averages are automatically calculated by the company's system.

Note 3: The "reference field" provides the reference number for the costing report which is drawn up for all imported goods to arrive at the unit cost. The reference applies to a hardcopy file which contains the costing report itself as well as copies of all supporting documentation.

11.17 **(40 marks 48 minutes)**

You are a member of the team on the 31 July year-end audit of Bookbox (Pty) Ltd. You have been assigned to the audit of inventory.

Bookbox (Pty) Ltd is a wholesaler of books. The company sells books on a wide range of topics, e.g. fictions, sport, business, but does not sell text books. You have been provided with the following information :

1. The year-end inventory count will take place after hours on Wednesday 28 July. The company does not conduct cycle counts during the year.

2. The company's inventory records are computerized and their software is compatible with your firm's audit software. (Once the year-end inventory masterfile is finalized, it is downloaded onto the audit team's laptops for audit interrogation).

3. The company purchases its books from publishing houses, both local and foreign. In excess of five thousand titles are on hand and quantities and unit costs can vary significantly. The company attempts to sell only "popular" titles, avoiding specialist titles for which there is little demand.

4. All titles are listed on the inventory masterfile which contains the following information :
   - 4.1 Title and author
   - 4.2 Publisher and country of publisher
   - 4.3 ISBN number (a number unique to each book title)
   - 4.4 Unit cost in rand
   - 4.5 Selling price
   - 4.6 Quantity on hand, e.g. 100 copies
   - 4.7 Category, e.g. business, sport
   - 4.8 Date of last sale
   - 4.9 Quantity sold year to date.

5. The warehouse is well laid out. Each category of book is kept in a designated area. Within each category's designated area, books are stacked in boxes, alphabetically by author.

6. You have carefully reviewed the company's inventory count instructions and are satisfied that an accurate, efficient count will take place. Count teams will record count quantities on pre-printed inventory sheets and the count will be controlled by Barry Potter the financial controller, and Jakes Mda the warehouse manager. You and other team members will attend the inventory count.

7. Once any discrepancies between theoretical and actual quantities have been resolved the necessary amendments to the inventory masterfile will be made. At the same time amendments will be made for all damaged inventory. All damaged inventory is regarded as unsaleable and is sent to a waste paper depot for recycling. Masterfile amendments are authorized by Barry Potter and Jakes Mda.

8. The company values its inventory on the FIFO basis.

9. The value of inventory per the inventory masterfile at year-end, is reduced by a writedown for slow-moving inventory. The basis of the writedown, which is usually material, is as follows :
   9.1 the selling price of all titles for which there have been no sales for the nine month period prior to year-end, is reduced to the special "stock clearance" selling price of R50 per unit, regardless of the title's unit cost (there are no titles which have a unit cost of less than R50).
   9.2 the company's customers are provided with a list of these titles and are notified that they can be purchased on a "whilst stocks last" basis. The offer is valid only for August.
   9.3 at the end of August, the unsold books are donated to charity.

10. Books sold at the "stock clearance" price are invoiced on unique sequenced "stock clearance invoices" to distinguish them from normal sales.

It has been agreed with your audit manager that your audit of inventory will take place during the early part of August but that you will return in the first week of September, to conduct audit procedures on the writedown of slow moving inventory.

YOU ARE REQUIRED TO:

a) describe the substantive audit procedures you will conduct in respect of the ***completeness*** assertion for Bookbox (Pty) Ltd's inventory at 31 July 2017. (6)

b) describe the substantive audit procedures you will conduct in respect of the accuracy, valuation and allocation assertion applicable to Bookbox (Pty) Ltd's inventory before the writedown for slow moving inventory is carried out. (20)

c) describe the substantive audit procedures you will conduct in respect of the writedown for slow moving inventory at 31 July 2017 when you return to the client in early September. (14)

CHAPTER 12

FINANCE AND INVESTMENT CYCLE

12.1 **(25 marks 30 minutes)**

1. Explain briefly what the finance and investment cycle deals with. (2)

2. Identify four types of transaction which will affect the "equity" section of the statement of financial position of a company, (2)

3. Comment briefly on the following in relation to the Finance and Investment cycle.
   3.1 frequency of transactions.
   3.2 size (materiality) of transactions.
   3.3 internal controls relating to transactions.
   3.4 legal and regulatory requirements.
   3.5 documentation. (8)

4. Comment on whether transactions in the cycle, in general terms, will increase ***audit risk***. (5)

5. Suggest five ways in which the directors of Joker (Pty) Ltd, a large industrial company, could engage in fraudulent reporting of account headings related to the finance and investment cycle. (5)

6. Risk assessment procedures at Joker (Pty) Ltd revealed that the company concluded a number of complex transactions in the finance and investment cycle in the year under audit. The risk assessment also revealed that management, including senior accounting personnel, lacked competence with regard to the financial reporting requirements of these transactions. Discuss your firm's overall response to this increased risk of misstatement. (3)

12.2 **(15 marks 18 minutes)**

The following procedures were carried out during the audit of the finance and investment cycle at Xpaper Ltd, a manufacturer of a large range of paper products. Xpaper Ltd also has a number of investments in shares of both private and listed companies.

1. Inspected minutes of the meetings of the investment committee for authority for the purchase of shares in a private company which had taken place during the year under audit.

2. Reperformed the calculation of interest paid to debenture holders for the year.

3. Inspected the accounting policy note in respect of the valuation of investments to confirm that it was relevant and understandable in the context of the IFRS.

4. Compared the schedule of long-term liabilities at the current year-end to the schedule of long-term liabilities at the previous year-end.

5. Inspected the share certificates for a sample of investments in private companies, to determine whether the certificates were in the name of Xpaper Ltd.

6. Inspected Xpaper Ltd's final bank statement for the year to confirm that the repayment of a loan made by Xpaper Ltd to a client had been recorded in the year under audit.

7. Discussed and evaluated the basis on which the useful life of one of the company's registered trademarks was determined.

8. Inspected the notes to the financial statements to confirm that ***all*** disclosures in respect of the company's intangible assets required in terms of the financial reporting standards had been made.

9. Obtained written confirmation of the balance owing at year-end directly from Cartons Ltd, a company to whom Xpaper Ltd had made a loan.

10. Obtained the share market price of the company's listed investments at year-end.

11. Discussed with management whether any of the company's paper manufacturing equipment was lying idle.

12. Traced the postings from the journal entries which recorded the profit or loss on sale of fixed assets to the general ledger to confirm that the "transactions" had been recorded in the proper accounts.

13. Reviewed correspondence with Xpaper Ltd's attorneys to confirm that an economic inflow from a court case which had been disclosed in the notes as a contingent gain would "probably" but not "virtually certainly" occur.

14. Enquired of management as to the source of funding for major acquisitions identified during the audit of fixed assets.

15. Selected a sample of items of plant and equipment from the fixed asset register and physically inspected them matching the description/asset numbers to the details extracted from the register.

YOU ARE REQUIRED TO indicate to which assertion each of the procedures listed above relates.

12.3 **(15 marks 18 minutes)**

YOU ARE REQUIRED TO select the most appropriate answer for each of the questions listed below:

1. Which of the following is not an assertion applicable to the "property, plant and equipment" account heading?
   1.1 existence.
   1.2 rights.
   1.3 occurrence.
   1.4 accuracy, valuation and allocation.

2. Which of the following is not an assertion applicable to the long term liabilities account heading?
   2.1 classification.
   2.2 obligation.
   2.3 rights.
   2.4 existence.

3. Which of the assertions applicable to long term liabilities is generally considered to present the greatest risk of material misstatement?
   3.1 completeness.
   3.2 accuracy, valuation and allocation.
   3.3 existence.
   3.4 occurrence.

4. In terms of IAS 16 – Property, Plant and Equipment, a company:
   4.1 must apply the cost model for the valuation of its PPE.
   4.2 may apply the replacement model for the valuation of its PPE.
   4.3 must choose between the cost and revaluation models for the valuation of its PPE.
   4.4 may apply the cost model to some classes of PPE and the revaluation model to other classes of PPE.

5. In terms of IAS 16 – Property, Plant and Equipment, the directors of a company are required to review the residual value and useful life of its property, plant and equipment at least:
   5.1 at the end of every second financial year.
   5.2 at the end of every financial year.
   5.3 whenever major capital expenditure takes place.
   5.4 whenever the disposal of a major item of capital expenditure takes place.

6. The depreciable amount of an item of plant and equipment is:
   6.1 the initial cost of the item of plant and equipment divided by its useful life.
   6.2 the estimate of the amount which the company would obtain should the item of plant and equipment be disposed of at the current date.
   6.3 the cost of the item of plant and equipment less the residual value.
   6.4 none of the above (6.1 to 6.3).

7. Mastertech Ltd recently acquired an item of plant and equipment from Germany for R150 million. Which of the following costs should ***not*** be included in the initial cost of this item of plant and equipment?
   7.1 VAT charged by local contractors to transport and install the plant and equipment.
   7.2 engineers fees for the design of the platform on which the plant was installed.
   7.3 non-refundable import duties.
   7.4 road freight costs incurred in moving the equipment from the harbour in Durban to Pretoria.

8. Which of the following costs should be included in the initial cost of the item of plant and equipment purchased by Mastertech Ltd (see 7 above)?
   8.1 training of skilled employees to operate the machine.

8.2 costs of bringing the CEO of the German company which supplied the equipment to South Africa for the unveiling of the new plant.
8.3 a R70 000 fine for failing to implement proper safety procedures whilst the equipment was being transported from Durban.
8.4 costs incurred in testing the equipment incurred prior to commencing production.

9. Cartrite (Pty) Ltd a transport company, invests some of its surplus cash in shares in both listed and unlisted companies. The assertions which apply to the investment in the listed companies account heading will be:
9.1 occurrence, cut-off, classification and completeness.
9.2 valuation, completeness, accuracy and existence.
9.3 existence, completeness, valuation and obligation.
9.4 rights, existence, accuracy, valuation and allocation and completeness.

10. The investment in shares held by Cartrite (Pty) Ltd (see 9 above) should be valued at:
10.1 cost less brokerage fees (transaction costs).
10.2 cost plus brokerage fees (transaction costs).
10.3 fair value.
10.4 replacement value.

11. Gardroute (Pty) Ltd made a long term loan to one of its subsidiaries during the year. The assertions applicable to this transaction are:
11.1 obligation, accuracy, valuation and allocation, completeness, existence.
11.2 occurrence, accuracy, cut-off, and classification and completeness and presentation.
11.3 occurrence, cut-off, valuation and accuracy.
11.4 obligation, occurrence, cut-off and completeness.

12. Whilst planning the audit of Series (Pty) Ltd a manufacturing company, you decided to rely on the internal audit section to assist with certain aspects relating to the audit of property, plant and equipment. This decision would be regarded as part of your:
12.1 risk assessment procedures.
12.2 audit strategy.
12.3 audit plan.
12.4 materiality assessment.

13. Ringking (Pty) Ltd imported a piece of manufacturing equipment on 31 January 2017 (transaction date). The cost was $100 000. The foreign creditor was paid on 15 February 2017 (settlement date). The company's financial year end is 28 February 2017 (reporting date). The rand/dollar exchange rate was different on each of these three dates. The company adopts the cost model for its PPE. At the financial year end the cost of the equipment will be reflected in the AFS at the rand/dollar exchange rate on the:
13.1 reporting date.
13.2 transaction date.
13.3 settlement date.
13.4 none of the above.

14. Which of the following is a condition which must be satisfied for the recognition of a provision?

14.1 the outflow of future economic benefits must be possible.
14.2 the company must have a present obligation arising from a past event.
14.3 the obligation must be a legal obligation.
14.4 the provision must be material.

15. Contingent assets
15.1 can only be recognized in the financial statements where the inflow of economic benefit is possible.
15.2 are always disclosed, (assuming they are material) in the financial statements but never recognized.
15.3 will be recognized as an asset in the financial statements where the flow of economic benefit is virtually certain.
15.4 can be disclosed or recognized provided the company adopts a policy consistent with the prior year.

12.4 **(10 marks 12 minutes)**

Listed below are procedures commonly performed by external auditors when auditing non-current assets.

1. Examine the repairs and maintenance account (and similar accounts) to confirm that non-current assets are not being written off in full on acquisition.

2. Select various non-current assets on the factory floor and trace them to the fixed asset register.

3. Examine the profit and loss on disposal of non-current assets account to assess the reasonableness of depreciation rates.

4. Examine sundry revenue accounts for receipts from disposals of non-current assets and confirm that the item for which the cash has been received, is included on the list of disposals.

5. Discuss the validity of the journal entry recording the impairment of a category of plant and equipment with the financial controller.

6. Inspect the Certificates of Registration for trademarks included under intangible assets in the annual financial statements.

7. Inspect the accounting policy note for plant and equipment in the annual financial statements to determine whether it is clearly expressed.

8. Reperform the depreciation calculation for the year for all plant and equipment.

9. Obtain a list of all investments in listed shares (name and quantity) held by the audit client from the company's brokers and compare to the client prepared list.

10. Inspect purchase documentation for a newly acquired machine to confirm the date and price at which the purchase was recorded.

YOU ARE REQUIRED TO state the assertion to which each of the above procedures relates.

12.5 **(12 marks 14 minutes)**

The following procedures were carried out on the audit of ProTeen (Pty) Ltd.

1. inspected the title deeds for the company's office building.

2. reperformed the depreciation calculation for the company's manufacturing plant.

3. inspected the minutes of directors meetings to determine whether an expensive piece of equipment purchased during the year had been authorised by the directors as required by company policy.

4. traced a sample of large power tools from the production floor to the fixed asset register.

5. discussed potential financial reporting issues relating to the finance and investment cycle with the audit committee.

6. inspected the cash book and bank statement to determine whether an electronic transfer had been made for the purchase of a new machine.

7. inspected the prior year audit documentation to gain an understanding of the company's impairment policy for plant and equipment.

8. inspected all operating lease contracts to confirm that none of them should have been categorised as finance leases.

9. conducted a search for unrecorded disposals of equipment.

10. inspected documentation relating to the company's plans to expand its operations, and discussed plans with the operations manager.

YOU ARE REQUIRED TO:

a) indicate whether each of the above procedures is a risk assessment procedure, a test of controls or a substantive test.

b) indicate, for each procedure you have identified as a substantive test, to which assertion it relates.

c) indicate for each procedure you have identified as a test of controls, to which control objective it relates (validity, accuracy or completeness).

12.6 **(20 marks 24 minutes)**

1. Define property, plant and equipment in the context of IAS 16. (2)

2. What are the assertions which relate to property and its related disclosures reflected in the company's financial statements? (2)

3. State the two measurement models which are acceptable for property, plant and equipment. (1)

4. The assertions relating to property, plant and equipment will depend on the measurement model selected by the company. True or false? Justify. (2)

5. Landgrab Ltd uses huge bulldozers to move sand and rubble on construction sites. It has recently purchased three new bulldozers at a cost of R4 000 000 each. The bulldozers have two significant parts: the chassis and structure of the bulldozer (R3 000 000) and the hydraulic lifting motor and gearing (R1 000 000). The useful life of the chassis etc is estimated at 15 years and the useful life of the hydraulics is estimated at 5 years.
   5.1 when is a part of an asset considered to be a "significant part"? (1)
   5.2 what is the reason for identifying parts of an asset as significant? (2)
   5.3 should the significant parts of an asset be recognized in separate accounts? (1)
   5.4 if a set of tyres for each bulldozer which last 5 months under normal conditions, cost R200 000 (R50 000 each), should the tyres be identified as a significant part and be recognized in a separate (asset) account? Justify your answer. (3)

6. If a large industrial company elects the cost model for its property, plant and equipment, can it include the following as part of the cost of a new machine:
   6.1 VAT?
   6.2 the cost of hiring a crane to position the machine on the factory floor?
   6.3 producing an instruction manual for operators who will be working on the machine?
   6.4 the annual insurance premium? (3)

7. Distinguish between the depreciable amount and residual value of an asset. (2)

8. Explain the relationship between the useful life of an asset and its depreciable amount.(1)

12.7 **(25 marks 30 minutes)**

You are the senior in charge of the audit of Hotstuff Ltd, a spice processing company. The processes are mostly mechanised and as a result, plant and equipment are reflected in the statement of financial position at R55 million. This figure includes leased assets as well as owned assets.

One of your junior trainee accountants has been assigned to assist you on the audit of plant and equipment and whilst reading through the previous year's working papers, he made some notes which he has brought to you for explanation. He wishes to know:

1. What testing for "overstatement" means, and whether it means that we will not consider the assertions. (4)

2. Why such a significant figure in the statement of financial position would have been regarded as having only low/medium ***audit risk***. (5)

3. How leased assets can be included in the statement of financial position under plant and equipment. (5)

4. Why the audit team conducted tests to determine whether any impairment of assets had taken place in addition to auditing the allowance for depreciation. (5)

5. Why some of the property, plant and equipment is accounted for on the cost model and some on the revaluation model. (3)

6. How some individual items of machinery appear to be depreciated using different rates of depreciation for different parts of the same machine. (3)

YOU ARE REQUIRED TO respond to the questions raised by your trainee accountant. Answer in the context of Hotstuff Ltd's plant and equipment.

12.8 **(38 marks 45 minutes)**

You are a member of the team on the audit of Plummate (Pty) Ltd a large plumbing concern, the financial year end of which is 31 December. The business which is owned by a number of individual shareholders, concentrates on the domestic market. The company has 60 teams of two (an artisan and his assistant) which operate within a radius of one hundred kilometers of the head office in the industrial area of Isando outside Johannesburg.

The company purchases Nissan bakkies which it adapts itself at a cost of roughly R10 000 per vehicle to turn them into mobile workshops suitable for the company's purposes. Each team is assigned a vehicle which the artisan is allowed to take home every evening. However every vehicle must return to head office on Friday afternoons to be cleaned and restocked and for the week's job cards to be handed in. Vehicles are collected on Monday morning at 7a.m. by the artisans unless they are on weekend duty. For the teams on weekend duty the vehicle is taken on Friday evening after it has been cleaned and restocked. Ten teams are on duty each weekend on a rotational basis. All vehicles are linked to head office by radio and cell phone and are therefore not required to return to head office (other than on Fridays) when they are not on a job (which is very seldom).

During the current financial year the company added two new teams (with vehicles) to its staff bringing the total to sixty teams and in addition purchased 2 further bakkies to replace existing vehicles. The client has presented you with the following details with respect to these vehicles.

Additions

Date	Vehicle	Cost
2.1.16	Nissan TRP 123 GP	143 320
2.1.16	Nissan TXM 872 GP	143 320
1.7.16	Nissan TXL 918 GP	144 460
1.7.16	Nissan TPT 154 GP	144 460

Note 1: All vehicles were purchased from Sandonissan Motors for cash.

Note 2: Cost is made up of invoice price including VAT and costs of mobile workshop conversion.

Disposals

Date	Vehicle	Book value at 30.6.16	Sold For R	Method of sale
30.6.16	Nissan TPM 842 GP	20 000	24 000	sold to workshop foreman to be repaid in six equal installments deducted from monthly salary
30.6.16	Nissan TPR 561 GP	18 000	21 000	Cash: to member of the public

The company's policy is and always has been to depreciate their vehicles in terms of the wear and tear allowances granted by the CIR (SARS).

The company keeps a fixed asset register which contains a section for vehicles. All decisions to purchase/dispose of property, plant and equipment are taken at directors meetings.

Due to the fact that vehicles do not come into head office on a daily basis it has been necessary to give each team some means of purchasing plumbing requisites to complete their jobs without delay. Each team carries a range of requisites in their bakkies but this is not always sufficient, some teams having to spend up to R500 a week on items not in the standard range which they carry. Traditionally each artisan has been given a cash float, but with the steady expansion of the business this has proved unsatisfactory as it presents a significant security risk. The directors now wish to do away with the cash float system and introduce a credit card system to facilitate the purchase of extra plumbing requisites.

Based on his risk assessment procedures, the senior in charge of the audit has asked you, inter alia, to carry out substantive procedures on all of the assertions relating to the Motor Vehicles account at reporting date.

YOU ARE REQUIRED TO:

a) describe the substantive audit procedures you would carry out in respect of your senior's request. You may ignore the ***classification*** and ***presentation*** assertions and are not required to include procedures to address related disclosures. (20)

b) describe the control procedures which should be put in place by Plummate (Pty) Ltd to ensure that purchases made using credit cards are valid and that the recording of purchases is accurate and complete, including the charging of such purchases to jobs carried out by the various teams. (18)

12.9 **(40 marks 48 minutes)**

You have recently been appointed as the internal auditor of North Shore (Pty) Ltd, a large shipping company in Port Elizabeth. Your first assignment was to evaluate the company's accounting systems and related internal controls. The company is divided into five sections, each of which has its own section accountant who is responsible for producing monthly accounts and ensuring that sectional financial matters run smoothly. While reviewing the financial records of the warehousing section you were surprised to see that considerable capital expenditure had been incurred just before the financial year-end (30 June). You found that the same occurred in the other four sections of the company and on visiting the various sections (in July), you noticed a fair amount of equipment still in boxes and not in use. Deciding to follow this up, you approached Andy Bell the most senior sectional accountant, for an explanation of how the system for capital expenditure operated. He responded as follows:

1. Each sectional accountant is responsible for capital expenditure for his section.

2. A budget is prepared in the office of the financial director. Budgeting figures are calculated by increasing the prior year's budget by the average consumer price index for the year. Sectional accountants are notified as to what their section can spend on the purchase of capital items.

3. However, if sections do not spend their capital budget in any financial year, that section's budget is reduced for the following year. As you can see, we all try to avoid a cut in our budget by making sure we spend our budget before the end of the financial year.

4. If a staff member in the section requires equipment, for example in my warehouse section the foreman may decide he needs a new fork lift, he will email my assistant with the precise details of what is required as well as the name of a supplier. None of the equipment used by North Shore (Pty) Ltd is particularly complicated, so this method works fine.

5. My assistant will then complete a pre-printed, numerically sequenced, multi-copied order form (which I as sectional accountant will sign) and send the top copy to the supplier. The second copy of the order is sent with the supplier delivery note, to the central creditors department for payment. The third copy is left in the order book and used by the assistant to write up the new equipment in the assets register.

6. The supplier delivers the equipment to the section and my assistant signs the supplier delivery note after agreeing the items to the supplier delivery note. He retains a signed copy of the supplier delivery note which is sent to the creditors department as described in point 5 above.

YOU ARE REQUIRED TO identify and describe the weaknesses in the system of investing in capital equipment at North Shore (Pty) Ltd, based on the information given above ***and*** to recommend improvements to address the weaknesses you have identified.

Do not concern yourself with payments to creditors.

Lay your answer out on a double page as follows:

Weakness	Explanation
1. ……………………..	1. ……………………….
………………………..	………………………….
2. ……………………..	2. ……………………….
………………………..	………………………….

12.10 **(25 marks 30 minutes)**

You are the senior on the audit of Public Opinion (Pty) Ltd, an advertising agency. The company operates out of rented premises in Johannesburg. The only non-current assets which the company owns are office furniture and equipment. (The equipment consists solely of computers, printers, etc.) As the company has a staff consisting of account executives, graphic artists, jingle writers and administrative staff, the company has a material amount of money invested in upmarket office furniture and state of the art computers.

Every item of furniture and equipment has a small metal tag attached to it onto which the asset number is stamped. The asset number is a simple numerical sequence starting at 0001. Each new asset purchased is given the next number in the sequence. The asset numbers of assets disposed of are not re-allocated to new assets.

Public Opinion (Pty) Ltd pays for all of its office furniture on purchase – it does not lease or acquire on hire purchase.

Depreciation is as follows:

1. Office furniture 10% reducing balance
2. Computers $33^{1}/_{3}$% straight line.

The company has a policy of donating all computers to educational charities once they have been written down to nil after 3 years.

Hunter Leshaar, the administration manager, has provided you with the following schedule of office furniture and equipment at 28 February 2017, the financial year-end.

Office Furniture – cost			
Opening balance at 1 March 2016		1 367 248	
Add: New Furniture	Note 1	436 294	
		1 803 542	
Less: Disposals	Note 2	148 200	
Closing balance at 28 February 2017			1 655 342
Computers – cost			
Opening balance		768 240	
Add: New computers		273 065	
		1 041 305	
Less: Disposals	Note 3	83 612	
			957 693
Office Furniture and Equipment: total cost			R2 513 035
Office Furniture – accumulated depreciation			
Opening balance at 1 March 2016		462 355	
Add: Depreciation for the year		134 118	
		596 473	
Less: Accumulated Depreciation on Disposals		69 440	
Closing balance at 28 February 2017			527 033

Computers – accumulated depreciation		
Opening balance at 1 March 2016	384 116	
Add: depreciation for the year	256 054	
	640 170	
Less: accumulated depreciation on disposals	83 612	
Closing balance at 28 February 2017		556 558
Office Furniture and Equipment : Accumulated Depreciation		R1 083 591

Note 1 & 2: During the year Public Opinion (Pty) Ltd refurbished the offices of its four senior account executives at a cost of R436 294. The old furniture from their offices (cost R148 200, accumulated depreciation of R69 440) was sent to the auctioneers where it was sold as a complete lot for R20 000, net of auction fees etc.

Hunter Leshaar has a detailed break down of the additions and disposals of furniture.

Note 3: This figure represents the cost of computers which had been fully depreciated and donated to educational charities in terms of company policy.

Public Opinion (Pty) Ltd uses a very simple software package to maintain its fixed asset register. Your firm does not have compatible audit software. You don't believe this to be a problem or restrictive in any way as Hunter Leshaar prints out a hard copy of the asset register at year end as it is not very extensive. For the previous two audits you spent very little time on this account heading as the risk of material misstatement was considered to be low. However this year, due mainly to the extensive refurbishment, you have decided to carry out a reasonably comprehensive audit of office furniture and equipment.

YOU ARE REQUIRED TO describe the substantive audit procedures you will conduct in respect of the 28 February 2017 audit of office furniture and equipment. You may ignore the classification and presentation assertions and are not required to include procedures to address related disclosures.

12.11 **(40 marks 48 minutes)**

Megaloads Ltd owns a fleet of huge dump trucks which are leased out to move iron ore and other bulk materials at remote mining and construction sites around Africa. The company's most recent purchase is a giant "Supatruck" which was purchased at the start of the current financial year. The cost of the vehicle is reflected in the fixed asset register at R8 402 400.

As part of the audit team responsible for the year end audit (30 June 2017) of non-current assets, your senior has asked you to carry out year end verification procedures on the Supatruck. He has indicated that in his opinion it will not be necessary for you to visit the Northern Cape. See point 1.5.

You have gathered the following information:

1. A schedule provided by the financial accountant revealed that the cost of the Supatruck was made up as follows:

1.1	***Purchase price*** The truck was purchased from Fiatrucks Inc, the manufacturer in Italy for 563 655 euros. Megaloads Ltd paid Fiatrucks Inc in full through its bank on 31 July 2016	R7 440 250
1.2	***Shipping costs, clearing charges, import duties*** The importation of the truck was handled by a local company Seacarriage (Pty) Ltd who acted as both forwarding and clearing agents. Seacarriage (Pty) Ltd paid all parties involved on behalf of Megaloads Ltd and then invoiced Megaloads Ltd for the total amount owed including Seacarriage (Pty) Ltd's fees. The Supatruck was loaded onto a ship on 1 July 2016 and shipped FOB. The Supatruck was cleared from the Durban Port on 31 August 2016. None of the charges/duties are refundable.	R439 000
1.3	***Assembly costs*** This amount was paid to Fiatrucks (South Africa) (Pty) Ltd in respect of the final assembly and commissioning of the truck. Four engineers from the South African company performed this specialized work. Due to insurance and warrantee restrictions, no Megaloads Ltd staff were involved in this activity.	R96 200
1.4	***Driver and mechanic training costs*** This amount covers the cost of training four drivers to operate the Supatruck and three mechanics to service and maintain it. Training was provided by Fiatrucks (South Africa) (Pty) Ltd.	R40 000
1.5	***Abnormal load transport*** Although registered and licenced as a vehicle the Supatruck is not permitted to be driven on public roads and must be transported on a special purpose flatbed truck as an abnormal load. Two payments were made to Outsize Flatbeds (Pty) Ltd. * the first payment of R110 000 was in respect of moving the Supatruck from Durban to the company's head office and truckyard in Northern KwaZulu Natal for final assembly (see 1.3). * the second payment of R198 500 was in respect of moving the Supatruck from the head office to a remote mine in the far Northern Cape on 1 November 2016.	R308 500
1.6	***Unveiling of truck*** This amount represents the cost of the truck unveiling ceremony held on the Northern Cape mine which has leased the truck and at which the Supatruck will operate for a period of 18 months. Costs include the transport, accommodation and entertainment costs of bringing provincial dignitaries to the ceremony.	R78 450
		R8 402 400

2. At the financial year end, the Supatruck was on the mine in the Northern Cape. It started operating on 2 January 2017 at the start of its 18 month contract. Up until 1 January the Supatruck had not been operated other than whilst minor tests were being carried out on it. On completion of the 18 month contract the Supatruck will be transported back to the head office for cleaning and routine maintenance before moving to its next contract.

3. Due to the rugged conditions in which the truck operated and the fact that it is normally in operation for eighteen hours a day, six days a week, its useful life is expected to be eight years. After eight years the Supatruck is expected to have a residual value of R500 000. The Supatruck is not worth rebuilding and will be sold off to be stripped for saleable parts and scrap.

4. The depreciation on the Supatruck for the financial year has been calculated by the accountant as follows:

	R
Cost of Supatruck	8 402 400
Less: residual value	500 000
	7 902 400
Depreciation 12.5% straight line	987 800
Carrying value at 30 June 2017	6 914 600

YOU ARE REQUIRED TO discuss the substantive procedures you would carry out to satisfy yourself that the Supatruck is fairly presented in the financial statements at 30 June 2017.

Note 1: Structure your answer in terms of the following assertions:
existence
rights
accuracy, valuation and allocation
completeness
Do not concern yourself with related disclosures.

Note 2: If, in your opinion, any adjustments are required to achieve fair presentation, these should be included in your answer.

12.12 **(28 marks 33 minutes)**

You are a member of the team on the audit of Interprint Ltd, a large company which prints text-books, diaries and numerous government documents e.g. income tax tables. You have been assigned to the audit of certain aspects of the finance and investment cycle for the financial year-end 30 June 2017.

The company is situated in Pietermaritzburg. The company owns the land on which its printing and storage facilities are built and investment in plant and equipment is substantial.

John Nquka the financial controller has provided you with, inter alia, the following information pertaining to plant and equipment.

1. ***Accounting policy***
The company accounts for its plant and equipment using the cost model.

2. ***Additions***
Cost of additions for the financial year-end 30 June 2017 amounted to R8 321 941. New equipment is purchased from both local and foreign suppliers. Forward cover is not taken on foreign purchases.

3. ***Disposals***
Numerous items of plant and equipment were disposed of during the year mainly to keep abreast of the advancements in printing and photocopy technology.

4. ***Impairments***
The only impairment which the company recognized at 30 June 2017 was in respect of 8 embossing machines (used for printing in gold on diary covers) with a carrying value at 30 June 2017 of R505 291. As the ink which was used for the gold printing is no longer available, the embossing machines cannot be used and will be replaced before the production of 2018 diaries commences. A local machine repair company has agreed to purchase the 8 machines for a total of R60 000. They intend to strip the machines for spare parts.

5. ***Data***
The company maintains a computerised fixed asset register. The chief engineer also maintains extensive information pertaining to plant and equipment e.g. capital budgets which include planned disposals, maintenance records, insurance etc.

Included in the additions of R8 321 941 mentioned above is a high speed digital printing machine purchased by the company to increase its production capacity.

This machine was shipped (FOB) by the French supplier on 1 November 2016 and was finally cleared through customs and delivered to Interprint Ltd on 5 December 2016 by FreightIn (Pty) Ltd, the company's locally based shipping agents. FreightIn (Pty) Ltd administers both the shipping and clearing of all equipment which Interprint Ltd imports. All shipping and custom clearing charges are paid by FreightIn (Pty) Ltd on behalf of Interprint Ltd as they occur. FreightIn (Pty) Ltd in turn invoices Interprint Ltd to recover these costs, as well as invoicing for its fees. During December Interprint Ltd's maintenance crew installed the machine on the specially designed (by Interprint Ltd's chief engineer) and reinforced concrete floor prepared for the printer. Extensive testing of the machine was carried out by a specialist firm, Digital Functions (Pty) Ltd. The printer was brought into use on 2 January 2017. On 31 December 2016 in terms of their normal trading terms, Interprint Ltd paid the supplier the full invoice price of 300 000 Euros. Reference to financial bulletins revealed that the euro/rand exchange rate on the various dates were as follows:

1 November 2016	1 euro = R16.50
5 December 2016	1 euro = R16.30
31 December 2016	1 euro = R16.95

Having completed your procedures for testing existence of plant and equipment during July, you are, towards the end of July, addressing other aspects of your audit of the cycle.

YOU ARE REQUIRED TO:

a) describe the substantive procedures you would have conducted in respect of the ***existence*** assertion applicable to plant and equipment at 30 June 2017. When testing existence, your firm includes a search for unrecorded disposals as part of the audit plan when it is appropriate to do so. (6)

b) describe the substantive procedures you will conduct to verify that the cost at which the new digital printer has been included in the accounting records is appropriate in terms of financial reporting standards. (14)

c) describe the audit procedures you will conduct to
   i. vouch the impairment loss recognized in respect of the embossing machines (4)
   ii satisfy yourself that no other impairment losses in respect of plant and machinery are required. (4)

12.13 **(57 marks 69 minutes)**

Your firm which has offices in Durban, Johannesburg and Cape Town has recently been appointed as auditors of Glassguard (Pty) Ltd, a company which installs door and window glass. The company was formed many years ago by Dave Dean and, due to sound management and quality service, has grown steadily. Dave Dean has retained the major shareholding in the company and is also the Chairperson and Managing Director of the company. The other directors, all of whom are key to the success of the company, are Tom Perry the Operations Director, Peter Terry the Financial Director and Gordon Green the Marketing Director, all of whom have shares in the company. The company has thirty branches spread around the country and approximately 160 delivery vans which are used for transporting glass and installation crews to job sites. A branch manager is in charge of each branch.

The company's accounting records are computerised and are centralized at the head office in Durban. Branches submit details of operating costs (including running costs for each of their vehicles) to head office monthly.

Details of all of the company's vehicles are held in the Vehicle Masterfile which contains the following fields:

Field	***Example***
Registration number	ND 673 219
Engine number	327x29B418
Description	Isuzu 2.5 diesel
Location	Nelspruit
Cost	R150 000
Date of Purchase	1 Aug 2013
Depreciation rate	20% p.a. reducing balance
Current year depreciation	R24 000
Accumulated depreciation	R54 000
Book value	R96 000
Date of disposal/scrapping	date
Disposal Price	rand amount
Profit/Loss on Disposal	rand amount

All vehicles are purchased for cash from Tekwini Motors, a General Motors dealer in Durban, and are registered/licenced in Durban. No vehicles are leased. Before Glassguard (Pty) Ltd takes delivery, Tekwini Motors adapts the vehicles to facilitate the transport of sheets of glass.

Shatterprufe Shabalala, the company's financial controller has prepared the following schedules and notes for the 31 July 2017 audit.

Motor vehicles – cost

Opening balance	Additions	Disposals	closing balance
R24 200 000	R3 650 000	R2 520 000 (note 1)	R25 330 000

Motor Vehicles – accumulated depreciation

Opening balance	Provision	Disposals	closing balance
R8 742 000	R3 197 500	R907 200	R11 032 300

Note 1: The vehicles disposed of were 20 Corsa "bakkies" which had originally been purchased (at different times) for use at country branches. However, they had proved to be too small. The vehicles were placed on a vehicle auction in Durban and sold as a single lot for R1 400 000. Details of each vehicle are **listed on the "Auctioneer's Sale List."**

Note 2: In June 2017 one of the company's new Isuzu bakkies (purchased 1 May 2017, cost R250 000) was extensively damaged (it cannot be repaired and has no scrap value) when it rolled backwards down a hill and was hit by a passing cement truck owned by Conmix. All of our vehicles are comprehensively insured but the insurance company has refused to pay out for the Isuzu or the R300 000 damage to the cement truck. A clause in the insurance contract states clearly that company vehicles may only be driven by a permanent employee of the company. In the case of this vehicle, a casual labourer who had been hired for the day was asked to move the vehicle in question. He did so, parked the vehicle but failed to engage the handbrake. A directors' minute relating to this matter reads as follows:

> "We have referred the matter to our lawyers who intend to contest the insurance company's refusal to pay on the grounds that as no one was actually driving the vehicle at the time of the accident, the specific clause does not apply. Our lawyers will not comment on the likelihood of the case succeeding. We acknowledge that we are responsible for the damages to the cement truck but believe we are fully covered by insurance.
>
> No entries will be made in the accounting records (including the Vehicle Masterfile) in respect of this matter for the 31 July 2017 financial year. We will treat this entry entirely as a 2018 matter assuming that a decision is reached in the courts in the new financial year."

You have been placed in charge of the audit of Motor Vehicles (by far the largest account heading on the statement of financial position) and are about to commence work (early October) on the year-end audit. Your manager has indicated that a comprehensive audit of motor vehicles should be carried out. Your firm's audit software is compatible with the client's system and you intend to make use of it. You are located in the Durban office.

As you have a sound knowledge of statutory matters and corporate governance you have also been asked to deal with the following:

In April 2017 Glassguard (Pty) Ltd issued ten, 9% redeemable debentures of R100 000 each to 10 private investors to finance the purchase of "state of the art" machinery for the manufacture of armour plated glass. The debentures are repayable in five years time at a premium on redemption of 10%. There are no other debentures in issue.

Glassguard (Pty) Ltd put the supply of the armour plating machinery out to tender and the best tender was submitted by Namandla (Pty) Ltd, a black economic empowerment company. However, before Namandla (Pty) Ltd are prepared to do business with Glassguard (Pty) Ltd, it requires that Glassguard (Pty) Ltd undertakes to comply within a reasonable time, with the recommendations of the King IV report on Corporate Governance in respect of, inter alia, the composition of its board of directors. As Glassguard (Pty) Ltd anticipates significant business dealings with Namandla (Pty) Ltd they are quite prepared to comply.

YOU ARE REQUIRED TO:

a) state whether the risk of material misstatement in the motor vehicles account at 31 July 2017 should be regarded as low, medium or high. Justify your answer. (4)

b) indicate, giving reasons whether Glassguard (Pty) Ltd's decision to treat the matter described in Note 2 "entirely as a 2018 matter assuming that a decision is reached in the courts", is appropriate. (8)

c) describe the substantive audit procedures you will conduct in respect of the assertions relating to the account heading "Motor Vehicles" reflected in the 31 July 2017 draft financial statements. Do not concern yourself with the presentation assertion or with related disclosures. (30)

d) describe the substantive audit procedures you will conduct in respect of the debenture issue. Do not concern yourself with the presentation assertion. (10)

e) advise Dave Dean on the changes that need to be made to the composition of Glassguard (Pty) Ltd's Board of Directors so as to satisfy the recommendations of the King IV. (5)

12.14 **(14 marks 18 minutes)**

You have been assigned to assist with the audit of certain aspects pertaining to the presentation and disclosure of the annual financial statements of Backstop (Pty) Ltd for the financial year-end 28 February 2017. The company manufactures helmets for various sporting activities.

You are currently busy with the presentation and disclosure of contingent liabilities. Note 20 to the financial statements reads as follows:

Note 20 – Contingent liabilities

1. The company has been sued by a customer who suffered facial damage and visual impairment when a cricket ball struck him in the eye during a cricket match. He is claiming R800 000 from the company on the grounds that his helmet (manufactured by the company) was defective. As the matter is currently with our attorneys, we are unable to provide any information as to the likely outcome of the matter.

YOU ARE REQUIRED TO:

a) discuss briefly the assertions which apply to the disclosures related to transactions and events. (4)

b) define a contingent liability. (2)

c) distinguish between a contingent liability and a provision. (2)

d) describe the audit procedures you would conduct in respect of the assertions relating to disclosure of the contingent liability described in Note 20. (6)

12.15 **(32 marks 38 minutes)**

You have been assigned responsibility for the identification of related parties (and material related party transactions) on the audit of Baggdad Ltd, a large diversified holding company. Management have supplied you with a list of related parties and you have carried out basic procedures in respect of the completeness of the list. You are about to instruct the audit team on the kind of transactions which they should look out for during the course of the audit which may indicate the existence of related parties not included on the list supplied by management.

YOU ARE REQUIRED TO:

a) explain why the auditor is concerned about the identification of related parties. (3)

b) define an arms length transaction (in terms of ISA 550 – Related Parties). (2)

c) describe the procedures you would have adopted to determine the completeness of the list of related parties supplied by management. (7)

d) describe to your audit team the kinds of transactions which may assist in identifying related parties not on the list supplied by management. (6)

e) describe the action you would take if your procedures identified an undisclosed related party or significant related party transaction. (6)

f) state the two matters to which reference should be made by the directors in the management representation letter in respect of related parties. (2)

g) define a "related person" in terms of the Companies Act 2008 and indicate whether a related person should be regarded as a related party from an audit perspective. Do not concern yourself with juristic persons. (3)

h) state whether the following would be regarded as "related parties" in respect of Baggdad Ltd:
   i. Ed Reddy, the non-executive chairperson of the company.
   ii. Jordan Ltd, an associate company of Baggdad Ltd.
   iii. King Carpet CC, a close corporation owned by the wife of Baggdad Ltd's financial director. (3)

12.16 **(44 marks 53 minutes)**

You are a member of the team on the audit of Medilife Ltd a large company in the medical services sector. The company has offices and other properties in a number of cities around the country. You have been assigned to the audit of property for the financial year-end 31 March 2017. The head office of the company (at which the audit is conducted) is in Durban.

Riley Human, the financial controller has presented you with a schedule of properties and other information relevant thereto.

Land and Building at cost	***R'000***
Opening balance 1 April 2016	32 400
Add: acquisition of office block (note 1)	4 200
	36 600
Less: sale of domestic property (note 2)	3 300
	33 300
Less: expropriation of property (note 3)	3 000
Balance at 31 March 2017	30 300

Note 1. Purchase of office block situated at:
14 Hosking Drive
Greenvale
Port Elizabeth

Just prior to the purchase of this property the seller had the building (excluding the land) valued at R3.5m. The full purchase price was paid in cash.

Note 2. This property, in an upmarket suburb, was sold to Elijah Goodenough, the former chief executive officer of Medilife Ltd in October 2016 prior to his retirement from the company.
The property is situated at:
23 Grosvenor Point
Edgecombe
Durban
The property which was purchased about five years ago for Elijah Goodenough to live in was sold for R3.4 million. He paid the full purchase price in cash.

Note 3. This vacant stand, Lot 72 Silverkloof, Cape Town was expropriated by the government along with a number of adjoining lots owned by other entities to make way for a low cost housing development. The expropriation price was R1.5m and although all the necessary documentation was signed on 31 May 2016, the amount of R1.5m has not yet been received by Medilife Ltd.

1. Other properties owned by the company (all stated at cost) are

1.1	Medilife house 32 Grant Street Pinetown	R9 100 000
1.2	Health Heights 52 Potgieter Straat Pretoria	R7 500 000
1.3	Vacant Land Lot 84 Silverkloof Cape Town	R3 000 000
1.4	Chest Warehouse Park 102 Industrial Way Alberton	R6 500 000

2. The company rents small office blocks in East London, George and Polokwane.

3. The company accounts for its property using the cost model.

4. Land is not depreciated. Buildings are depreciated at 2% per annum

YOU ARE REQUIRED TO:

a) comment on the risk of material misstatement in the property (land and buildings) account in the financial statements at 31 March 2017. (7)

b) describe the substantive audit procedures you would conduct in respect of the sale of the property to Elijah Goodenough. Do not concern yourself with the presentation assertion. (11)

c) describe the substantive audit procedures you will conduct in respect of the property (land and buildings) account for the 31 March 2017 financial year-end. Do not concern yourself with the presentation assertion or with the procedures applicable to related disclosures. (26)

12.17 **(30 marks 36 minutes)**

You are the auditor of Logical Logistics (Pty) Ltd. The company was started about four years ago by the three current directors, Granville Cox, Rudolf Strydom and Sizwe Aghulas, all with good business skills but with little knowledge of accounting systems. Since inception your company has assisted with this side of the business with some success.

However, on a recent visit to the company you discovered that the company was investing its surplus cash in the stockmarket. Concerned by this you asked Granville Cox what control procedures had been implemented over trading. Surprised by your question, he responded that he would explain to you how it worked and you could "decide for yourself" about the controls. His description was as follows:

1. "Originally as you know, our financial accountant placed all of our surplus cash in a money market account. But the three of us feel that we can make more money by investing on the stock market. We are learning a lot and didn't even know that there were things like derivatives and futures that we can invest in.

2. Each of the three of us (myself, Rudolf and Sizwe) makes investments. Rudolf and Sizwe both make use of brokers to buy and sell on their instruction and I have set up an online trading facility through a bank.

3. We all use our secretaries to assist, so for example if Sizwe decides to make a trade, he will instruct his secretary to contact his broker, and she does so.

4. We have set up a bank account into which we transfer some of our surplus cash for investing. The brokers identify on the brokers note, the secretary who placed the instruction, so when it arrives it is directed to that secretary. If a purchase has been made the secretaries make an EFT for the amount promptly as late payments attract penalties. Where the broker has made a sale, the broker banks the proceeds directly into our account and sends through the brokers note. Brokers notes and the monthly statement of shares held sent by the broker are filed by the secretaries in case of any subsequent queries.

5. In my case with the online trading, it is much simpler. From time to time I authorise the transfer of cash into the trading account the company opened for my online trades, and if I want to buy or sell, my secretary goes on line and does the trade. It's a matter of following instructions on the screen.

6. The online trading system simply debits or credits the trading account for purchases and sales respectively. If there are insufficient funds for a purchase, the system rejects the instruction to purchase. Records of purchases and sales as well as a list of investments held are available on the site.

So that is how it works and we are quite enjoying it."
YOU ARE REQUIRED TO identify the weaknesses in the system described above for the trading in investments by Logical Logistics (Pty) Ltd, and make recommendations to address those weaknesses.

12.18 **(27 marks 32 minutes)**

You are a member on the audit team of Flintstones (Pty) Ltd, a company which prepares granite work surfaces, e.g. for kitchens and hotel reception areas. With the increase in the popularity of granite, Flintstones (Pty) Ltd has, in the last few years, grown to the extent that during the financial year-end 31 July 2017, the company needed to raise additional finance. You are engaged on the audit of the finance and investment cycle for the 31 July 2017 audit and have established the following:

1. According to the 31 July 2016 financial statements, Flintstones (Pty) Ltd had 200 000 shares of no par value in issue. The authorized share capital was 220 000 shares of no par value.

2. The 200 000 shares in issue were held by

Fred Flint	50 000 shares
Stan Stones	50 000 shares

   10 other investors holding various quantities of shares.

3. At 31 July 2016, Fred Flint and Stan Stones were the only directors of the company but at the annual general meeting held in September 2016, Klippies Kritzinger and Rocky Radebe were appointed as directors.

4. In November 2016 the company issued an additional 100 000 shares of no par value at R10 a share. These shares were issued equally to the four directors.

5. Share issue expenses of R5 000 were incurred.

The money raised by Flintstones (Pty) Ltd from the share issue was used to purchase a stone polishing machine. In addition the company entered into an agreement with Technicut Ltd to lease a high-speed granite cutter. This lease was capitalized in the 31 July 2017 financial statements and reflected under long term liabilities. Although the company does lease other equipment from time to time, no other leases (or long-term loans) were included in this account heading. Rashid Ramsi, the company accountant, has provided you with a schedule of these leases.

YOU ARE REQUIRED TO:

(a) briefly describe three characteristics of the finance and investment cycle which distinguish it from the other cycles in a company such as Flintstones (Pty) Ltd. (3)

(b) describe the further audit procedures you would conduct in respect of the issue of shares by Flintstones (Pty) Ltd. Structure your answer in terms of the assertions applicable to transactions and explain the meaning of each assertion in the context of the share issue. Do not concern yourself with the presentation assertion. (16)

(c) discuss the audit procedures you would conduct to satisfy yourself that
   (i) the capitalization of the lease agreement with Technicut Ltd is the appropriate accounting treatment (5)
   (ii) all leases which should have been included in the statement of financial position at the financial year end have been included. (3)

12.19 **(23 marks 28 minutes)**

You are a member of the audit team on the audit of Maximum Ltd, an industrial company. The company has an investments committee which is, inter alia, responsible for the purchase of minor holdings of shares in other companies when the company has spare cash available for such investment. The policy of the investment committee is to build up a solid portfolio of shares with the intention of holding them long term and the committee have elected to recognize gains and losses through profit and loss. You have been given the responsibility of auditing investments for the financial year end 31 March 2017. At 31 March the schedule of shares presented to you by the investment committee is as follows:

Listed investments

Company	Purchase date	No of shares	Cost	Market value 31 March 2016	Market value 31 March 2017
Amwell Ltd	Jun 2016	10 000	2 837 416	-	3 235 206
Baxter Ltd	Dec 2016	5 000	465 000	-	419 230
CKS Holdings Ltd	Sept 2014	15 000	227 750	252 750	240 000
Spanta Ltd	Oct 2014	40 000	184 000	157 200	204 300
				409 950	4 098 736

All shares held are ordinary shares.

Unlisted investments

Tarzan (Pty) Ltd	Nov 2016	4 000	100 000	-	100 000
Swingz (Pty) Ltd	July 2012	10 000	150 000	220 000	236 000
				220 000	336 000

You have also obtained the following information:

1. The investment committee instructs the company's brokers Dhlamini and Dobson in writing when a purchase of shares is to be made.

2. All the listed shares are listed on the JSE and are dematerialized (i.e. electronic ownership through Computer Share Services).

3. Neither of the shares purchased during the year were purchased cum div.

4. All details pertaining to share investments are recorded in a register of investments.

5. The company uses the fair value model for valuing its shares. However, in respect of the two unlisted investments, you have been informed as follows by the investment committee chairman.
   5.1 The investment in Tarzan (Pty) Ltd has been shown at cost as the shares are not readily tradable and there is absolutely no way for the investment committee to place a "fair value" on the investment, although the committee believes that what the company paid was a fair value at the time.
   5.2 With regard to the investment in Swingz (Pty) Ltd, the investment committee has determined a fair value at 31 March 2017. Shortly after the financial year end the company had received an offer from another shareholder of Swingz (Pty) Ltd to purchase the shares for R236 000. The investment committee had considered this to be a fair offer but as the company has no intention of selling the investment, the committee turned down the offer.

YOU ARE REQUIRED TO describe the further audit procedures you will carry out to satisfy yourself as to the fair presentation of listed and unlisted investments in the statement of financial position at 31 March 2017. Do not concern yourself with the presentation assertion.

CHAPTER 13

STATUTORY

13.1 **(19 marks 23 minutes)**

1. What is the name of the Act which provides for the establishment of the Independent Regulatory Board for Auditors (IRBA). (1)

2. Briefly describe the objects of the Act identified in 1. above. (2)

3. Give three requirements which must be satisfied by an individual who wishes to register as a registered auditor with the IRBA. (1.5)

4. What is a registered candidate auditor? (1)

5. Give the circumstances under which an individual may ***not*** be registered with the IRBA. (2)

6. May an unrehabilitated insolvent, who otherwise qualifies, be registered with the IRBA? (1)

7. Can a firm of registered auditors and a firm of lawyers merge to offer a full range of professional services and call themselves Dershowitz, Dhlamini and Deans Inc Registered Auditors and Lawyers? Justify your answer. (2)

8. In terms of Section 44 of the said Act, a registered auditor may ***not*** express an opinion without qualification unless…. (4)

9. List five permanent committees which the IRBA is obliged, in terms of the Act, to establish. (2.5)

10. Jerry Jeeves CA(SA) is the financial director of Jjsquared (Pty) Ltd. He has recently been convicted of foreign exchange fraud; will he be disciplined by the IRBA? Justify. (2)

13.2 **(25 marks 30 minutes)**

PART A **(15 marks 18 minutes)**

Hashim and Wiseman is a small auditing firm in Durban. The two partners Dev Hashim and Peter Wiseman are the only two registered auditors in the practice but they are assisted by Juanita Claasen who has passed her professional examinations but has not yet completed her training contract and Sabela Samat who is a registered candidate auditor with the firm. Neither of the partners deals with tax matters, these are left to Ella Kotze, who is a qualified lawyer, but who has chosen to specialize in taxation. The practice also has a computerized bookkeeping section which is headed by Bakkies Botha and which keeps the books and records for numerous small businesses. Bakkies Botha has a BCom with a major in Information Technology and many years of experience.

The two partners have decided to convert the partnership into a ***company*** to engage in public practice at the earliest opportunity i.e. they wish to register Hashim and Wiseman Inc with the IRBA. The partnership has a number of audit clients which they intend to retain.

YOU ARE REQUIRED TO:

a) identify the Act under which Hashim and Wiseman Inc must be incorporated and registered. (1)

b) comment on whether:

1. Juanita Claasen and Ella Kotze can be shareholders of the company. (4)
2. Bakkies Botha may be appointed a director of the company. (2)
3. the company to be formed must have at least seven shareholders. (1)
4. forming themselves into a company will protect the shareholders from being liable for the debts of the company in their personal capacities. (2)
5. Dev Hashim and Peter Wiseman could offer shares in the company to be formed, to one of the “Big 4” auditing firms, e.g. Deloitte, so that their company could benefit from the technical expertise of the Big 4 firm. (1)
6. if one of the shareholders wishes to leave the company, may the company purchase that shareholder’s shares or must they be sold to other shareholders? (2)
7. Sabela Samat can be a shareholder in the company? (2)

PART B **(10 marks 12 minutes)**

Peter Pumpkin was, until July 2016 a registered auditor in public practice. He was the only registered auditor in his practice but he employed five staff members who under his guidance carried out a number of small company audits and other work. During the early part of 2016, he was involved in fraud and as a result, was permanently removed from the register of practitioners (registered auditors) by the Independent Regulatory Board for Auditors. Because of this, Peter Pumpkin, in an attempt to retain his practice, entered into an agreement with Doug Dooley, a registered auditor, whereby he was employed by Doug Dooley, was paid a salary by him, and shared profits with him.

Doug Dooley was fully aware of Peter Pumpkin's circumstances. The "partnership" letterhead was revised to read “D. Dooley and Co (in association with Pumpkin and Co) – Registered Auditors and Accountants”.

The arrangement was that Peter Pumpkin would continue to service all his clients but that Doug Dooley would sign all reports without having to perform any audit work.

YOU ARE REQUIRED TO discuss the actions of Peter Pumpkin and Doug Dooley in terms of the Auditing Profession Act 2005.

13.3 **(24 marks 29 minutes)**

1. Sidwell Sithole is a registered auditor practising under the name of S. Sithole – Registered auditor and accountant. He has recently accepted a four year employment contract to be the financial controller of a new mine which has commenced operations in Nigeria. He has decided to sell his practice to Greg Minnow who is an internal auditor at a large company. Greg Minnow is very knowledgeable on auditing but is not eligible to register with IRBA. Both Greg Minnow and Sidwell Sithole wish to retain the current name of the practice; Greg Minnow because he believes it will be less disruptive and will promote continuity, and Sidwell Sithole because he would like to keep the option of buying back

the practice if and when he returns from Nigeria. Comment on this situation in terms of the Auditing Profession Act 2005. (4)

2. Swann and Rawlinson a firm of registered auditors, has decided to reorganise and incorporate itself. The following proposals inter alia, have been made :
   2.1 Sam Swann the current senior partner of Swann and Rawlinson, will not be a shareholder as he wishes to be less active in the practice. However he will be appointed chairman of the board as he is well respected in the business world and will be able to guide the new incorporated practice.
   2.2 Robbie Rawlinson who is also currently a partner in Swann and Rawlinson, will become the ***majority*** shareholder and managing director of the new incorporated practice.
   2.3 Dickie Dann CA (SA) currently the financial director of Exis (Pty) Ltd a manufacturing company, will become a shareholder and director. His role at the new practice will be advisory and he will not leave his current position at Exis (Pty) Ltd.
   2.4 Jacob Nda will be appointed as a director to head up the proposed "independent accounting professional" section of the new practice. The section is being set up to cope with the expected increase in demand for independently compiled annual financial statements from companies and close corporations. Sam Swann believes that Jacob Nda is perfect for this position as he is a member of two professional bodies, ACCA and CIMA.
   2.5 Grace Good BA LLB who is currently in charge of taxation and legal matters at Swann and Rawlinson, will become a minor shareholder and director of the new practice.

Comment on the proposed appointments listed in 2.1 to 2.5 above in terms of the Auditing Profession Act 2005. (10)

3. Lucy Leishman a registered auditor in public practice, is in the process of conducting an independent review of the financial statements of Nu-Treads (Pty) Ltd, a company which has a public interest score of 198 and has its financial statements independently compiled. During the course of the review, she is convinced that the company is involved in fraudulent trading activities which constitute a reportable irregularity. In respect of the above situation, indicate whether each of the following statements is true or false. Justify your answers :
   3.1 Lucy Leishman can ignore the matter on the grounds that the Auditing Profession Act refers only to reportable irregularities in the context of an ***audit*** engagement. (2)
   3.2 Lucy Leishman can ignore the matter on the grounds that the AFS were not prepared by the company itself. (2)
   3.3 Lucy Leishman need not report the matter to any external body but must submit a full report of her findings to the chairman of the board of Nu-Treads (Pty) Ltd. (2)
   3.4 Lucy Leishman should report the matter to the IRBA. (2)
   3.5 Lucy Leishman can ignore the matter on the grounds that if there is a reportable irregularity, it is the responsibility of the independent accounting professional who compiled the AFS to report it to the IRBA. (2)

13.4 **(31 marks 37 minutes)**

You are the engagement partner in charge (designated auditor) of the audit of Roadhogs (Pty) Ltd, a road transport company with an annual turnover of approximately R85 million. In terms of its public interest score, Roadhogs (Pty) Ltd must be externally audited annually. The audit senior has raised the following matters concerning the audit for the year ended 28 February 2017, for your attention:

The minutes of directors' meetings include a resolution approving payment of R15 000 per month to a Johan Costa, for consultancy fees. Further enquiries revealed that Johan Costa is a senior road traffic inspector at the provincial vehicle testing station. When the audit senior enquired about the services which Johan Costa rendered for his fee, the financial director explained that since they had begun paying these fees, the following benefits have accrued to the company:

* their vehicles no longer need to go for the annual provincial roadworthy inspection which is required for all vehicles used for commercial transportation purposes. This has resulted in increased earnings, as vehicles which would have been taken off the road for two full days for servicing and the inspection, are now able to continue with scheduled work, without interruption.

* repair and maintenance expenses have decreased significantly as the directors no longer consider it necessary to carry out such extensive servicing and preventative maintenance on the company's vehicles.

Although your audit senior pointed out to the directors that it is a statutory requirement that the company's vehicles pass the annual roadworthy inspection, they maintain that part of their agreement with Johan Costa, is that he sees to it that the necessary paperwork is completed to ensure that the company encounters no difficulties with the provincial authorities.

YOU ARE REQUIRED TO:

a) discuss fully whether the above situation constitutes a reportable irregularity in terms of the Auditing Profession Act, 2005. (16)

b) comment on whether the fact that Roadhogs (Pty) Ltd is a private company (as opposed to a public company) affects your duties in terms of Sec 45 of the AP Act 2005. (3)

c) explain what action you would take, if any, regarding this matter. If no action is required, justify your answer. (8)

d) comment on whether we would still have a duty to report a reportable irregularity if Roadhogs (Pty) Ltd's public interest score required that the company's AFS be independently reviewed and not externally audited. (4)

13.5 **(20 marks 24 minutes)**

You are a member of the team responsible for the annual audit of ElleGent (Pty) Ltd, a large company which retails mens clothing. The company has outlets throughout Southern Africa through which it sells both imported and locally manufactured goods.

Whilst conducting some routine audit tests on payments, you noticed that at reasonably regular intervals, cheques (made out to "cash") for amounts ranging between R5 000 and R10 000 were being drawn on the bank.

You also noticed that these payments coincided with consignments of clothing that were imported from China, but for which there were no documents reflecting entry into South Africa. Puzzled by this, you approached Walter Melon, who is a chartered accountant and financial manager of ElleGent (Pty) Ltd. His response was as follows:

> ○Don't worry about it - it's a pretty normal business practice in the clothing industry. We land the goods in Zimbabwe, change the "Made in China" labels on the garments to "Made in South Africa" labels, re-package them and bring them in through the border post in one of our delivery trucks. Our distribution manager gives the cash to the driver in case any customs officials don't want to accept that the goods are being returned to our local depot from our Zimbabwean outlets. The cash certainly helps them to see it our way! I raised it a year or two ago with the financial director and he nearly exploded, and told me just to get on and do my job and the Board would worry about how ElleGent (Pty) Ltd does business. I ignored it - he's not the right person to get on the wrong side of!"

YOU ARE REQUIRED TO:

a) comment on Walter Melon's response in terms of his compliance with the SAICA Code of Professional Conduct. (5)

b) discuss Walter Melon's response in terms of your firm's duties in terms of the Auditing Profession Act 2005. (15)

13.6 **(30 marks 36 minutes)**

1. Select the correct answer. A special resolution of the shareholders is ***not*** required to :
   - 1.1 approve the issue of shares to a director
   - 1.2 remove a director
   - 1.3 approve the disposal of the greater part of the assets of the company
   - 1.4 authorise the granting of financial assistance to a director. (1)

2. Select the correct answer. A public company must have :
   - 2.1 at least three directors
   - 2.2 at least four directors
   - 2.3 at least four directors and a company secretary
   - 2.4 at least five directors and a company secretary. (1)

3. State whether each of the following is true or false. Justify your answer :

3.1 In terms of the Companies Act, a company must have a mix of executive and non-executive directors on the board (1)
3.2 The quorum for a meeting of directors which has eight directors is, in terms of the Companies Act, five directors (1)
3.3 The company's MOI may stipulate that a meeting of the board cannot be conducted electronically, i.e. directors must be "physically" present (1)
3.4 If a ***sole director*** in a company has a financial interest in a contract to be entered into by the company and he holds 60% of the shares, he is not required to declare his interest in the contract and can approve the contract immediately. (3)

4. Fred Moses, one of five directors of Hurdles (Pty) Ltd, is aware that his wife Millie will earn a commission of R200 000 if a contract to be approved by the directors, between Hurdles (Pty) Ltd and another company, is entered into. Millie Moses is not a director of Hurdles (Pty) Ltd or the other company. What duties or obligations does this impose on Fred Moses as a director of Hurdles (Pty) Ltd? (6)

5. Describe briefly how a director should ***exercise the powers and functions*** of a director, to comply with the required standards of directors' conduct. (3)

6. A company's MOI can relieve a director of his duty to disclose any information which is material to the company and which comes to his attention, other than where the information relates to that director's financial interests (as defined) in the company. True or false? (2)

7. 7.1 A listed company need not appoint a company secretary if it has appointed a chief audit executive. True or false? Justify. (1)
7.2 Indicate whether each of the following is true or false. The company secretary of a listed company should be:
- a director of the company (.5)
- resident in the Republic of South Africa (.5)
- able to speak and write at least two official languages (.5)
- a member of either SAICA or the IRBA. (.5)

8. Prologue Ltd wishes to appoint additional members to its audit committee. Discuss whether each of the following individuals could be appointed as a member of this committee. Consider each one individually :
8.1 ***Bernie Best,*** the company secretary
8.2 ***Sbu Kaiser,*** the chief audit executive
8.3 ***Fabian Wiggins,*** the chairman of the board
8.4 ***Brad Pott,*** the financial director
8.5 ***Solomon Wisdom*****,** the audit engagement partner
8.6 ***Doug Bells,*** an independent non-executive director who is a retired engineer
8.7 ***Elna Elliott,*** the head of the auditing department at Unisa, who has no financial or personal relationship with the company
8.8 ***Petra Cruise,*** registered auditor, the wife of the company's major supplier of raw materials. Petra Cruise's firm is not involved in rendering any services to Prologue Ltd. (8)

13.7 **(20 marks 24 minutes)**

1. The Companies Act 2008 identifies two categories of company. Name these categories. (1)
2. Into which category do the following fall:
   * public companies
   * personal liability companies. (1)
3. Give three prohibitions in terms of the Companies Act, regarding the name of a company. (Note, do not give three examples of the same prohibition). (3)
4. What designation should follow the names of the following companies to indicate their type:
   * state-owned company
   * private company
   * personal liability company
   * non-profit company. (2)
5. What is the founding document for a company and how many persons may incorporate a
   * non-profit company?
   * profit company? (2)
6. How are amendments to this founding document authorised other than where the amendment is in terms of a court order? (3)
7. Companies may no longer issue par value shares. True or false? (1)
8. The rights and limitations attaching to shares which are stated in the company's founding document can be altered by a resolution of the Board of Directors. True or false? Justify. (3)
9. Can a natural person and a juristic person be "related" in terms of the Companies Act 2008? Justify. (2)
10. For the purposes of the application of the Companies Act 2008 are the following considered to be related? Give reasons for your answers.
    10.1 a mother and her grandson (1)
    10.2 a father and his son-in-law. (1)

13.8 **(16 marks 19 minutes)**

In terms of the Companies Act 2008, some provisions of the Act are regarded as "alterable provisions" and others are "unalterable provisions". Consider the following provisions of the Act.

1. The shareholders of a public company must appoint an audit committee.
2. The board of a company must call a meeting of directors if 25% of the directors of a board consisting of at least twelve directors require it to do so.

3. A person who is an unrehabilitated insolvent is disqualified from being appointed a director of a company.

4. The shares of a company will not have a nominal or par value.

5. If a company has more than two shareholders, a meeting of shareholders may not begin unless at least three shareholders are present.

6. For an ordinary resolution to be approved by the shareholders, it must be supported by more than 50% of the voting rights exercised on the resolution.

7. For a special resolution to be approved by the shareholders, it must be supported by at least 75% of the voting rights exercised on the resolution.

8. The quorum for a directors meeting is a majority of the directors present at the meeting.

9. Every share issued by a company has associated with it an irrevocable right of the shareholder to vote on any proposal to amend the preferences, rights, limitations and other terms associated with that share.

10. If a director is present at a meeting to consider a matter in which that director has a personal financial interest, the director must leave the meeting after disclosing his interest in the matter.

YOU ARE REQUIRED TO:

a) explain the difference between an alterable provision and an unalterable provision of the Companies Act 2008. (2)

b) indicate whether each of the provisions listed above (1 to 10) is alterable or unalterable. Where a provision is alterable, describe briefly what alteration to the provision can be made. (14)

13.9 **(30 marks 36 minutes)**

1. What is the maximum number of directors in a public company? (1)

2. Classify each of the following directors of Snowman (Pty) Ltd, as either executive or non-executive and where you have identified a director as non-executive, state whether that director is an independent non-executive director or not, justify:
   - 2.1 Tommy Toll, human resources director
   - 2.2 Patrick Plaza, an IT specialist who advises Snowman (Pty) Ltd on computer system matters
   - 2.3 Tim Tanker, the financial director
   - 2.4 Dandie Dlamini, whose business supplies Snowman (Pty) Ltd with air-conditioning units
   - 2.5 Penelope Plaza, the marketing director
   - 2.6 Nix Naidoo, a partner in an audit firm (this audit firm does not perform the audit of Snowman (Pty) Ltd). (4)

3. Which of the following statements is false; justify:
   3.1 an independent non-executive director cannot be remunerated by the company, but can have his expenses for attending meetings, reimbursed (1.5)
   3.2 the audit committee is a committee of the Board (1)
   3.3 the Memorandum of Incorporation of a private company can stipulate that the chairman of the board appoint new directors without the consent of the shareholders (2)
   3.4 a company is not obliged to give reasons to a director for removing that director from office (2)
   3.5 a resolution at a directors meeting will be approved if 50% of the directors vote in favour of the resolution. (1.5)

4. What is the quorum for a directors' meeting where the company has:
   4.1 two directors
   4.2 three directors
   4.3 nine directors
   4.4 twelve directors? (2)

5. For a meeting of directors for a public company, the following individuals cannot be included in determining the quorum for that meeting: True or false? Justify.
   5.1 company secretary
   5.2 independent non-executive chairman
   5.3 other non-executive directors
   5.4 the chief audit executive (head of internal audit). (3)

6. Briefly discuss the standards of conduct which govern a director's relationship with the company of which he is a director. (7)

7. A shareholder may appoint a proxy.
   7.1 may a shareholder appoint more than one proxy to attend the same meeting?
   7.2 may a proxy be heard at a meeting, or is a proxy only allowed to vote? (2)

8. State the notice period required for each of the following meetings:
   8.1 the annual general meeting
   8.2 a general meeting of shareholders
   8.3 a general meeting of shareholders, at which a special resolution will be proposed.(3)

13.10 **(36 marks 42 minutes)**

1. Which of the following are ***not*** taken into consideration when calculating a company's public interest score?
   1.1 The amount of money donated to public causes.
   1.2 Turnover.
   1.3 Average wage paid to hourly paid employees.
   1.4 Whether or not the company is a subsidiary company.
   1.5 Whether the company is a private or public company.
   1.6 The average number of employees during the financial year. (2)

2. The following details pertain to two unrelated companies :

		Padds (Pty) Ltd	*Podds (Pty) Ltd*
2.1	Donations to charity	R700 000	R50 000
2.2	Turnover	R 97.2m	R27.6m
2.3	Employees at the start of the year	132	37
2.4	Employees at the end of the year	116	48
2.5	Number of board committees	5	2
2.6	Amounts owed to short and long term creditors	R13.8m	R1.3m
2.7	Individuals (all shareholders) with a direct or indirect interest in the company's shares	17	9
2.8	AFS compiled independently	no	no
2.9	Directors	5	3

a) Calculate the public interest score for each company (show workings). (5)

b) State, giving brief reason, whether each of the companies will have to be audited or reviewed, or will require no external intervention. (4)

c) Can either company be classed as "owner/managed"? Give reasons. (1)

3. Cornpatch (Pty) Ltd has a public interest score of 154 and currently compiles its annual financial statements internally. This in turn means that the AFS must be audited. However, the company has decided that it would be cheaper and less disruptive to have the AFS compiled by an independent accounting professional and then have the AFS independently reviewed. The financial director of Cornpatch (Pty) Ltd is considering who to appoint as the independent accounting professional to compile the AFS and has approached you for advice. The following individuals/firms are being considered:

3.1 ***Your firm*** of registered auditors. The firm has been the auditors of Cornpatch (Pty) Ltd for a number of years.

3.2 ***Uys and Buys CC*** a close corporation which offers bookkeeping and financial services. The members of the CC are all members of CIMA and neither they nor the CC itself have any involvement with Cornpatch (Pty) Ltd in any way.

3.3 ***Herb Malherbe*** who has no formal qualifications but who serves as an independent non-executive director and audit committee member for two listed companies. His strengths lie in financial reporting.

3.4 ***Pitso Motaung*** a registered auditor in his own practice. He is the husband of Majestic Motaung, the marketing director of Cornpatch (Pty) Ltd.

3.5 ***Verbena Williams*** a chartered accountant who up until a year ago, was the financial manager at Cornpatch (Pty) Ltd. She left to join her sister Saturn Williams in the IT systems firm of "Saturn Verbena & Co – financial systems consultants".

3.6 ***Gordy Ringasund*** a chartered accountant and registered auditor, is the father of Steve Ringasund, one of the shareholders of Cornpatch (Pty) Ltd.

State giving reasons, which of the above (3.1 to 3.6) would be eligible for appointment as the independent accounting professional to compile Cornpatch (Pty) Ltd's annual financial statements. (12)

4. The shareholders of Note-for-Note (Pty) Ltd, a profit company which sells a large range of music-related goods, have recently included a clause in its MOI which requires that the company has its annual financial statements externally audited. Based on its public interest score, the company is required to have its financial statements reviewed but as none of the shareholders are active in the business, they have decided to include the audit requirement in the MOI. The following individual/firms are being considered for appointment as the company's auditor:

   4.1 ***Jandre Kruger***, a newly qualified chartered accountant who is registered with the IRBA. Whilst studying fulltime at university before he commenced his training contract, Jandre Kruger worked for short periods in the accounting department at Note-for-Note (Pty) Ltd during his university vacations.

   4.2 ***Wilson Pickett and Co***, a firm of registered auditors. Wilson Pickett the senior partner, is one of the shareholders of Note-for-Note (Pty) Ltd.

   4.3 ***Wim Grove***, a chartered accountant and financial consultant who has been working on a project for the last year to expand Note-for-Note (Pty) Ltd's business into Africa.

   4.4 ***John Stemmet***, the former financial director of Note-for-Note (Pty) Ltd. He left the company three years ago and has since set up a successful practice specialising in medium-size company external audits and independent reviews.

   4.5 ***Emo Adams and Co***, a small financial services partnership which does all of Note-for-Note (Pty) Ltd's company secretarial work, e.g. submitting returns to the Commission. Emo Adams himself would not be the auditor. This role would be filled by Seb Shabani, a chartered accountant and partner in the business.

   4.6 ***Shanai Stemmet***, a registered auditor and daughter-in-law of John Stemmet. She does not work in John Stemmet's practice and is a sole practitioner.

a) Describe the procedure the shareholders would have gone through to add the audit requirement to the company's MOI. (2)

b) Discuss whether the individuals/firms listed above (4.1 to 4.6), would be eligible to take up the appointment of auditor of Note-for-Note (Pty) Ltd. (10)

13.11 **(30 marks 36 minutes)**

You are the senior on the audit of Polimex (Pty) Ltd, a large manufacturing company. Polimex (Pty) Ltd's public interest score is over 400. The company is not part of any group. One of the directors of the company has recently attended a seminar on the Companies Act but is confused about some of the sections which were dealt with at the seminar and has approached you to obtain some explanations. He raised the following queries with you:

1. The presenter referred o the Companies Regulations which I found confusing. Are they the same thing as the Companies Act? (4)

2. What is the solvency/liquidity test? Can you explain by example how is it used. (5)

3. The presenter also said that special resolutions no longer have to be passed by at least 75% of the voting rights exercised on the resolution. Is he correct? (3)

4. I understand that Polimex (Pty) Ltd must appoint a company secretary. Can't we just appoint one of these companies which offer company secretarial services? (2)

5. The presenter mentioned on a number of occasions, standards of directors' conduct and something about a director having to "keep himself informed". What is this all about? (6)

6. He also mentioned something about directors relying on information provided by senior employees. As a director, can I rely on what senior employees at Polimex (Pty) Ltd tell me? (3)

7. I understand that if we want to appoint your firm as auditors again, we would have to appoint an audit committee who would then appoint you but only if you can prove your independence. Is my interpretation correct? (3)

8. We, the directors, are also a bit concerned about having to appoint non-executive directors. We expect our directors to work hard and we don't like paying people for doing nothing! Are we going to have to do this? (4)

YOU ARE REQUIRED TO respond to the director.

13.12 **(45 marks 54 minutes)**

You are a registered accountant and auditor in public practice. Lionel Lester and Wendell Webb have made an appointment to see you about a company they want to form.

Lionel Lester has designed a new industrial sewing machine which he has patented and now wants to sell to the clothing industry. Wendell Webb comes from a wealthy family and will provide most of the finance required for the venture. The two of them will initially be the only shareholders and directors of the company but it is expected that over time, a few new shareholders will be found as well as one or two directors appointed.

The company will operate from a factory which they believe will be suitable for lease. The owner of the factory wants to tie up the lease as soon as possible. Lionel Lester estimates that in the first year of operation they will employ about twenty people (including themselves) and generate turnover of approximately R20 million, and that liabilities will not exceed R3 million at anytime).

The following questions were put to you:

(a) Lionel Lester asked what the major differences between a public company, private company and personal liability companies are, and what type of company they should choose for their purposes. (8)

(b) Lionel Lester asked if forming a close corporation instead of a company, was an option. Explain your response. (2)

(c) Wendell Webb enquired as to whether it would be in order for them to call the company "Sew-sew Ltd". (4)

(d) Lionel Lester asked if you would outline the steps required to incorporate a company. (5)

(e) Wendell Webb asked whether, it was necessary to produce annual financial statements and what company records it was required to keep and for how long they needed to be kept. (8)

(f) Wendell Webb said that he had been told about something called a public interest score and that if your business has one it had to be externally audited. He wanted to know what this was about. Lionel Lester added that he had heard that their company financial statements would have to be independently reviewed by an auditor. (8)

(g) Lionel Lester asked whether the shares the company is to issue, should be par value shares or no par value shares and how the preferences or rights applicable to the shares, are determined. (3)

(h) Wendell Webb enquired as to whether it was possible for the proposed company to enter into the lease contract for the factory before the company was incorporated. (7)

YOU ARE REQUIRED TO respond to the questions asked by Wendell Webb and Lionel Lester.

13.13 **(30 marks 36 minutes)**

You are a trainee accountant at the firm of Smiley and Grouch. One of the firm's audit clients is Pendex Ltd, a public company which manufactures office furniture and equipment. The following statutory matters have arisen.

1. Due to the resignation of the previous incumbent, the directors need to appoint a company secretary. The following have been put forward at a meeting of the directors, for consideration for appointment as company secretary:

   1.1 Smiley & Grouch (your firm).
   1.2 The Management House (Pty) Ltd - a financial services consulting company located in Gauteng.
   1.3 Monty Els, the production director who is retiring but wishes to maintain his links with the company. He has been on the board of directors for a number of years.
   1.4 Sevi Garcia, a former director of Pendex Ltd, who currently works in the finance department at Pendex Ltd. Sevi Garcia who is a member of the Chartered Institute of Secretaries, resigned his directorship last year because he is an unrehabilitated insolvent. His insolvency came about due to losses made from gambling.
   1.5 Ajay Singh, who currently holds the position of company secretary of a dairy company in KwaZulu Natal. In his application for the position at Pendex Ltd, Ajay Singh revealed that he and his family held 5% of Pendex Ltd's ordinary share capital.

2. During the course of the year, Pendex Ltd sold a piece of vacant land adjoining its factory. This property had been bought some years ago when the company was

considering opening a factory to manufacture domestic furniture. However, this did not materialize and the directors decided to sell the land and to distribute the cash raised from the sale as a dividend to shareholders. Due to the slightly depressed property market in the area, a small loss was made on the sale.

3. Scrutiny of the minutes of directors meetings revealed that the directors had resolved to make a loan of R8.2 million to Deco (Pty) Ltd, a company which supplies Pendex Ltd with upholstery fabric, to fund an expansion programme. 65% of the shares in Deco (Pty) Ltd are owned by Abdul Paruk. He formed the company some years ago, but subsequently resigned from employment at Deco (Pty) Ltd (but retained his shareholding) to take up the position of production director at Pendex Ltd.

YOU ARE REQUIRED TO:

a) indicate, giving brief reasons whether each of the parties listed in 1 above would be eligible for appointment as company secretary of Pendex Ltd. (10)

b) discuss the permissibility of the distribution to the shareholders of the proceeds of the sale of the vacant land by way of dividend. (5)

c) identify and discuss the statutory implications of the loan made by Pendex Ltd to Deco (Pty) Ltd. (15)

13.14 **(30 marks 36 minutes)**

You are a member of the technical department of your audit firm. The firm has received numerous enquiries from existing and potential clients as to whether they need to be audited, or reviewed, which reporting standards they must comply with, whether it is compulsory for them to have an audit committee, etc. You have been asked by your manager to draw up a schedule with the following headings and to complete it in respect of the latest batch of clients who have queried what they need to do. A brief explanation should be given in a note for each company at the end of the schedule. The column headings of the schedule must be as follows:

Client name	Must be audited	Must be reviewed	Must appoint audit com	Must appoint company secretary	Financial Reporting Standard

The existing and prospective clients who have made enquiries are as follows:

1. Lazar Ltd. This company is not listed on any stock exchange. It is a warehousing company with a public interest score of 312.

2. Wix CC. This close corporation imports candles. It has a public interest score of 87 and its financial statements are compiled by your firm.

3. Scud (Pty) Ltd. This company offers investment services and holds financial investments totalling R153 million on behalf of the general public. It has a public interest score of 178.

4.	Warmup (Pty) Ltd.	This is a family run company which wholesales a range of exercise equipment. All of the shareholders are directors of the company and it has a public interest score of 200 and compiles its own financial statements.
5.	Sunn CC.	This close corporation manufactures heaters and has a public interest score of 355. It compiles its own financial statements.
6.	Crew (Pty) Ltd.	This company builds small boats. Its MOI requires that it comply with Chapter 3 of the Companies Act 2008 in all respects. It has a public interest score of 375.
7.	RR (Pty) Ltd.	This company sells and repairs lawn mowers. It has a public interest score of 63. The company's AFS are compiled by the company's bookkeeper. There is only one director and he is not a shareholder in the company.
8.	Rule Ltd.	This listed company operates in the industrial sector.
9.	Toolz (Pty) Ltd.	This company retails machine tools. It has a public interest score of 240 and its financial statements are compiled by your firm.
10.	Ozz CC.	This close corporation transports containers. It has a public interest score of 320 and its financial statements are compiled by Deloitte.

YOU ARE REQUIRED TO:

a) compile the schedule as requested by your manager. (Do not forget to include the explanatory note as required by your manager.) (25)

b) list the requirements necessary for an individual to be classified as an independent accounting professional. (5)

13.15 **(26 marks 31 minutes)**

You are the auditor of Scallachi (Pty) Ltd, and as normal you decided to attend the annual general meeting for the year ended 30 April 2017, although no matters of particular interest appeared on the agenda. The company's financial statements must be audited by virtue of its public interest score. The company does not have an audit committee.

Your audit report for the year-end 30 April 2017 was qualified as a result of the uncertainty surrounding a reportable irregularity which you had reported to the IRBA but which the directors of Scallachi (Pty) Ltd had not yet acted upon.
The reportable irregularity which you reported related to what you believed to be illegal foreign exchange dealings.

At the annual general meeting one of the shareholders stood up and addressed the meeting as follows:

"I have spoken to the financial director and I believe that this qualified audit report is totally unjustified; we as a company are being found guilty and sentenced of illegal foreign exchange dealings by our auditor without the chance of a fair trial. Anyone reading this audit report will immediately believe that the company is guilty, and our reputation will suffer. In my opinion, as a shareholder, the auditor is there to assist us, he is supposed to be on our side, and if this is how he responds he should be removed. I thereby propose that he withdraw his report and that he be removed from the office of auditor as from the close of this meeting. Furthermore, our company is not a public company it is a private company and does not have to be audited so this auditor is completely overstepping the mark"

After some debate, during which you were not allowed to speak (the chairman deciding that you were not allowed to speak as you were not a shareholder) the matter of the withdrawal of your audit report and your removal was put to the vote and the motions were accepted by a small majority.
Your audit had been carried out in terms of the International Standards on Auditing and you had followed the procedures laid down in the Auditing Profession Act relating to reportable irregularities correctly and completely.

YOU ARE REQUIRED TO:

(a) comment critically on the statement made by the shareholder. (15)

(b) discuss fully, the legality of your removal from office. (8)

(c) comment on whether the shareholders are within their rights to insist that you withdraw your report. (3)

13.16 **(32 marks 38 minutes)**

You are the auditor in charge of the audit of Skrums (Pty) Ltd, a large company in the leisure industry. The managing director of Skrums (Pty) Ltd is Lew Bigg, a very autocratic man, who also has a material shareholding in the company. There are nineteen other shareholders (none of whom are directors) and seven other directors. During the current audit, you came across a number of payments which you decided required further audit attention. The details of these payments are as follows:

1. A payment of R2 million to Hi Jinks Promotions (Pty) Ltd. On further investigation, you ascertained that this was the first of four payments in respect of an R8 million contract awarded to Hi Jinks Promotions (Pty) Ltd for an advertising campaign to promote Skrums (Pty) Ltd. On reading the contract you discovered that the contract had been signed by Lew Bigg himself and that the shareholders of Hi Jinks Promotions (Pty) Ltd were Lew Bigg's son, Francois (70% holding) and Sidestep (Pty) Ltd (30% holding). Besides the contract itself and the entry in the cash book, no further evidence relating to the contract could be found. You also established that Sidestep (Pty) Ltd was jointly owned by Lew Bigg (60% holding) and one of his business partners (40% holding) and that decisions on contracts of this nature should be taken by the board of Skrums (Pty) Ltd.

2. A loan of R1.5 million made to Sidestep (Pty) Ltd to enable this company to purchase a piece of property. The loan, authorized solely by the directors, is to be repaid over 5 years and interest is charged at market rates.

3. A payment to Griff Edwids of R750 000 as compensation for loss of office as director of Skrums (Pty) Ltd.

YOU ARE REQUIRED TO:

a) discuss the contract with Hi Jinks Promotions (Pty) Ltd in terms of common law and the Companies Act 2008. (14)

b) discuss the legality of the loan from Skrums (Pty) Ltd to Sidestep (Pty) Ltd. (6)

c) describe the audit procedures which you would carry out in respect of the payment to Griff Edwids. You may assume that the MOI contains no conditions relating to such payments. (8)

d) explain how a meeting of shareholders can be called. (4)

13.17 **(40 marks 48 minutes)**

You are a member of the audit team working on the 30 June 2017 audit of Smugglers (Pty) Ltd, an export/import company. 70% of Smugglers (Pty) Ltd's capital is held by Borders Ltd whilst other companies in the group are Guards (Pty) Ltd which is 100% held by Borders Ltd and Contraband (Pty) Ltd which is 60% held by Smugglers (Pty) Ltd. The remaining shares in Smugglers (Pty) Ltd are held by eleven private investors.

Of the four companies within the group, you hold only the audit appointment of Smugglers (Pty) Ltd, the three remaining companies being audited by other firms.

Borders Ltd purchased 30% of its shares in Guards (Pty) Ltd on the 31 October 2016. Prior to this, it already owned 70% of the shares.

Your permanent audit file revealed the following:

1.	Directors of	: Borders Ltd	Billy Kidd Roy Rogers Davy Crockett Horst Trigger
		: Smugglers (Pty) Ltd	J T Edson Louis L'amour Bill Ocean
		: Contraband (Pty) Ltd	Roy Rogers Willy Nelson
		: Guards (Pty) Ltd	Bill Haley Chuck Berry

You have been assigned to the audit of statutory matters and as part of your procedures, have extracted the following matters for consideration:

1. A loan of R2.5 million made by Smugglers (Pty) Ltd to Borders Ltd. Borders Ltd has used the money to pay the shareholders of Guards (Pty) Ltd for the shares acquired in October 2016. The loan was adequately secured and subject to market related terms.

2. A loan of R1.5 million made to Roy Rogers for his personal use.

3. During the financial year Smugglers (Pty) Ltd had, on the instruction of Border Ltd, revalued certain of the company's property portfolio upward by R3 million. Shortly thereafter, Border Ltd had instructed the board of directors of Smugglers (Pty) Ltd to distribute the R3 million as a dividend.

YOU ARE REQUIRED TO:

(a) discuss your firm's right of access to the books and records/financial information of Guards (Pty) Ltd and Contraband (Pty) Ltd. (5)

(b) discuss the loans made by Smugglers (Pty) Ltd in terms of the Companies Act 2008.
Loan 1 (7)
Loan 2 (8)

(c) discuss the legality of the dividend distributed by Smugglers (Pty) Ltd in respect of the fixed asset revaluation. (10)

(d) state the procedures you would carry out to determine whether any special resolutions passed by Smugglers (Pty) Ltd during the year complied with the requirements of the Companies Act 2008. Your answer should cover notice of meetings, quorums, approval etc, but it is not necessary to cover adjourned meetings. (10)

13.18 **(25 marks 30 marks)**

Block (Pty) Ltd is a company which manufactures brass plumbing requisites. The company has five directors. The most senior directors of Block (Pty) Ltd, John Joint and Eric Elbow, have been concerned about the falling sales of brass plumbing requisites and the appearance on the market of a new plastic range of plumbing requisites imported from Taiwan. They intend taking the following action:

Firstly, they intend to sell all the company's manufacturing equipment, thus getting out of the brass plumbing requisites market, and secondly purchasing the sole franchise for South Africa for the import and distribution of "Easiplumb", the new Taiwanese plumbing system. The franchise is currently held by Import Investors CC, a close corporation, one of the two members of which is Joan Joint, John Joint's wife, who has a 65% members' interest.
In order to pay for the franchise, the directors intend to issue to Import Investors CC 50 000 ordinary shares of no par value at R10 per share. In addition they will appoint Joan Joint a director of Block (Pty) Ltd.

A scrutiny of the company's statutory records reveals that the company has 150 000 authorised shares of which 100 000 are in issue and that John Joint and Eric Elbow hold minor shareholdings. No other directors hold shares. The authorised shares are no par value shares.

YOU ARE REQUIRED TO discuss the intentions of John Joint and Eric Elbow in relation to the Companies Act 2008.

13.19 **(20 marks 24 minutes)**

Kwin (Pty) Ltd is a wholesaler of medical supplies. Due to sustained growth in the business, the directors have decided that additional shares in the company should be issued to raise the amount of R10 million needed to fund a proposed expansion of the business. The directors have considered various other financing options but have decided that a share issue would be the best option. Dick Kwin the financial director, has approached you for some initial advice on the issue and has provided you with the following:

1. Kwin (Pty) Ltd has 350 000 ordinary no par value shares in issue. The authorized share capital is 400 000 ordinary no par value shares. All shares are of the same class.

2. The 350 000 shares are held as follows:
   : 90 000 by BioMed (Pty) Ltd
   : 45 000 by each of three of the directors of Kwin (Pty) Ltd. (The two other directors do not hold any shares)
   : 50 000 by a share scheme trust for employees of Kwin (Pty) Ltd
   : 75 000 by eight private investors who hold various quantities of the shares (totalling 75 000).

3. The intention is to issue a further 250 000 shares at R40 a share. Shares would be offered to the existing five directors and the private investors in equal quantities, but not to BioMed (Pty) Ltd or the share trust scheme.

4. The MOI requires that the issue of shares be carried out in terms of the Companies Act 2008. It contains no additional requirements relating to the issue. Ordinary resolutions and special resolutions must be approved by 50% and 75% of the voting rights respectively.

YOU ARE REQUIRED TO advise Dick Kwin on the statutory requirements applicable to this proposed issue. Your answer must cover, inter alia, notice requirements for meetings, quorum requirements, etc.

13.20 **(30 marks 36 minutes)**

1. What is the maximum number of members permissible in a close corporation? (1)

2. Can a private company convert itself into a close corporation? (1)

3. State at least six particulars that the founding statement of a close corporation will contain. (3)

4. Which document provides conclusive evidence that all requirements in respect of the registration of a close corporation, have been complied with? (1)

5. When a close corporation wishes to convert to a company, what three documents must be lodged with the Registrar? (1)

6. May the following be members of a CC?
   6.1 a company
   6.2 an "inter vivos" trust
   6.3 a minor. (3)

7. May the following take part in the management of a CC?
   7.1 an individual who has been placed on probation as a director of companies
   7.2 an unrehabilitated insolvent
   7.3 any person who holds less than a 50% members interest and has been convicted and imprisoned for theft within the last 3 years. (3)

8. How is an individual's membership in a CC expressed? (1)

9. May two or more members become joint holders of a members interest? (1)

10. What evidence does a person have of their interest in a close corporation? (1)

11. How does a person obtain an interest in a close corporation? (2)

12. Can a CC acquire (buy back) a members interest? (1)

13. Can a CC provide financial assistance for the acquisition of a members interest by a person who is not already a member? (1)

14. What requirements must a payment made to a member by virtue of his membership, satisfy? (2)

15. May a CC make a loan to one of its members? (2)

16. By what date must a CC compile its AFS? (1)

17. Must a CC appoint an accounting officer even if it has a member who has an accounting background? (2)

18. Must an accounting officer have obtained a formal accounting qualification? (1)

19. Are the members of a CC jointly and severally liable for the debts of the CC? (1)

20. If a CC converts to become a private company, can it retain its name? (1)

13.21 **(18 marks 22 minutes)**

1. All close corporations must calculate a public interest score. True or false? (1)

2. Calculate the public interest score for the following close corporations, Jax CC, Joes CC:

		Jax CC	Joes CC	
2.1	members	2	10	
2.2	employees at start of financial year	46	162	
2.3	employees at end of financial year	32	200	
2.4	turnover	R18m	R74m	
2.5	number of government contracts	0	2	
2.6	prior year profit	R3m	R17.2m	
2.7	amounts owed to third parties	R3.7m	R11.1m	(5)

3. In the case of a close corporation, the public interest score is used to determine whether the close corporation (CC) must be independently reviewed or audited. True or false? (2)

4. Which of the following statements is true (justify your answer)?
   4.1 a CC with a public interest score of 400, must be audited
   4.2 a CC with a public interest score of 250, which has prepared its financial statements internally, must be audited
   4.3 a CC with a public interest score of 300, but which has had its AFSs prepared by an independent accounting professional, must be audited. (3)

5. If a CC has a public interest score in excess of 100, it is not required to appoint an accounting officer? True or false? Justify. (1)

6. If a CC is required to be audited because of its public interest score, the audit may be carried out by its accounting officer, provided the accounting officer is registered with IRBA. Discuss. (4)

7. Which financial reporting standards must be adopted by a CC with a public interest score of 355? (1)

8. If a CC is in financial distress, would the requirements relating to financial rescue stipulated in the Companies Act 2008 regulations, apply to it? (1)

13.22 **(28 marks 34 minutes)**

You have recently been approached by the members of Crossbow CC for advice on certain matters. Crossbow CC consists of four members all of whom have an equal interest. The CC's main business is the construction of bowling greens, cricket pitches and golf driving ranges. In addition, the corporation has various non-trading investments in shares and vacant land. The CC does not have an association agreement.

The members are seeking your advice on a number of matters.

1. The corporation wishes to diversify its operations into landscaping so as to more fully utilise the machinery which it owns. All the existing members will remain but Mary Mason a qualified landscaper will join the corporation, provided she becomes an equal member. In return for her membership she will contribute certain equipment and inventory (plants and shrubs) to Crossbow CC.

2. Prior to Mary Mason joining the CC, the existing members wish to revalue the investment in the vacant land and to make a distribution of the amount of the revaluation to themselves.

3. Ronnie Rist one of the existing members, stated that although he was prepared to support the decision to accept Mary Mason as a member, he was a little worried that "things may not work out" as the four existing members had been together for seven years and the corporation had operated very smoothly. He felt that the introduction of a new member could be very disruptive. He specifically wanted to know whether the existing members would in the future, be able to terminate Mary Mason's membership if they so wished, particularly if she proved disruptive to the corporation.

4. Abdul Razzag raised the question of whether the CC would have to be audited. "I understand the concept of the public interest score and have calculated it to be two hundred and forty six (246) due mainly to our labour force. What I can't figure out is whether this means we have to have our AFS audited." At this point, one of the other members asked what the criteria for working out the public interest score actually were.

YOU ARE REQUIRED TO:

a) advise the existing members of Crossbow CC on the inclusion of Mary Mason as a member of Crossbow CC in terms of the Close Corporation Act. (6)

b) advise the existing members on the proposed revaluation and distribution as contemplated in (2) above. (8)

c) respond to the question posed by Ronnie Rist. (8)

d) respond to Abdul Razzag and state the criteria to be used by Crossbow CC to calculate its public interest score. (6)

13.23 **(23 marks 28 minutes)**

You are a member of Groundfloor CC. The founding statement indicates that the corporation's business is that of carpet and flooring supplier. The other six members are all skilled in the various different aspects of flooring, e.g. tiling, floor heating etc, whilst you, being a chartered accountant, look after the financial and statutory aspects of the corporation. You are also the accounting officer. During the current year you had been away on an extended business trip and you have returned to find that the following matters are awaiting your attention :

a) Tommy Tinker, a qualified plumber, wishes to acquire an interest in Groundfloor CC from the CC itself. The other members have all agreed that he would be a good person to have in the CC and that he should join. Some of the members feel that, as the CC is very liquid, it is not really necessary for Tommy Tinker to make a contribution but others insist that he has to make a contribution of R10 000 to the CC as that is the amount which each of the other members contributed when the CC was originally founded, and is the basis on which the members interest is calculated. Unfortunately Tommy Tinker does not have any funds available and has asked whether Groundfloor CC will advance him the money to purchase his interest. (10)

b) Whilst you were away, one of the members of the CC, in good faith, signed a contract with Scarry (Pty) Ltd for Groundfloor CC to carry out some building alterations. Some members wish the corporation to get out of the contract on the grounds that to enter into such a contract is a contravention of the founding statement and therefore the corporation does not have the necessary legal capacity. The association agreement gives the members express authority to bind the corporation. (4)

c) Groundfloor CC had completed a major flooring contract for a new hotel during your absence. The contract had been negotiated by Terry Tootle, one of the members of Groundfloor CC, without consulting the other members. As it turned out the CC had made a loss on the contract. The hotel is owned by Town Inns (Pty) Ltd, the shareholders of which are Terry Tootle's wife and her brother, Donny Doolittle. (6)

d) One of the members, Peter Patch, has raised the possibility of Walter Winks being appointed as the marketing manager of Groundfloor CC. Walter Winks had been the very successful marketing director of Warm and Toasty Flooring (Pty) Ltd. However a year ago he was declared delinquent by the court on the grounds that he had grossly abused his position as a director. Peter Patch is of the opinion that Walter Winks was "set up" by the other directors and is in fact innocent of all charges, and that if all members agree, he should be appointed. (3)

YOU ARE REQUIRED TO discuss the above situations in terms of the Close Corporations Act.

13.24 **(28 marks 33 minutes)**

You have been a registered auditor in public practice for the last five years. One of your clients is Mastermatch CC, a textile and fabric concern for whom you act as accounting officer. Bill Conners, one of the members, is the financial manager of the CC and is responsible for the financial reporting function including the preparation of the annual financial statements. Half way through the current financial year, Mastermatch CC were awarded a major contract to design and manufacture high quality fabric to be used in the refurbishment of all the hotels in a major hotel chain operating throughout Southern Africa.

As a direct result of this, Mastermatch CC needed to quickly employ thirty four new staff members (which brought the total number of staff employed to ninety six). The contract was also largely responsible for boosting revenue for the year ended 31 March 2017 to nearly R38 million.

Mastermatch CC has eight members, all of whom have roughly the same members interest. Besides undertaking the importation and manufacture of textiles, Mastermatch CC holds a 60% interest in Grafix (Pty) Ltd, a fabric design company. The majority of Grafix (Pty) Ltd's directors are also members of Mastermatch CC.

Kelsey Jordaan, one of the members of Mastermatch CC, and a director of Grafix (Pty) Ltd, has contacted you for some advice.

1. Mainly as a result of being awarded the hotel contract, Mastermatch CC wish to take on an additional member to strengthen the corporation's design capabilities. The person the members have in mind is Terri Shrimpton, a talented design artist who had her own design studio. Unfortunately, due to her lack of business acumen, the studio

collapsed and Terri Shrimpton was recently declared insolvent. Kelsey Jordaan is very keen to involve Terri Shrimpton on a permanent basis for her creative abilities.

2. Prior to taking on Terri Shrimpton, Mastermatch CC want to repay a portion of each of the existing members contributions as certain members want to invest in another scheme (in their private capacities). As there is presently insufficient cash in Mastermatch CC to make the repayments, the corporation intends borrowing the balance of the amount required from Grafix (Pty) Ltd.

YOU ARE REQUIRED TO:

a) indicate whether Mastermatch CC's annual financial statements for the year ended 31 March 2017 will be audited or reviewed or will require no external intervention. Give reasons. (3)

b) discuss whether you could be classed as an "independent accounting professional" in relation to Mastermatch CC. (5)

c) advise Kelsey Jordaan in respect of the matter relating to Terri Shrimpton. (9)

d) advise Kelsey Jordaan on
   (i) the legality of the repayments of members' contributions in terms of the Close Corporations Act. (4)
   (ii) the legality of the loan to be made by Grafix (Pty) Ltd to Mastermatch CC. (7)

CHAPTER 14

COMPLETING THE AUDIT

14.1 **(15 marks 18 minutes)**

The evaluating and concluding stage of the audit process is very important. At this stage all the evidence that has been gathered on the audit must be brought together so that decisions can be taken as to whether anything further needs to be done and ultimately what the appropriate audit opinion will be.

YOU ARE REQUIRED TO:

a) state, giving reasons which member of the audit team should conduct the evaluation of audit evidence and conclude on fair presentation (3)

b) discuss what the evaluation of the audit evidence at this stage of the audit process sets out to determine. (12)

14.2 **(10 marks 12 minutes)**

Select the most appropriate answer:

1. Which of the following does ***not*** form part of the concluding stage of the audit?
   1.1 evaluating whether the financial statements adequately disclose the accounting policies selected and applied.
   1.2 concluding on whether sufficient appropriate evidence has been gathered.
   1.3 evaluating whether the audit has been conducted effectively and efficiently.
   1.4 concluding on whether all material events occurring after the reporting date, have been identified and appropriately dealt with.

2. When concluding on whether the financial statements have been prepared in all material respects in accordance with the applicable financial reporting standards, the auditor will evaluate
   2.1 whether the terminology used in the financial statements is appropriate.
   2.2 whether the financial statements achieve fair presentation.
   2.3 whether the accounting policies selected and applied are consistent with the financial reporting standards and appropriate for the company's business.
   2.4 all of points 2.1, 2.2 and 2.3 above.
   2.5 points 2.2 and 2.3 above but not point 2.1.
   2.6 points 2.1 and 2.2 above but not point 2.3.

3. When concluding on the financial statements, the auditor will evaluate whether the information presented in the financial statements is
   3.1 relevant and reliable.
   3.2 relevant, reliable, comparable and timeous.
   3.3 relevant, reliable, comparable and understandable.
   3.4 relevant, reliable, valid and material.

4. By extrapolating the misstatements identified in a sample, the auditor estimated the amount of misstatement in the population from which the sample was drawn. This misstatement would be termed a

4.1 judgemental misstatement.
4.2 projected misstatement.
4.3 provisional misstatement.
4.4 factual misstatement.

5. Management considers that a reasonable impairment write off on a particular piece of machinery is R375 000; the auditor's opinion is that a reasonable impairment would be R450 000. The R75 000 difference would be regarded by the auditor as a
   5.1 factual misstatement.
   5.2 quantitative misstatement.
   5.3 judgemental misstatement.
   5.4 projected misstatement.

6. Which of the following statements is true?
   6.1 misstatements should be considered in isolation; a collective evaluation of misstatements can distort the true situation.
   6.2 when evaluating misstatements at the concluding stage, only the quantitative (and not qualitative) circumstances of the misstatement need be considered by the auditor.
   6.3 where a misstatement reflects a level of dishonesty by the directors, it should be corrected, even if the misstatement is below the final materiality level.
   6.4 uncorrected misstatements should be off set against each other whenever possible.

7. The auditor has identified a number of misstatements which must be corrected by the client to avoid having to issue a modified audit report. Which of the following would justify the auditor giving an ***unmodified*** report even if the misstatements were not ***corrected*** by the client
   7.1 providing the audit committee with written notification of the misstatements.
   7.2 a written notification from the directors that they disagree with the auditors contention that the financial statements are misstated.
   7.3 a written request by the directors that the audit report not be modified as to do so, may jeopardize important negotiations which are currently underway and which if successful, will significantly benefit shareholders.
   7.4 none on the above.

8. Which of the following statements is ***incorrect***?
   8.1 the auditor has a duty to carry out procedures to identify subsequent events up until the AGM at which the financial statements are accepted by the shareholders.
   8.2 the auditor should request management to provide a written representation that all events occurring subsequent to the date of the financial statements which require adjustment or disclosure, have been adjusted or disclosed.
   8.3 after the financial statements have been issued, the auditor has no obligation to make any enquiry regarding those financial statements.
   8.4 if the auditor believes that it is necessary to prevent further reliance on his audit report, he may address the shareholders at the AGM.

9. Timberdoor (Pty) Ltd has a 28 February 2017 year end. On 15 April during the post reporting period, the directors declared a dividend of R1.5 million for ordinary shareholders. The appropriate accounting treatment would be to

9.1 adjust the financial statements at 28 February 2017 for the amount of the dividend.
9.2 disclose the declaration in the notes to the AFS.
9.3 disclose the declaration in the Chairman's Report.
9.4 ignore the dividend with regard to the 28 February 2017 financial statements.

10. The auditor should sign his audit report
    10.1 once the annual financial statements have been discussed and accepted by the shareholders.
    10.2 as instructed by the audit committee.
    10.3 once he has obtained sufficient appropriate evidence on which to base his opinion.
    10.4 before the directors have signed the financial statements to assert that they have taken responsibility for those financial statements.

14.3 **(25 marks 30 minutes)**

Hitten Amla is a first year trainee accountant with Keep & Co, a large firm of auditors.

Willie Wicket, the manager in charge of the "Private Company Audit Division" (PCAD) has summoned Hitten Amla to his office, accused him of incompetence and threatened to have his training contract cancelled. The reason for his outburst is that Bails Away (Pty) Ltd, a client company has just been declared insolvent and it is less than a month since Keep and Co issued the company with an unqualified audit report based on the audit work Hitten Amla performed. The relevant facts are as follows:

During mid-September, Willie Wicket had assigned Hitten Amla to do the audit of Bails Away (Pty) Ltd. He had informed him that it was a small audit which had always run very smoothly in the past and was therefore ideal for Hitten Amla's first "solo audit". He added that as it was an audit required in terms of the company's Memorandum of Incorporation and not in terms of the company's public interest score, it wasn't that important. He had explained that Carol Dullinan, an experienced member of the PCAD had performed the audit for the past five years, but had recently left the firm for an extended holiday in the Far East. He had concluded the briefing by suggesting that as long as Hitten Amla followed her work papers for the previous year, he should have no problem with the audit.

Hitten Amla had been somewhat concerned to discover that Carol Dullinan did not appear to have completed the standard audit programmes that the firm normally used on audit, as no such programmes could be found on the prior year audit files. On querying this with Willie Wicket, he had informed Hitten Amla that for small clients like Bails Away (Pty) Ltd, it was often not worth wasting time working through the standard audit programmes because so many of the standard procedures were not relevant or necessary. He had repeated that Carol Dullinan's work papers should be followed as this would be the most efficient way for Hitten Amla to determine what audit procedures were necessary.

As Hitten Amla had proceeded with the audit, he had realised that it was easier than he had originally anticipated. Most of Carol Dullinan's procedures had been analytical reviews and many of the figures in the financial statements required little more audit work than to add the comment "Appears reasonable - accept".

Once Hitten Amla had done what he could, he had telephoned Willie Wicket for further instructions. "Any problems?" Willie Wicket had asked. When Hitten Amla had answered "Not that I am aware of", he had instructed Hitten Amla to get the financial statements (including an unqualified audit report) printed and bound by the PCAD secretary and mark them for his attention. Hitten Amla had not heard any more from Willie Wicket as regards this audit until being summoned to his office.

Willie Wicket is now blaming Hitten Amla for not having identified that Donald Allen, a major shareholder and a director of Bails Away (Pty) Ltd, in a desperate attempt to prevent the inevitable liquidation of the company, had acted as follows:

1. Overstated inventories to the extent that the inventory records showed 1 000 bales more wool than it was physically possible to fit into the company's warehouse.

2. Made changes to accounting policies during the current year which individually were not material but which in aggregate resulted in a substantial overstatement of assets. These changes had not been adequately disclosed in the financial statements. (Hitten Amla had identified some of these overstatements and noted them in the workpapers relating to the assets concerned but had accepted them as immaterial as this had been in line with Carol Dullinan's approach in the previous year).

3. Understated warranty obligations relating to the colour fastness of dyed wool which had been sold. (Hitten Amla had relied on Donald Allen's integrity and experience in accepting this estimate as Carol Dullinan had done so in the previous year).

4. Included some wool sales which were made in the post reporting period in turnover at year end (reporting date). Hitten Amla had identified this but Donald Allen informed him that as the orders for the wool had been placed prior to year end it was acceptable to do so. Hitten Amla had noted this on the workpaper.

YOU ARE REQUIRED TO discuss whether Willie Wicket is justified in accusing Hitten Amla of incompetence. Include in your discussion an evaluation of Willie Wicket's compliance with International Standards on Auditing, where applicable.

14.4 **(10 marks 12 minutes)**

The following events (subsequent events) took place after the reporting period at various audit clients of your firm.

1. The internal audit department discovered (whilst conducting a site visit) that machinery and equipment had, during the financial year under audit, been stolen from the site.

2. A final judgement was given by the court in a case in which the audit client was successfully sued for damages amounting to R5m. At reporting date the client had provided R3m in respect of this claim.

3. The directors announced a plan to discontinue a specific manufacturing operation as a result of an explosion at the audit client's factory (after the financial year-end).

4. Due to escalating fuel prices, Transrail Ltd disposed of a major subsidiary which operated a commuter bus service.

5. The company has a 28 February 2017 year end. An inventory item included in the year end inventory balance at R200 000, was sold for R150 000 in March 2017. This particular item had been damaged in a flooding of the company's warehouse in January 2017.

6. The company declared a dividend of 25c per share to its ordinary shareholders.

7. At an emergency meeting held after the reporting date, the directors, having carried out a comprehensive assessment, accepted that the company was no longer a going concern. The decision was a direct result of the sudden collapse of the company's market in the Middle East.

8. The Board of Directors took the decision to terminate the employment of two of its senior executives. The two executives have agreed to accept the termination with a severance package of R2m each, payable in three months time.

YOU ARE REQUIRED TO:

a) distinguish between the two types of subsequent event. (2)

b) classify with a brief reason, each of the subsequent events (1 – 8) according to the type you identified in (a) above. (8)
Consider all matters to be material.

14.5 **(25 marks 30 minutes)**

Each of the following ***unrelated*** subsequent events took place at various audit clients of your firm:

1. Legislation was passed which immediately lifted import restrictions on the type of product sold by your client Rubtek (Pty) Ltd. Within a short period, demand for your client's product dropped as the market was flooded with cheap imports of a similar product from China. Rubtek (Pty) Ltd were forced to drop the selling price of its product drastically. (4)

2. The share price of Anglometal Ltd fell sharply on the JSE declining by nearly 30% on the share price at 31 March 2017. At its financial year end, 31 March 2017, your client Conveyers (Pty) Ltd, a manufacturing company held shares in Anglometal Ltd as a long term investment. (3)

3. A major design defect was discovered in the safety mechanisms of a number of panel presses manufactured and sold by your client Giantpress (Pty) Ltd. This will result in

recalls and modifications having to be made. The directors are also of the opinion that a number of lawsuits may follow. All presses must be sold with a safety guarantee. (3)

4. An explosion at your client's premises shortly after year end resulted in the impairment of an expensive piece of manufacturing equipment. The directors took the decision to account for the impairment at 31 March 2017, the company's financial year end. (3)

5. A major debtor of Medipowder (Pty) Ltd, one of your clients, was declared insolvent after the company's financial year end of 31 March 2017. Medipowder (Pty) Ltd anticipated this and had included an amount equal to 50% of the debt in the allowance for bad debts at year end. Early estimates from the liquidator are that creditors will receive only 10% in the rand if they are lucky. (3)

6. Maxmines Ltd a client which operates a mine in a foreign African country, was notified in the post reporting date period that certain non-current assets on the mine had been totally destroyed during drawn out strike action. Although the assets destroyed have been clearly identified, exact details of when they were destroyed have not been established. (3)

7. Shortly after the financial year end, your client Norton (Pty) Ltd, a large engineering company, were advised by their lawyers that a group of 20 employees intend to bring a civil action against the company for failure to provide adequate safety precautions in the workplace. The group of 20 contend that this has left them with impaired hearing. Although no details have been provided, e.g. the amount of the claim, the directors of Norton (Pty) Ltd have indicated that they will contest any action. (3)

8. At a meeting of the directors held three weeks after the financial year end 31 March 2017, a decision was taken to propose a dividend for the financial year 2017 of R7.50 a share. The dividend must be approved at the AGM to be held on 1 May 2017. (3)

YOU ARE REQUIRED TO indicate, giving reasons, how each of the above (1 to 8) should be treated, if at all, in the financial statements of the respective companies.

14.6 **(20 marks 24 minutes)**

You are the senior on the audit of Weston (Pty) Ltd, a large manufacturing company. The company is efficiently run and has a sound management reporting system in operation. It has a head office and manufacturing plant in Cape Town and manufacturing plants in East London and Durban.

You have just completed your identification of subsequent events for the financial year end 28 February 2017, and have made the following notes:-

1. On the 31 March 2017 an incentive bonus of R1.8m was paid out to employees. This arose out of an agreement with the union that should a particular production target be met by the manufacturing plant at 28 February, the bonus would become payable. The complicated computations to determine the amounts to be paid were completed for all

employees at the Durban plant by 20 March and the amount (R1.8m) was paid out on 31 March. You were not aware of the agreement until you had conducted your identification of subsequent events. (7)

2. On 1 August 2016 Weston (Pty) Ltd brought an action against another manufacturing company. The company alleged that Cordfit (Pty) Ltd has been manufacturing a product for which Weston (Pty) Ltd has the exclusive licence to manufacture. On 20 March 2017 Weston (Pty) Ltd's lawyers informed the company that Cordfit (Pty) Ltd had made an offer of R2.5 million as an out-of-court settlement. The directors of Weston (Pty) Ltd had decided to accept the offer at a directors meeting held on 1 April 2017. (8)

3. On 4 March 2017 a fault in the automatic fire extinguishing system had caused the water sprinklers to come on. This has destroyed raw materials inventory used for packaging. The sprinkler system had been installed in October 2016 but the inventory insurance policy had never been amended to cover damage to inventory by accidental operation of the sprinkler system. Although the value of the inventory was material, no disruption to production is envisaged. The company which supplied the system will not accept responsibility. (5)

The directors of Weston (Pty) Ltd are willing to comply with your advice concerning the treatment of the above matters as they wish to comply fully with financial reporting standards and to make their financial statements as informative as possible. Your reporting deadline is 15 April 2017.

YOU ARE REQUIRED TO state the further procedures you would carry out in respect of the above matters and indicate, with reasons, how each matter should be treated in the 2017 year-end financial statements. Assume that all matters are material.

14.7 **(25 marks 30 minutes)**

In the portfolio of clients for which you are responsible at your audit firm, are a number of companies which have 31 December financial year-ends.

In carrying out the subsequent events review during the first week of February at these clients for the financial year ended 31 December 2016, you identified the following ***unrelated*** matters:

1. During October a new truck valued at R580 000 belonging to one of your clients, Roadcarry (Pty) Ltd had been hijacked whilst on a delivery. The truck which was insured has not been seen since. The financial director wrote the vehicle off at 31 December, recognised the small loss that was anticipated when taking into account the expected payout from the insurance company and raised the insurance company as a debtor. You were satisfied with this treatment. However late in January the insurance company notified Roadcarry (Pty) Ltd that they would not be paying out any amount in respect of the hijacked vehicle as their investigation had suggested that the driver of the hijacked vehicle had been involved. The driver who was an employee of Roadcarry (Pty) Ltd resigned from the company shortly after the incident. The

company had referred the matter to its lawyers who have indicated that in terms of a strict interpretation of the insurance policy, the insurance company may be within its rights, but they recommended that the matter be taken to court. Roadcarry (Pty) Ltd has agreed to this. (5)

2. During the first week of February 2017 your client B M Car Manufacturers Ltd issued a notice in the press recalling all the units sold of a model which was launched during September 2016. A defect in the rear axles of this model had been brought about by a robot malfunction in the assembly of the vehicle of which the company had been unaware until late in January 2017. Modifications to the rear axels of all vehicles of this model will need to be carried out. (5)

3. One of your clients, Ausum Trucks Ltd, had during the year made a long-term investment of surplus funds in an investment company Financebond Ltd. Your audit procedures indicated the investment as being secure at 31 December. The directors had concurred with this. Late in January 2017 it was announced in the press that a major fraud (which had been in progress over a number of years) at Financebond Ltd had been exposed and that the company had been suspended from the JSE. Confirmation of this had been obtained from the company but no further details other than that the company is likely to be placed in liquidation, are available. (5)

4. Another of your clients, Sport Fibre (Pty) Ltd, supplies imported resin and glassfibre to manufacturers of canoes, sailboards, yachts and other glass fibre products. At year-end, large inventory of both resin and glassfibre was on hand. On 1 February 2017 certain trading restrictions on resins and glassfibre were lifted causing the cost of these products to drop considerably. (5)

YOU ARE REQUIRED TO:

a) list the procedures commonly performed by auditors to ***identify*** subsequent events. (5)

b) discuss each of the situations above indicating how each matter should be dealt with (if at all) in the financial statements of the various companies at 31 December 2016. (20)

14.8 **(24 marks 29 minutes)**

You are the auditor of Easyliv (Pty) Ltd a company which manufactures a range of small household appliances. The company which has grown steadily and is expected to continue growing, is reasonably profitable recording a net income for the current year of approximately three million rand. Turnover for the year was approximately R24 million. You are commencing your evaluating and concluding procedures for the 31 March 2017 year end audit and have the following unresolved matters to deal with:

1. During the financial year the company paid R600 000 to Raj Reddy, a computer consultant, for computer software which he had developed for Easyliv (Pty) Ltd. This software, which has significantly enhanced the company's computing capabilities, will be owned by Easyliv (Pty) Ltd. The software is expected to meet all of the computing needs of the company for the next three years after which the company's strategic plan

suggests new software will need to be written. The software is compatible with the computer hardware leased by Easyliv (Pty) Ltd. This lease has five years to run after which it may be extended or new hardware leased. The directors have decided to write the R600 000 off in the current year. (5)

2. During the year the company incurred research and development expenditures of R800 000 on the development of a new appliance for waterless cooking. At the end of the 2016 financial year the company had written off R200 000 research costs incurred on the same product as initial market research indicated that there was little demand for the product. However, a series of television programmes on the benefits of waterless cooking had sparked a huge interest by the public and Easyliv (Pty) Ltd had immediately recommenced the research and development programme on their product as a matter of priority. The directors reversed the R200 000 written off at the end of 2016 and have decided to write the total of R1 000 000 off over the next 5 years. (10)

3. During the year Easyliv (Pty) Ltd was sued for R400 000 by one of the appliance retailers it supplied for breach of contract. Correspondence between the retailer and Easyliv (Pty) Ltd's lawyers indicate that the retailer will accept an out of court settlement of R250 000. The lawyers believe that this is a realistic amount and should be accepted. However, the directors of Easyliv (Pty) Ltd have chosen to disclose by note, a contingent liability of only R50 000 as they believe that "if we just sit it out" the retailer will eventually accept R50 000. Legal fees are estimated at R25 000 for work already carried out but not yet billed by the company's lawyers. (5)

4. For a number of years Easyliv (Pty) Ltd has supplied a range of appliances (the "Easy" range) to a single chain of retail stores. This contract has traditionally made up about 30% of Easyliv (Pty) Ltd's total sales but the contribution to profits is only around 12% of net income as the range is priced for the lower income bracket. During the current financial year, the retail chain which Easyliv (Pty) Ltd supplies, was bought out by another chain which markets its own range of appliances. This chain has informed Easyliv (Pty) Ltd that they will phase out the "Easy" range. The directors have not been able to establish another retail outlet for the "Easy" range. (4)

YOU ARE REQUIRED TO discuss how the above matters should be treated in the financial statements at 31 March 2017.

14.9 (33 marks 40 minutes)

You are the senior in charge of the recently completed 28 February 2017 audit of Masterheat (Pty) Ltd, a medium-sized company involved in the heating and cooling industry. The company does not have an internal audit section or an audit committee. The company supplies electric/gas heaters, air-conditioning etc. During the audit, you had found the senior financial staff to be slightly unco-operative but you had put this down to the fact that the company had not had a particularly good business year. You also got the impression that the financial director was in a rush to get the audit completed and the financial statements and audit report signed and sent to the company's shareholders, loan finance providers and the bank.

Besides this strange atmosphere which you sensed, you were able to carry out the procedures you deemed necessary and all outstanding audit matters were resolved. The financial statements and audit report were signed off by the financial director, the chief executive officer and the engagement partner on the 15 April 2017, and distributed to users that afternoon.

The week after the financial statements were signed, you returned to Masterheat (Pty) Ltd to finish off one or two things and were very surprised to be approached by the financial manager who indicated that he needed to discuss an audit matter with you in private. He informed you that there had been some deliberate manipulation of the financial statements which he wanted you to know about as it had been "done with good intentions and nobody got hurt". He went on to explain that one of the company's loan finance providers had clauses in its loan agreement with Masterheat (Pty) Ltd which enabled the finance provider to elect to have its loan repaid immediately if the audited annual financial statements did not reflect certain ratios and percentages. Unfortunately, because the company had not had a particularly good trading year, the specified ratios and percentages would not have been achieved unless the financial statements were manipulated.

At this point you asked him how the financial statements had been manipulated and he responded as follows :

> "We overstated sales and debtors by manipulating cut-off at year-end to include some sales made in March in the February sales and debtors figures, as well as creating a few fictitious sales to related parties. We also overstated inventory and didn't record some of the amounts owed to trade creditors at year-end. Having been auditors ourselves, we had a reasonable idea of what procedures you and your team would be carrying out and what you would be looking for. Although the financial misstatements are probably materially misstated overall we made sure that individual account headings were not materially misstated. You may have noticed that we were all a little tense. Anyway, we are expecting a good profitable year this year, so there is no likelihood of this happening again or the investor suffering any loss. As you know, the audited financial statements have been sent to all the interested parties and we hope the matter can rest. The financial director is aware that I have spoken to you and we hope that you will keep it confidential. We won't be conveying this information to your manager or engagement partner, or anyone else for that matter, so you and your audit team will not have anything to answer for with regard to your audit".

YOU ARE REQUIRED TO:

a) explain giving reasons, whether you would "keep this matter confidential" or whether you would notify your manager and/or the engagement partner. (8)

b) discuss whether you and your team could justifiably be accused of failing to carry out risk assessment and further audit procedures properly. (7)

c) discuss whether the audit manager could justifiably be accused of failing to conduct the evaluation and concluding procedures properly. (4)

d) discuss whether the manipulation of the financial statements constitutes a reportable irregularity. (8)

e) discuss whether the annual financial statements at 28 February 2017, should be revised, and explain the action which your firm will take should the directors refuse to revise them, which is what your engagement partner believes will happen. (6)

14.10 **(19 marks 23 minutes)**

You are the senior in charge of the audit of Superfood (Pty) Ltd, a company which operates a number of supermarkets. The financial statements reflect a pre-tax profit of nearly R14 million for the year. You have completed most of the audit work and are assisting the audit manager with the final evaluation so that the appropriate audit report can be drawn up. Your firm's policy is to consider contingent liability disclosure as part of the final evaluation and he has asked you to deal with Note 15 which is shown below.

Note 15 – Contingent liability
The company has been sued by two customers who suffered serious injuries whilst shopping in one of the company's stores. A rack containing tinned goods collapsed on one of the customers resulting in a severe spinal injury. The second customer was permanently blinded in one eye when a piece of glass entered her eye, from a bottle broken in the collapse of a rack. The total amount for which the company is being sued is R5 million. It is unclear when the matter will be settled or what amount may be awarded as damages. For various reasons it is uncertain whether any damages awarded in this case will be covered wholly or partially by the company's insurance if the complainants are successful.

YOU ARE REQUIRED TO:

a) discuss the assertions which relate to the contingent liability above. (5)

b) outline what information should be provided when disclosing a contingent liability. (3)

c) indicate whether in this case it would not be better to make a provision for R5 million in the financial statements at year end in view of the fact that the accident happened prior to year end. Justify your answer. (3)

d) describe the substantive audit procedures you would conduct in respect of the assertions relating to the disclosure of this contingent liability. (6)

e) comment on whether this particular matter could not simply be ignored for financial reporting purposes. (2)

14.11 **(15 marks 18 minutes)**

1. In terms of ISA 570 (Revised) - Going Concern, the adoption of the going concern basis of accounting in the preparation of the annual financial statements means ...? (2)

2. What are the objectives of the auditor when conducting audit procedures relating to the going concern assumption? (2)

3. Is going concern an assertion? Justify. (2)

4. If the auditor issues an unmodified report on the annual financial statements, can a user take this as a guarantee that the company will remain a going concern for the foreseeable future? Justify. (2)

5. Para 10 of ISA 570 (Revised) states that "the auditor shall, when performing risk assessment procedures as required by ISA 315 (Revised), consider whether there are events or conditions that may cast significant doubt on the entity's ability to continue as a going concern". Is the risk assessment stage of the audit the only stage during the audit that the auditor needs to consider the going concern ability of the company? Justify. (3)

6. If management (the directors) have already performed an assessment of their company's going concern ability, is it necessary for the auditor to perform an assessment of going concern? Justify. (2)

7. What is a mitigating factor? (1)

8. If the financial statements are prepared on the going concern basis and the auditor is satisfied that this basis is ***inappropriate***, what type of audit opinion should the auditor give? (1)

14.12 **(27 marks 33 minutes)**

You are responsible for the audit of Swytch (Pty) Ltd, a small company which tenders for contracts to supply (and install) electrical fittings on mass housing projects. Swytch (Pty) Ltd does not have the resources to install the fittings and therefore sub-contracts installation to Litefit CC. Although Swytch (Pty) Ltd does not have a public interest score which requires that it have its financial statements audited, Ray Bright its major shareholder who is not involved in the day-to-day running of the business, requires that a proper set of financial statements be drawn up each year and that they are externally audited for use if needed by the bank and SARS. On commencing the audit for the year end 28 February 2017 you were concerned to find that the company's trading position had worsened significantly since the previous year. The previous year's financial statements had shown a small profit and a small amount of retained earnings. The current situation is reflected in the draft statement of financial position at 28 February 2017 shown below:

		2017 '000
ASSETS		
Non-current assets		
Property, equipment and vehicles	Note 5	1 188
Investment (unlisted)	Note 4	200
Current assets		5 902
Inventory Trade Receivables Cash		1 526 4 376 -
Total assets		7 290
EQUITY AND LIABILITIES		
Share capital		1 000
Accumulated loss		(639)
Non-current liabilities		
Long term loan		500
Current liabilities		6 429
Trade payables Bank overdraft		4 902 1 527
Total equity and liabilities		7 290

Note 1: The long-term liability represents a 13% unsecured loan made to the company by Ray Bright who also holds 70% of the share capital. The balance of the shares are held by the two directors of Swytch (Pty) Ltd. As indicated above Ray Bright is not a director and does not play an active role in the business.

Note 2: The directors are currently negotiating to have the overdraft limit of R1.5 million increased. The bank overdraft is currently secured by the company's non current assets and guarantees from Ray Bright in his personal capacity.

Note 3: An amount of R213 816 included in creditors is still owed to Litefit CC, the electrical contractors who Swytch (Pty) Ltd sub-contracts to install the fittings which Swytch (Pty) Ltd supply. At balance sheet date this debt was already 120 days overdue, and Litefit CC is pressing for payment.

Note 4: The unlisted investment represents a 10% holding purchased in 1998 in Kablex (Pty) Ltd, which manufactures electrical cable. The fair value of this investment is about R500 000 at 28 February 2017. (The financial records have not been adjusted to reflect the fair value of the investment but the adjustment will take place prior to the final preparation of the AFS.)

Note 5: The non-current assets all fairly valued, are made up as follows:

Small storage facility in a business park	R850 000
Fittings and Office equipment	38 000
2 Izuzu Bakkies	300 000
	R1 188 000

Other information:

1. The company operates a simple but efficient cash forecasting and management reporting system.

2. The market for mass housing is expected to increase steadily as a result of the government's intentions, but is expected to remain very competitive.

3. The company's lawyers are currently trying to settle a dispute with a construction company which claims that defective light fittings supplied by Swytch (Pty) Ltd resulted in fire damage to six newly erected houses.

4. Swytch (Pty) Ltd experiences great difficulty in obtaining payment for completed contracts mainly because they have to deal with provincial and local authorities, and do not have the administrative staff to constantly follow up outstanding payments.

5. At reporting date the company had submitted a number of tenders for provincial housing contracts.

Whilst you were finalizing the audit, Shawn Gregg, a director of Swytch (Pty) Ltd phoned to inform you that the company had been awarded one of the provincial housing contracts for which it had tendered. This, he felt, would assure the "future of the company".

YOU ARE REQUIRED TO:

a) discuss whether the presentation of the financial statements on the going concern basis is appropriate for the financial year end 28 February 2017. (You are not required to reach a conclusion). (20)

b) state, briefly, the enquiries you would make of Shawn Gregg to determine whether the awarding of the contract would have any affect on your going concern evaluation. (You are not required to go into detail.) (7)

14.13 **(25 marks 30 minutes)**

You are the auditor of Boardroom (Pty) Ltd a company which supplies expensive office furniture. The company operates out of rented premises. You are currently (May) working on the 31 March 2017 year-end audit and have been given the following abridged draft statement of financial position at 31 March 2017 by the financial manager.

	Note	2017
		R'000
Assets		11 355
Non-current assets		4 095
Office furniture and Equipment	4	845
Investments	2	3 250
Current assets		7 260
Inventory		2 833
Trade receivables		4 427
Equity and Liabilities		11 355
Issued share capital		1 500
Reserves – accumulated loss		(680)
Non-current liabilities		1 600
Long term borrowings	1	1 600
Current liabilities		8 935
Trade payables		6 920
Bank overdraft	3	1 615
Current portion of long term loan		400

Note 1. The long-term borrowing is a loan from Fundbank at 13% payable in arrears. The loan of R2 million is payable in 5 annual instalments, the first of which is due on 1 June 2017. The loan is secured by non-current assets to the value of R400 000 and by a cession of the book debts for the balance.

Note 2. Investments are as follows

- 10% holding in Maxichair (Pty) Ltd, a local company which manufactures unique office chairs solely for Boardroom (Pty) Ltd.
- A 15% holding in Coolfloor (Pty) Ltd, a carpeting and flooring manufacturing company.

The amount of R3.5 million reflected in the draft statement of financial position is the directors fair valuation at 31 March 2016 (previous financial year end).

Note 3. The overdraft has a limit of R1.5 million and is secured by a notarial bond over inventory.

Note 4. The company uses the cost model for its "office furniture and equipment" and the value of R845 000 is fair.

The following additional information is available:

1. The office furniture market is very competitive.

2. The former sales director of Boardroom (Pty) Ltd left the company during the current financial year and has gone into direct competition with Boardroom (Pty) Ltd. Boardroom (Pty) Ltd has instituted restraint of trade proceedings against him. The

sales director has filed a lawsuit against Boardroom (Pty) Ltd for R4 million alleging unfair dismissal.

3. Maxichair (Pty) Ltd has been closed down by strike action for some months and its continued existence is severely threatened. Boardroom (Pty) Ltd is awaiting a large consignment of chairs to be supplied to a customer in terms of a contract. Should Maxichair (Pty) Ltd be liquidated, the shareholders (including Boardroom (Pty) Ltd) are expected to receive a minimal amount.

4. Coolfloor (Pty) Ltd is experiencing a boom and is in the process of raising finance to fund a factory expansion programme.

5. Accounts receivable include an amount of R500 000 owed by an office developer, Space Place CC, to whom Boardroom (Pty) Ltd supplied furniture. This developer has recently been placed under business rescue and it is uncertain whether the debt will be settled. No allowance has been made in the books for any potential loss. Boardroom (Pty) Ltd do not hold any form of security over this debt.

6. None of the shareholders of Boardroom (Pty) Ltd have additional funds to invest in the company.

7. Other than where indicated above, accounts receivable and inventory are fairly presented in the draft statement of financial position.

YOU ARE REQUIRED TO discuss the additional information/evidence you would gather to enable you to form an opinion on the appropriateness of preparing the annual financial statements at 31 March 2017 on the going concern basis. Your discussion should include the reasons for requiring the specific information/evidence.

14.14 **(25 marks 30 minutes)**

You are the auditor of Housefashion (Pty) Ltd, an upmarket interior decorating business. The company is 60% owned by Interiors Ltd, a listed company and has a 31 March year end.

Early in the post-reporting date period, the developers of a luxury hotel complex on the KwaZuluNatal South Coast went insolvent and fled the country, owing creditors in excess of 36 million rand. R4.2 million of this amount was owed to Housefashion (Pty) Ltd. An early estimate from the liquidators of the development company has indicated that creditors cannot expect more than 25 cents in the rand and that settlement is likely to take many months if not years.

Should Housefashion (Pty) Ltd write off 75% of the R4.2 million owed, it will place the company in a situation where its assets fairly valued are exceeded by its liabilities.

At a meeting with the directors of Housefashion (Pty) Ltd about this matter held in May 2017, the following views were expressed:

Brent Bonnow the managing director, felt that the matter was of no concern for the current audit as the problem arose after the reporting date (31 March 2017), but would be addressed by the company in the financial year 31 March 2018.

Fred Fulcrum the financial director, concurred but suggested that if you, as auditor, would feel happier, and consequently give an unmodified report he would request that Interiors Ltd subordinate their loan account of R3 million in Housefashion (Pty) Ltd.

Fanie Greyling, the financial director of Interiors Ltd who was at the meeting indicated that Interiors Ltd would be prepared to subordinate its loan for a short period if you (as auditor) insisted.

YOU ARE REQUIRED TO:

a) discuss whether the opinion of the managing director is valid, (7)

b) discuss the audit procedures you will carry out in respect of the subordination agreement should Housefashion (Pty) Ltd write off 75% of the amount owed by the developer and should Interiors Ltd agree to subordinate their loan to Housefashion (Pty) Ltd. (15)

c) comment on the audit report your firm would give if you were satisfied the going concern basis of accounting was appropriate for the presentation of the financial statements, as a result of the subordination agreement and that proper disclosure of the material uncertainty had been made. (3)

CHAPTER 15

REPORTS

15.1 **(10 marks 12 minutes)**

Select the appropriate answer to the following:

1. The title of the audit report (Independent Auditor's Report) includes the word "Independent" to
   - 1.1 signify that the audit is an assurance engagement
   - 1.2 enhance the credibility of the report by emphasising the independence of the auditor
   - 1.3 distinguish it from the report of the internal auditors contained in the financial statements
   - 1.4 limit the auditor's liability should the audit report prove to be inappropriate.

2. The annual audit report for a listed company will be addressed to
   - 2.1 the audit committee
   - 2.2 the shareholders
   - 2.3 the chairman of the board
   - 2.4 the chief audit executive.

3. The audit report does ***not*** provide an opinion on
   - 3.1 the fair presentation of the financial position of the company
   - 3.2 the fair presentation of the cash flows of the company
   - 3.3 the effectiveness of the company's internal control
   - 3.4 the fair presentation of the company's financial performance.

4. When signing off the audit report, the terms "registered auditor" and "chartered accountant (SA)" must be included. True or false? Justify.

5. The auditor may need to modify his audit ***opinion*** because
   - 5.1 there is a disclosure in the financial statements which must be brought to the attention of users due to its importance
   - 5.2 the budget for the audit was exceeded
   - 5.3 there are uncorrected misstatements that are material to fair presentation
   - 5.4 none of the above.

6. Which of the following will result in a disclaimer of opinion in the audit report?
   - 6.1 the selected accounting policies result in pervasive misstatement because they are inappropriate
   - 6.2 the selected accounting policies have been appropriately selected but result in pervasive misstatement because they have not been applied in terms of the applicable standard.
   - 6.3 significant limitations have been placed on the auditor by the client's management
   - 6.4 none of the above.

7. Which of the following will result in an adverse opinion in the audit report?
   - 7.1 a disclosure which has a material affect on fair presentation, has been omitted from the financial statements
   - 7.2 the auditor wishes to draw the attention of users to a very important matter which is disclosed in the notes

7.3 the selected accounting policies result in pervasive misstatement because they are inappropriate
7.4 the auditor is unable to obtain sufficient appropriate audit evidence due to circumstances beyond his control.

8. Which of the following combinations is possible in the same audit report on the financial statements as a whole?
   8.1 an adverse opinion and a disclaimer of opinion
   8.2 an "except for" qualification based on disagreement and a disclaimer of opinion
   8.3 an "except for" qualification based on disagreement and an adverse opinion
   8.4 two "except for" qualifications, one based on a limitation of the auditor's scope and the other on a disagreement.

9. Where an "emphasis of matter" paragraph is included in the audit report it will contain, inter alia, the following wording
   9.1 in our opinion, the following matter requires emphasis…..
   9.2 our opinion is not modified in respect of this matter, …..
   9.3 as explained in the auditor's responsibility paragraph above, …..
   9.4 the following matter forms part of our audit opinion …..

10. With regard to ***other information*** in documents containing audited financial statements, e.g. a group report
   10.1 the auditor has no responsibility
   10.2 the auditor has a responsibility to conduct audit procedures appropriate to determine whether the other information is fairly presented
   10.3 the auditor has a duty to test the other information to confirm that the information is factually correct
   10.4 the auditor has a duty to read the other information with the intention of identifying material inconsistencies between the other information and the financial statements.

15.2 **(15 marks 18 minutes)**

YOU ARE REQUIRED TO select the most appropriate answer to each of the following:

1. Where a registered auditor has conducted the audit of a private company and is required to give a qualified opinion, the title of his audit report will be:
   1.1 Qualified Report of the Independent Auditor.
   1.2 Independent Auditor's Report.
   1.3 Qualified Auditor's Report.
   1.4 Modified Auditor's Report.

2. Where a registered auditor has conducted a review of a private company's annual financial statements, his report will be titled:
   2.1 Independent practitioner's report.
   2.2 Report of the registered auditor and accountant.
   2.3 Independent reviewer's report.
   2.4 Report of the independent accounting professional.

3. Which of the following sections will ***not*** be included in a qualified audit report for a private company:
   3.1 Key audit matters section.
   3.2 Other Information section.
   3.3 Opinion section.
   3.4 Basis for qualified opinion section.

4. An emphasis of matter paragraph may be included in the audit report of a listed company as a substitute for a qualification provided:
   4.1 the audit committee agrees.
   4.2 the qualification is not considered to be material.
   4.3 proper disclosure of the matter giving rise to the qualification is made in the notes.
   4.4 none of the above 4.1 to 4.3.

5. In terms of the Companies Act, a private company must have its annual financial statements audited:
   5.1 if it compiles its financial statement internally.
   5.2 if it compiles its financial statement internally and has a public interest score of 100 to 349.
   5.3 if it has its financial statements internally compiled and has a public interest score below 100.
   5.4 if it has its financial statements externally compiled and has a public interest score of 100 to 349.

6. The financial statements on which the auditor expresses an opinion comprise the statements of financial position, the statements of profit and loss and other comprehensive income, changes in equity and cash flows as well as:
   6.1 the chairman's report and other explanatory information.
   6.2 the audit committee's report and company secretary's certificate.
   6.3 notes to the financial statements including a summary of significant accounting policies.
   6.4 the directors report and the summary of significant accounting policies.

7. The audit report should be signed by:
   7.1 the senior partner of the auditing firm.
   7.2 the designated auditor.
   7.3 the designated auditor and the senior partner of the firm.
   7.4 the designated auditor and the chairman of the audit committee.

8. The independent review engagement report does ***not*** express a conclusion on:
   8.1 management's responsibility for appropriate internal controls.
   8.2 the fair presentation of the financial position of the company.
   8.3 the fair presentation of the company's financial performance.
   8.4 the fair presentation of the company's cash flows.

9. Which of the following is ***not*** regarded as an assurance engagement:
   9.1 a review of a set of annual financial statements.
   9.2 an audit of a set of annual financial statements.
   9.3 a review of interim financial information.
   9.4 an agreed upon procedures engagement.

10. The report provided by the ***auditor*** on a set of annual financial statements provides the user with:
    10.1 limited assurance.
    10.2 moderate assurance.
    10.3 reasonable assurance.
    10.4 unrestricted assurance.

11. The report provided by the ***reviewer*** of a set of annual financial statements provides the user with:
    11.1 limited assurance.
    11.2 reasonable assurance.
    11.3 restricted assurance.
    11.4 low assurance.

12. Which of the following will ***not*** result in a modification of the audit opinion:
    12.1 the auditor is unable to obtain sufficient evidence.
    12.2 the client has made inadequate and incomplete disclosures in the notes.
    12.3 a situation has arisen requiring an emphasis of matter.
    12.4 the client has selected an appropriate accounting policy but has applied it incorrectly.

13. A misstatement in inventory, the effect of which the auditor considers to be material and pervasive, will result in:
    13.1 a disclaimer of opinion.
    13.2 an except for qualification.
    13.3 an adverse opinion.
    13.4 an emphasis of matter and an adverse opinion.

14. Where the auditor has been denied access to information, the effect of which the auditor considers could be material, he will give:
    14.1 an except for opinion.
    14.2 an adverse opinion.
    14.3 a disclaimer of opinion.
    14.4 an emphasis of matter.

15. Which of the following combinations is possible in the same audit report on the financial statements as a whole:
    15.1 an ″except for″ opinion and an emphasis of matter.
    15.2 an adverse opinion and an except for opinion.
    15.3 an adverse opinion and a disclaimer of opinion.
    15.4 an ″except for″ and a disclaimer of opinion.

15.3 **(20 marks 24 minutes)**

Consider the following statements:

1. Annual audit reports for listed companies are addressed to the shareholders or to the audit committee, whilst annual audit reports for private companies are addressed to the directors.

2. The auditor may give an unmodified audit opinion where a modified audit opinion is required if, with the consent of the directors, he (the auditor) addresses the matter which gave rise to the need to modify the audit opinion at the annual general meeting. This applies only to private companies.

3. Where the only unresolved audit matter relates to inadequate disclosure, albeit material inadequate disclosure, the auditor can avoid a qualification by giving an emphasis of matter.

4. An unresolved audit difference (misstatement) which is based on a disagreement with the directors and renders the financial statements fundamentally misleading, must result in an adverse opinion.

5. An except for qualification can be given for a matter arising out of either a scope limitation or a disagreement with the directors.

6. To avoid a qualification of the audit report the auditor can adjust the financial statements if the directors refuse, provided the shareholders agree. If this occurs an "Other matter" paragraph must be added to the audit report.

7. The auditor has no responsibilities in respect of information contained in an annual report other than the information he must report on in terms of the Companies Act.

8. The audit report should not be signed prior to the date on which the directors sign the financial statements.

9. If the auditor ends up with two unresolved audit differences, both of which are material and pervasive, but one is based on a limitation of scope (inability to obtain sufficient appropriate evidence) and the other is based on a disagreement (misstatement), the auditor should give an adverse opinion and not a disclaimer of opinion.

10. Key audit matters must be communicated to shareholders for all companies with public interest scores in excess of 350.

YOU ARE REQUIRED TO state, giving reasons, whether each of the above statements is true or false.

15.4 **(12 marks 14 minutes)**

Circumstance	*Nature*	*Material/pervasive*	*Opinion*
1. No cash sales records		Material and Pervasive	
2. Deferred tax policy inappropriately applied			Except for
3. Inventory stated at replacement cost		Material and Pervasive	
4. Going concern dependent on award of contract; adequate disclosure made		Material	
5. Misclassification of liabilities			Except for
6. Finance leases accounted for as operating leases			Adverse
7. Insufficient evidence relating to capitalization of intangible asset development costs			Except for
8. Non-disclosure of subsequent event		Material	

YOU ARE REQUIRED TO complete the chart given above. Consider each circumstance separately.

15.5 **(16 marks 19 minutes)**

You are the partner in charge of the audit of Cordon (Pty) Limited, a large manufacturing company, and are evaluating the audit working papers for the audit year end 31 March 2017 with a view to concluding on your audit opinion. All matters other than those mentioned below, have been satisfactorily resolved.

Matter 1 - Inventory

The company has valued its inventory at replacement cost. In discussion with the directors, who are adamant that the value remain unchanged, they have explained that they intend moving to "fair value" accounting and that by valuing at anticipated replacement prices, the statement of financial position will reflect the real value of inventory. The effect of this decision has been to increase the value of inventory and the profit for the year ended 31 March 2017 by R1 750 000. There is no effect on the taxation figure which is correctly calculated and disclosed.

Matter 2 - Related party transactions

It has been established through scrutiny of the minutes and other documents, that the following related party transactions have not been disclosed in the annual financial statements:

1. Purchase of manufacturing equipment costing R2 million from Billben CC, a close corporation in which Bill Benson, the chief executive officer of Cordon (Pty) Ltd has a 50% member's interest.

2. A supply and maintenance contract with George Grove for Cordon (Pty) Ltd's computer equipment. George Grove is married to Marie Grove, the company's IT director.

YOU ARE REQUIRED to draft the audit report of Cordon (Pty) Limited for the financial year-end 31 March 2017 assuming that both matters 1 and 2 remain unresolved. You are not required to write out the sections dealing with the directors' and auditor's responsibilities or other information.

15.6 **(18 marks 22 minutes)**

You have recently completed the audit of Wearever (Pty) Ltd's debtors for the financial year-end 31 March 2017. You had paid particular attention to the allowance for bad debts and having evaluated all "problem" debtors individually, found that the allowance of R263 510, 10,5% of debtors was fair and consistent with the allowances for the previous four years which had ranged between 10 and 11 percent.
Shortly before your manager was due to review your working papers you conducted a final check of the balance on your debtors lead schedule against the draft financial statements. As all aspects of your audit of debtors had been successfully completed, you were surprised to find that they did not agree. On further investigation you established that subsequent to your audit, the allowance for doubtful debts had been reversed.

Besides increasing current assets, the reversal has resulted in an increase of 8 percent in net profit before taxation. You immediately raised the matter with the financial manager who informed you that "the directors decided to reverse the allowance for bad debts at 31st March and to write off any bad debts as and when they occur in the future. As far as we are concerned this is consistent with trends in current accounting theory which aims at fair value accounting".

When you met with your manager to discuss this matter, he decided to take the opportunity to give you some "on the job training" by posing the following questions:

a) What is the justification behind your view that our audit report must be modified? (4)

b) I agree that we need to address the matter in the audit report but must we qualify our audit opinion or can we give an emphasis of matter? Can you explain your answer please? (3)

c) If this matter was immaterial we could ignore it for reporting purposes, so what indications do you have that

1. it is not immaterial (i.e. it is material)? (2)
2 . it is not actually material and pervasive? (3)

d) Do you regard this as a factual misstatement or a judgemental misstatement? (3)

e) What will the opening phrase in your opinion paragraph be? (1)

f) Do we need to include a Key Audit Matters section in the audit report? Can you explain your answer please? (2)

YOU ARE REQUIRED TO respond to the questions put to you by your manager.

15.7 **(20 marks 24 minutes)**

Your firm holds the appointment of auditor of Citysun Hotels (Pty) Ltd. At a directors meeting held shortly before the financial year end 28 February 2017, the directors took a decision to sell the company's minority interest in Eastern Caterers (Pty) Ltd for an amount of R10 million. They also decided to have a share rights issue which would raise a further R5 million. Despite having incurred a trading loss of R2.9 million for the current year, the going concern ability of the company is not under threat regardless of whether the sale of the investment and the rights issue are successful.

Shortly after the year end the directors notified the majority shareholder of Eastern Caterers (Pty) Ltd of their intention to sell the Citysun Hotels (Pty) Ltd investment, and the majority shareholder expressed an interest in purchasing the shares as it would give them 100% ownership of Eastern Caterers (Pty) Ltd. Despite the fact that the investment was reflected in Citysun Hotels (Pty) Ltd's accounting records at a fair value of R6.5 million, the majority shareholder has indicated that it would be prepared to pay a "premium" to obtain 100% control of the company. By the time the audit for the financial year had been completed no formal agreement had been reached. However, the directors of Citysun Hotels (Pty) Ltd had adjusted the financial statements at 28 February 2017 to reflect the sale of the investment at R10 million and had also adjusted the financial statements to reflect the proposed rights issue.

On raising your concern about these adjustments with the financial director of Citysun Hotels (Pty) Ltd, he responded as follows "We took these decisions prior to the year end and they are going to happen. We know that the sale of the investment will go through at R10 million as the purchaser is desperate to get full control of the company. Early indications are that the rights issue will be a big success and to make the adjustments to the financial statements at 28 February 2017 will give a fairer view of the company."

YOU ARE REQUIRED TO draft the audit report for the financial statements at 28 February 2017 assuming the directors are not prepared to make any changes to the draft financial statements. You are not required to include the following sections/paragraphs of the audit report in your answer.

1) Other information.
2) Responsibilities of the directors.
3) Auditor's responsibilities.

4) The paragraph in the Basis for Opinion section which commences “We conducted our audit…” and concludes with “........ provide a basis for our opinion”.

You should provide a justification for the report you give.

15.8 **(20 marks 24 minutes)**

You are the auditor of Direct2U (Pty) Ltd, a company which sells children’s toys through its website.

At the financial year end 31 March 2017, Direct2U (Pty) Ltd has valued its inventory at cost. However, your audit procedures have revealed that the net realizable values of some of the company’s product lines have fallen to below cost due to competition in the market place. The directors have ignored this for financial reporting purposes on the grounds that the product lines are still selling (albeit at below cost) and will be phased out when all inventory of these lines have been sold.

In your opinion, the effect of this method of valuation has a material effect of the financial statements. The company prepares its financial statements in terms of IFRS for SMEs.

YOU ARE REQUIRED TO:

a) write the audit report which would be appropriate assuming that Direct2U (Pty) Ltd insisted on valuing its inventory in its annual financial statements at 31 March 2017 as indicated above. Do not concern yourself with the sections dealing with the directors’ and the auditor’s responsibilities, or other information. You are also not required to include the paragraph in the Basis of Opinion section which commences “We conducted our audit …” (16)

b) outline the information which will be conveyed in the other information section for a private company such as Direct2U (Pty) Ltd. (4)

15.9 **(30 marks 36 minutes)**

The following audit report was drafted by a trainee on the audit of Litetech (Pty) Ltd, a company which manufactures lighting systems. The trainee was asked to draft the report at the conclusion of the audit for the financial year end 30 June 2017 as part of “on-the-job” training and as part of your training, you have been asked to evaluate his report. The shareholders of Litetech (Pty) Ltd included a clause in the company’s Memorandum of Incorporation which requires that the company’s annual financial statements are externally audited.

Independent Report
To the board of directors.
We have evaluated the accompanying financial statements of Litetech (Pty) Ltd for fairness based on our annual audit carried out in terms of the Memorandum of Incorporation of the company.

Management is responsible for the preparation of the financial statements and for the prevention of fraud.

The auditor's responsibility is to perform the audit and in doing so, to detect any fraud which may have a material effect on the financial statements not having been prevented by the directors.

We report on the following aspects of the audit:

1. An expert was engaged by our firm to assist in the valuation of work-in-progress. Due to the complexity of some of the company's lighting systems, the risk of misstatement in work-in-progress warranted this.

2. The company is currently being sued by a former employee who suffered personal injury at work whilst testing electric current flow during quality control procedures.

3. With regard to the detection of fraud, we detected a small wage fraud relating to unauthorized overtime. We reported this to management who subsequently dismissed the perpetrators.

In our opinion, except for the matters raised in 1 to 3 above, there are no outstanding issues arising from the audit which was conducted in terms of the International Standards on Auditing and the International Financial Reporting Standards.

Emphasis of matter
There are no matters which require emphasis.

Mayweather and Mosely
30 June 2017
Packia Place
Pretoria

YOU ARE REQUIRED TO detail the errors/deficiencies in the audit report presented to you for evaluation (give explanations where necessary). You are not required to redraft the report.

15.10 **(22 marks 26 minutes)**

You are the engagement partner on the audit of Kleinvlei (Pty) Ltd, a gold mining company in Mpumalanga, for the financial year-end 31 March 2017. At the concluding stage of the audit you are faced with the following matter to resolve:

Early in the financial year under audit the company had come under investigation by government environmental bodies for pumping underground water into a nearby wetland system, causing a great deal of ecological damage. During the year the directors of the mine had made various submissions to these bodies explaining that the only alternative which the mine had, was to construct a water purification plant through which the underground water would be pumped before entering the wetland system. Although this option would prevent further ecological damage, the purification plant would take 18 months to construct and would cost R90 million. This amount was beyond the financial capabilities of the mine unless there were further significant favourable changes to the gold price and exchange rate. The directors explained further, that if the mine is prohibited from pumping its underground water, half of the shafts would be flooded within 6 months, severely threatening the ability of the mine to operate and resulting in the loss of nearly five hundred jobs.

On 10 May 2017 the company was officially notified by the government that the pumping of underground water was to cease within 60 days and that failure to comply would result in the immediate withdrawal of the mine's operating licence, but that they (the government) would consider any further representations from the company.

The directors have decided to present the financial statements on the going concern basis and disclosed this matter in the financial statements which are to be laid before the AGM on 5 June 2017. You have carefully considered the directors' deliberations on the going concern ability of the company but due to the multiple uncertainties, are unable to form an opinion on the appropriateness of the adoption of the going concern basis of accounting.

YOU ARE REQUIRED TO draft the appropriate report for Kleinvlei (Pty) Ltd for the 31 March 2017 financial year-end.

You must show your workings. You are not required to write out the sections dealing with the directors' responsibility or the auditor's responsibilities. All other paragraphs as required by SAAPS 3 (Revised November 2015) should be included in your report.

15.11 **(25 marks 30 minutes)**

You are the auditor of Sparkle Chemicals Ltd which is listed on the JSE. The company manufactures chemicals at five different plants across South Africa. One of the plants, situated in Port Elizabeth, recently commenced the manufacture of a highly toxic chemical used by heavy industry. Two months before year end, two employees working at this plant, died after falling seriously ill. The initial investigation into their deaths suggested that they were victims of chemical poisoning suffered from working with the toxic chemicals. A government investigation was instituted on the 15 January 2017.

At the last board meeting for the current financial year, the board of directors of Sparkle Chemicals Ltd took the decision to close the Port Elizabeth plant (with immediate affect) until the completion of the government investigation. The board also took the decision that should the government investigation indicate that the employees illness and death was directly attributable to their work, the Port Elizabeth plant would remain closed permanently. In addition a firm of attorneys has instituted legal proceedings against Sparkle Chemicals Ltd on behalf of the families of the two employees. You have also established from your client's attorney that should the government investigation connect the employees illness to the company's manufacturing process, the employees' families will in all likelihood, be successful in their action against the company and could receive in excess of R5 million each.

On discussing these matters with the financial director of Sparkle Chemicals Ltd, Fred Mercury, you are informed that the company has decided to treat the matters as follows in the year end 28 February 2017 financial statements.

1) No reference to the temporary or possible permanent closure of the plant will be made. However full disclosure will be made to the shareholders at the AGM.

2) The following disclosure will be included under the contingent liability note. "The company is the defendant in a lawsuit brought against it by two employees. The case

concerns health problems allegedly caused by the employees' work environment at the Port Elizabeth plant. "

You have decided that although the matters are both singularly and collectively material, the "going concern" ability of Sparkle Chemicals Ltd is in no way threatened. All other aspects of the audit have been satisfactorily dealt with.

The outcome of the government investigation has commenced but is expected to continue for some months. You have determined that besides this matter there are no key audit matters.

YOU ARE REQUIRED TO:

a) discuss fully, the audit report that you would consider appropriate should the directors treat the matters in the financial statements in the manner indicated by Fred Mercury. Your answer must include a discussion on whether an unmodified opinion with an emphasis of matter would be acceptable. (10)

b) draft the appropriate audit report to be included in the annual financial statements of Sparkle Chemicals Ltd at 28 February 2017, assuming that the directors proceed as they have indicated. You are not required to include the sections dealing with the responsibilities of the directors or the auditor or other information. (15)

15.12 **(24 marks 29 minutes)**

John Squires the manager in charge of the audit team on the 31 March 2017 year end audit of Cubic (Pty) Ltd, a construction company with a public interest score of 400, is faced with the following unresolved matter.

All records and supporting documentation relating to directors emoluments are kept by the financial director, Tertius Brown. He has denied access to these records to all members of the audit team (including the engagement partner, Mel Brooks) on the grounds that they are confidential. He also claimed that because of access to the detailed disclosures in the prior year's financial statements pertaining to directors' emoluments, the company's hourly paid employees had made outrageous wage demands and had gone on strike. (You are aware that there were strikes at the company's construction sites during the year.) In addition, certain of the directors had been personally targeted and threatened.

As a result of this, Tertius Brown has stated that there will be no disclosure in the financial statements of individual director's emoluments but that he personally would provide John Squires with written confirmation that all directors' emoluments were included in the salaries expense account and other related accounts as necessary. The previous year's directors' emoluments had been reflected at R14 million, a material amount in relation to the financial statements.

When John Squires indicated to Tertius Brown that this could result in a modification of the audit opinion, Tertius Brown's response was "your firm must do what it must do, a modification of the audit opinion is better than a strike or threats to the directors."

YOU ARE REQUIRED TO:

(a) discuss whether it will be necessary to modify the audit opinion for the financial year-end 31 March 2017, based on the information given above. (6)

(b) outline six matters which should be included in the auditor's responsibilities section of the audit report. (3)

(c) draft the appropriate audit report for the financial statements of Cubic (Pty) Ltd for the year-end 31 March 2017. Do not concern yourself with the sections dealing with directors' or auditor's responsibilities or other information. You may also exclude from the basis of opinion section, the paragraph which commences with the words "We conducted our audit in accordance with …" (15)

15.13 **(32 marks 38 minutes)**

ISA 701 – Communicating Key Audit Matters in the Independent Auditor's Report is a statement which is intended to enhance the communicative value of the audit report and provide users with a better understanding of the audit.

Consider the following:

1. The auditor of Titles Ltd, a listed company, provided the audit committee with a timetable for the upcoming financial year end audit. (3)

2. In terms of the basic evidence gathered on the audit of Pulsar Ltd, a listed company, the auditor was of the opinion that the directors' impairment write-down for a particular piece of machinery was understated. The matter was communicated to the audit committee, who after a short discussion, agreed with the auditor and requested management to make the necessary adjustments, which they did. (4)

3. On the audit of Vyfster Ltd, a listed company, the auditor qualified the audit opinion on the basis of material misstatement due to the incomplete disclosure of directors' emoluments. The directors and audit committee would not make any amendments requested by the auditor. (4)

4. On the audit of Intercom Ltd, a listed company, the audit of related parties and related party transactions required significant audit attention due to the complexity of Intercom Ltd's group structure (particularly the identification of related parties). In the auditor's judgement knowledge of related parties and related party disclosures were fundamental to a user's understanding of the financial statements and extensive audit resources were allocated to addressing this situation. (5)

5. At the commencement of the current year end audit, the engagement partner of ConText Ltd, a listed company, provided the audit committee with a statement to the effect that there were no threats to the independence of the firm or the members of the audit team in relation to ConText Ltd. (2)

6. On the audit of Sandrock Ltd, based on audit evidence obtained, the auditor concluded that a material uncertainty relating to events or conditions which cast significant doubt on the company's ability to continue as a going concern existed. However, the audit committee and management had come to the same conclusion and adequate disclosure in the financial statements relating to the material uncertainty had been made. The auditor was satisfied with this treatment after conducting extensive procedures on the matter itself and its disclosure. (5)

7. During the course of the financial year under audit, Pinarello Ltd, a listed company, commenced a major restructuring of the company (and its subsidiaries). This required the timely and appropriate recognition of costs and provisions, which due to their materiality and complexity, were considered by the engagement partner to give rise to significant risk. Both asset valuers and tax specialists were extensively used by the audit team to address the risk which resulted in a large increase in the annual audit fee. (5)

8. On the audit of Dominate (Pty) Ltd, the auditor was required to report a reportable irregularity to the IRBA based on evidence that the directors had implemented a scheme to evade significant municipal business levies by making fraudulent declarations relating to turnover and employment numbers. The directors have ignored the auditor's communications with them on the matter. (2)

YOU ARE REQUIRED TO:

a) define the term key audit matter. (2)

b) discuss whether each of the matters above (1 to 8) should be communicated in the audit report as a key audit matter. Your discussion should include your reason(s) for including or excluding each matter. (30)

15.14 (22 marks 26 minutes)

Your firm Holford and Maharaj Inc, has been the auditor of Scales Ltd, a company listed on the JSE for the past six years. The company sells domestic and commercial measuring scales of various makes as well as holding the South African franchise for a range of scientific measuring instruments. This franchise is very profitable and generates the major portion of the company's annual income. However, the original franchise agreement expires during the next financial year and it is conceded by the directors that should they fail to renegotiate the franchise, the company will no longer be a going concern. The directors have entered into negotiations with the franchiser and it has been agreed that Scales Ltd will retain the franchise provided that they upgrade their product service division. The directors estimate that they will have to raise twenty five million rand to make the necessary improvements.

Scales Ltd has approached various finance houses but these negotiations are still underway.

You have completed the audit for the year end 31 March 2017 and have delayed issuing your report for as long as possible due to the loan negotiations. Besides this matter, no other problems have arisen on the audit.

The directors have prepared the financial statements on the going concern basis and have disclosed full details of this material uncertainty in note 10 of the financial statements. Scales Ltd prepares its financial statements in accordance with the International Financial Reporting Standards. The extensive work which you conducted has satisfied you that, should the necessary finance be raised, the company will be able to continue as a going concern.

YOU ARE REQUIRED TO:

a) outline the matters which will be included in the Basis of Opinion section of the report. (2)

b) draft the audit report which you consider appropriate for the annual financial statements at 31 March 2017. You are not required to include the basis of opinion, responsibilities of the directors section, the auditor's responsibilities for the audit or the other information sections of the report (20)

15.15 **(31 marks 37 minutes)**

During late March, whilst conducting the audit of Tothepublic (Pty) Ltd, a consumer goods wholesaler, for the financial year-end 28 February 2017, one of your trainees obtained evidence which, in his opinion, suggested that the company had been over claiming input taxes on its VAT returns by claiming VAT on certain purchases in the month in which the purchases were made and then again on the same purchases in a subsequent month. This had been going on for a number of months. Without raising the matter with the financial director, you immediately carried out further procedures and as a result were satisfied that your trainee has uncovered a carefully orchestrated plan to illegally reduce VAT payments with the knowledge of some members of the board of directors.

To meet your Auditing Profession Act responsibilities you dispatched a report to the Independent Regulatory Board for Auditors without delay, and the following day made an appointment to see the financial director, Michael Bruce. After a somewhat aggressive start to the discussion, during which he accused you of going "behind his back" by reporting the matter to the IRBA, Michael Bruce calmed down and admitted that the company had been claiming the input tax twice, but that it was more to do with a liquidity crisis than anything else. He then asked whether there was any way in which the matter could be kept confidential particularly from the shareholders and those directors who had no knowledge of the fraud. His suggestion to keep the matter confidential was that he would go to the SARS office the next day and make a full disclosure to them and agree to pay the amount owed in back taxes, penalties, etc. He felt that this would obviate (remove) the need for any mention of the matter in the annual report for the 28 February 2017 year-end. You responded accordingly to Michael Bruce and advised him on the action he should take.

Just prior to the expiry of the 30 day period within which you needed to make your second report to the IRBA, you contacted Michael Bruce who informed you that he had not taken your advice and would be taking legal advice on your failure to discuss the matter with him prior to reporting to the IRBA, and your breach of confidentiality.

YOU ARE REQUIRED TO:

a) discuss how you would have responded to Michael Bruce's suggestion as to how the matter could be kept confidential. (7)

b) explain the advice you would have given Michael Bruce. (3)

c) comment on the response you expect Michael Bruce will receive from his legal counsel. (3)

d) draft the audit report you will give for the financial year-end 28 February 2017 assuming that you submitted the appropriate second report to the IRBA. (18)
You are not required to include the sections dealing with the directors' and auditor's responsibilities or other information.

15.16 **(20 marks 24 minutes)**

State whether each of the following statements is ***true*** or ***false***. Justify your choice.

1. An individual who qualifies as an accounting officer of a CC may conduct an independent review of a private company's annual financial statements provided the company's public interest score is in the range 100 to 349.

2. When conducting an independent review engagement on a set of annual financial statements a registered auditor is not required to comply with the International Standards on Auditing.
3. When conducting an independent audit the auditor is required to formulate a strategy for the audit, but for an independent review a strategy for the review is not specifically required.

4. A registered auditor conducting an independent review must set planning, performance and final materiality limits for the review engagement.

5. A registered auditor conducting an independent review does not need to obtain a detailed understanding of the client's internal controls.

6. An independent review engagement does not normally include risk assessment procedures.

7. A registered auditor conducting an independent review does not need to make specific inquiries concerning the existence and identity of related parties.

8. A practitioner conducting an independent review does not have to concern himself with reportable irregularities at the client.

9. An audit report gives rise to an audit opinion and a review engagement gives rise to a review opinion.

10. Because an independent review is not as detailed as an audit, only reasonable assurance that fair presentation has been achieved is given.

15.17 **(16 marks 19 minutes)**

You are a registered auditor in public practice. Your firm has been engaged by Batman (Pty) Ltd to compile a set of general purpose financial statements at 31 March 2017 for the company from the books and records which have been maintained by the company's accountant. Batman (Pty) Ltd has a public interest score of 160 and has decided to have its AFS externally compiled so as to enable it to have its financial statements independently reviewed and not externally audited.

Whilst preparing the financial statements, you come to the conclusion that the accountant has done a satisfactory job of maintaining the books and records and that they form a reasonable basis for the preparation of the financial statements in terms of the IFRS for SMEs.

YOU ARE REQUIRED TO:

a) comment on whether you could, in addition to compiling the annual financial statements, perform the independent review of the financial statements. (3)

b) explain the term "independent accounting professional". (4)

c) write the report which you consider would be appropriate for this engagement. (9)

15.18 **(15 marks 18 minutes)**

You are a registered auditor in public practice. You have been engaged by the directors of Checkx (Pty) Ltd to conduct an agreed upon procedures engagement in respect of certain aspects of the company's inventory. Your brother sits on the board of Checkx (Pty) Ltd. The procedures you agreed to conduct were:

1. To count all inventory in the warehouse and compare the quantities on hand to the inventory masterfile at 28 February 2017.

2. To open 10 percent of the boxes selected at random to confirm that the boxes contained the correct item.

3. To identify any inventory items (using generalized audit software) where the cost price of the item exceeded the selling price in the inventory masterfile.

4. Agree the cost price of every 20th inventory item in the inventory masterfile to the supplier's invoice.

You carried out the procedures with the following results:

1. With the exception of 13 inventory items, the quantities counted agreed with the inventory masterfile.

2. 42 boxes (10%) were opened and resealed. All boxes were found to contain the correct item.

3. The cost price and selling price of every inventory item in the inventory masterfile was compared. The cost price of 21 items was found to exceed the selling price as listed in the masterfile.

4. For all inventory items selected, the cost price in the masterfile was found to agree with the supplier's invoice.

YOU ARE REQUIRED TO:

a) draft the appropriate report for this engagement. (12)

b) comment on whether, based on the procedures conducted, you would have been in a position to give an opinion on the fair presentation of inventory in the financial statements of Checkx (Pty) Ltd at 28 February 2017 if the board requested you to do so. (3)

15.19 **(20 marks 24 minutes)**

You are a manager in the technical department of a large auditing firm. The firm offers a diverse range of services and from time to time you are required to advise colleagues on the reports which are to be given for various engagements. You are currently considering the following:

Client: Big Bun (Pty) Ltd

One of the firm's clients, Big Bun (Pty) Ltd, operates a chain of fast food outlets. It is a successful company, due to strong management and high quality burgers which go under the "Big Buns" trade name. However, during the financial year under audit, an American company Bigbunns Inc, which also operates in South Africa, filed a lawsuit against your client on the grounds of trademark infringement. Bigbunns Inc has also claimed royalties in respect of all prior sales made by Big Bun (Pty) Ltd. Big Bun (Pty) Ltd has reacted by instructing their lawyers to oppose the lawsuit and to investigate the possibility of bringing a counter action of some kind against Bigbunns Inc. Note 13 to the financial statements of Big Bun (Pty) Ltd for the financial year-end 31 July 2017, explains the entire matter described above appropriately. No adjustments to the financial statements have been made as it is impossible to determine the outcome of the various actions and counter actions. The company's attorneys have indicated that the matter has potentially serious consequences.

YOU ARE REQUIRED TO draft the appropriate report for the 31 July 2017 audit of Big Bun (Pty) Ltd based on the above information and assuming that all other audit matters were satisfactorily resolved. You are not required to write out the sections relating to the basis of opinion, directors' responsibility, the auditor's responsibility, and other information. (10)

Client: Strux (Pty) Ltd

Strux (Pty) Ltd is an industrial manufacturing company. As a result of its public interest score and the external compilation of its AFS, the company must have its annual financial statements reviewed by an external auditor. The company has extensive plant and equipment and up until the start of the current year (year-end 31 March 2017) all plant and equipment had been depreciated after the differentiation of significant parts. During the year ended 31 March, a number of expensive items of plant and equipment were acquired.

However during your review procedures you established that the company had not applied the "significant part" depreciation requirement to any of the plant and equipment acquired during the year. You raised the matter with Ferdinand Skay who informed you that although the new plant and equipment had "significant parts" which could be depreciated at different rates, the directors had decided that it was unnecessary and rather meaningless to do so. He also informed you that the "significant parts" method would still be applied to plant and equipment which had been on hand at the start of the year under review. Your further enquiries revealed that had the significant parts depreciation requirement been applied to the new plant and equipment, depreciation for the year would have increased by a material amount.

YOU ARE REQUIRED TO draft the appropriate report for the above engagement. You are not required to include the paragraphs dealing with directors' responsibility, the independent reviewer's responsibility or other reports required by the Companies Act. (10)

15.20 **(20 marks 24 minutes)**

Images (Pty) Ltd is a company which imports photographic equipment. The company has a public interest score of 134 for the financial year end 30 April 2017, and has its financial statements independently compiled by a small firm of registered auditors who specialise in providing services as "independent accounting professionals". Your firm had been the auditor of Images (Pty) Ltd but subsequent to the promulgation of the Companies Act 2008, had changed its professional relationship with Images (Pty) Ltd, to that of independent reviewer of the annual financial statements. The company's financial statements are prepared in terms of IFRS for SMEs. You have just completed the review for the 30 April 2017 financial statements and have only the following matter to deal with:

The company holds a number of listed investments on a long term basis. In prior years, the company has presented these on a "fair value" basis but for the year end 30 April, have included them at the value at which they were presented at the end of the prior year 30 April 2016. Had the fair value of the investments at 30 April 2017 been used, an impairment of R327 206 would have to have been recognised. Keegan Naidoo the financial accountant, tells you that the directors feel that as the value of the company's investments fluctuate, it is simply a pointless exercise to revalue them when the intention is to hold them in the long term. He also tells you that the independent accounting professional didn't think that not revaluing them at reporting date was anything to worry about. When you informed Keegan Naidoo that you would have to modify your conclusion in the review report, he responded by saying that the board understood fully that you were required to fulfil your duties responsibly. A modification was not an issue for the board, particularly as the users of the reviewed annual financial statements were only going to be the fifteen shareholders and possibly the bank and SARS.

YOU ARE REQUIRED TO :

a) explain the term "independent accounting professional" in the context of Images (Pty) Ltd. (5)

b) comment on whether your firm could compile and perform the review of the annual financial statements of Images (Pty) Ltd in view of the fact that your firm had previously been the auditor of the company. (3)

c) draft the report which would be appropriate for this engagement, based on the information given in the question. You are not required to write out the paragraphs dealing with the Independent Reviewer's Responsibility or Other Reports Required by the Companies Act. (12)

15.21 **(18 marks 22 minutes)**

Your firm has been engaged to perform an independent review of the annual financial statements (financial year end 31 March 2017) of Blackjack (Pty) Ltd a company which retails a range of home entertainment products through its own retail outlets. Blackjack (Pty) Ltd has a public interest score of 86 and prepares its financial statements internally in compliance with the IFRS for SMEs. You commenced your review but quickly realised that there was a problem with inventory. You found that inventory records were incomplete and that adequate internal controls were not in operation at the retail outlets in respect of inventory and cash sales. As a result you found yourself unable to perform the procedures you deemed necessary on inventory or cash sales (particularly completeness). When you discussed the problem with Graham Black he responded as follows:

"We are fully aware of the shortcomings in our inventory system. We estimated inventory at 31 March instead of counting it for precisely this reason. As for the internal controls over cash sales, we should perhaps have a look at it. However I can't see that it should be a problem for you as we have not engaged you to perform an audit. Just ignore the problems and get the review done!"

YOU ARE REQUIRED TO:

(a) comment on Graham Black's perception of your responsibilities in relation to this engagement. (4)

(b) write the report you consider appropriate for this engagement. Justify your choice of report. (14)