

AUE2601 - GRADED QUESTIONS ON AUDITING 2018

Topic 1: Introduction to auditing

Study unit 1.1: The auditor

1. Q1.1 (20 marks 24 minutes)

In your auditing studies and in the practice of auditing, you will frequently come across the following terms:

Auditee
Audit independence
Professional scepticism
Professional competence
Assurance engagement
Internal auditor
External auditor
Audit committee
Postulates of auditing
Audit evidence

YOU ARE REQUIRED TO briefly explain each of the above terms.

Ans: References: - Jackson & Stent (2016: 1/2 -1.6, 1/21 – 1/24)

- Study guide (Study unit 1.1)

- 1. Auditee:** The auditee is the entity which is subject to audit. In the case of external audit it may be the client company, and in the case of internal audit, it may be a branch, division or department within the company itself. ✓
- 2. Audit independence:** The characteristic of auditing which makes it unique and without which the audit function has little value, ie, the auditor must be independent of the auditee. ✓
- 3. Professional scepticism:** An attitude which an auditor must adopt and the auditor must not believe everything he or she is told in a naive manner. ✓ Auditors must keep in mind that auditees may attempt to deceive them. ✓ An auditor should remain unconvinced of the truth of a particular fact until suitable evidence to support the fact is provided. ✓
- 4. Professional competence:** This is one of the fundamental ethical principles which auditors must achieve and maintain. ✓ They must maintain professional knowledge and skill at the required level and have the necessary technical ability to perform their function in accordance with applicable technical and professional standards. ✓
- 5. Assurance engagement:** An assurance engagement is an engagement in which the professional accountant (e.g. an auditor) expresses a conclusion (e.g. opinion) designed to enhance the degree of confidence of the users (e.g. shareholders) of some form of information (e.g. AFS) in that information. ✓
- 6. Internal auditor:** A person who is employed (staff member) by a company to perform independent audits and related assignments within the company on behalf of the board frequently to provide the board with a level of assurance. ✓ Whilst the internal auditor is not independent of the company, he must be independent of whatever is being audited. ✓ Internal audits commonly relate to the efficiency and effectiveness of the company's systems and the company's ability to identify and respond to risk. It also forms part of the company's combined assurance mechanisms. ✓
- 7. External auditor:** A firm (or individual) which is appointed by a company to perform an external audit. ✓ This may be an audit required by the Companies Act 2008 (e.g. public company) or by virtue of the entity's public interest score or an audit required voluntarily by a company (e.g. in terms of a private company's Memorandum of Incorporation). ✓
- 8. Audit committee:** A grouping of directors independent of the company's day to day functions, constituted to act as an independent link between the board of directors and the external auditors, and to oversee internal audit and the integrity of the company's financial reporting. ✓ The audit committee is an important part of corporate governance. ✓
- 9. Postulates of auditing:** The "foundation stones" or basic assumptions on which the discipline of auditing is built. ✓
- 10. Audit evidence:** The auditor is required to gather information which is sufficient and appropriate to support the opinion he is required to provide on the fair presentation of the financial statements. ✓ The information which the auditor gathers is termed as audit evidence. ✓

2. Q1.12 (22 marks 26 minutes)

You are chatting to a close friend of yours, Vincent Nzimande an engineer, after a game of squash one evening and he tells you that he is purchasing the majority (75%) holding in a private company. In addition he will be the managing director but will retain the services of the two existing directors in the company, neither of whom are shareholders. (There are four other shareholders.)

He also informs you that the company has, besides himself, 27 employees and that the expected turnover for the year is R36 million and that the only liabilities which the company has are current creditors of just less than R1 million and long-term loans of R4.8 million. Vincent has just been told by his lawyer, who is responsible for the formalities related to the purchase of the company, that at the next annual general meeting of the company, an auditor will have to be appointed. Vincent is concerned about this and, knowing that you are in the auditing profession, he asks you the following questions:

YOU ARE REQUIRED TO respond to Vincent Nzimande's questions

1. Must the company have an auditor and if so, is it an external or internal auditor the company must have? (10)

Ans: References: - Jackson & Stent (2016: 1/2 -1.6, 1-13/1-14)

- Study guide (Study unit 1.1 and 1.2)

1. 1.1 With regard to whether the company must appoint an external auditor, you will first have to calculate your company's public interest score. ✓ Without going into too much detail this is the sum of points which are allocated to 4 attributes of your company as follows:

* One point is allocated for the average number of employees (28 points) ✓^A

* One point for every R1m (or portion thereof) of turnover (36 points) ✓^A

* One point for every R1m (or portion thereof) of liability to 3rd parties (6 points) ✓^A

* One point for every individual who has a direct or indirect interest in the shares of the company (5 points) ✓^A

1.2 If your company's public interest score is below 100 there is no requirement that your AFS be **audited**. ✓ Your PIS will be around 70 points. However with this PIS it will be necessary for your company to appoint a registered auditor (or a person who qualifies to act as an Accounting Officer of a close corporation) to independently review your financial statements. ✓

1.3 It is also possible that the company's Memorandum of Incorporation has a clause which requires that the company appoint an external auditor but this would be a requirement created by the shareholders. ✓ If this clause exists, your company would have to comply, but as you will own 75% of the shares you could remove this clause if you wanted to. ✓

1.4 With regards to an internal auditor, there is no requirement which makes it obligatory for a private company to appoint one. ✓

1.5 Appointing an internal auditor will not be a substitute for having an independent review and the internal auditor may not carry out the independent review because he is not independent of the company. ✓

2. Even if we aren't required to appoint an auditor, can we still appoint one? Could I appoint you as the auditor? (4)

Ans: 2. 2.1 You are certainly entitled to appoint an auditor and if the company already has one, you may retain the existing auditor, provided the existing auditor is available for re-appointment. ✓

2.2 Whilst there is nothing in the Companies Act which prevents you from appointing me as your auditor, I would not be in a position to accept such an appointment. ✓

2.3 For any audit opinion to be worthwhile (reliable) it must be given by someone who is independent of the company about which the opinion is being expressed. ✓

2.4 As you and I are close friends, I would not be, or be seen to be independent, and would therefore be in breach of the requirement explained in 2.3 as well as my profession's Code of Professional Conduct. ✓

2.5 If you end up only having to be independently reviewed (not audited) you could appoint the existing auditor to conduct the review, but for the same reason as above, I could not perform the review. Note, that the review engagement is, like an audit/assurance engagement. ✓

3. Whose responsibility would it be to appoint the auditor and must there be agreement amongst the directors as to who the auditor should be ? (2)

Ans: 3. 3.1 The shareholders would appoint the auditor by general resolution. As the other directors are not shareholders they have no say in the appointment. ✓

3.2 As you hold 75% of the shares, it will be your decision. The MOI (if this is relevant) may lay down some additional requirements for appointment of the auditor. ✓

4. What benefit would there be from an audit for the company and for me, bearing in mind that I am the majority shareholder and managing director? (6)

Ans: 4. Benefits: Overall having your financial statements audited adds to the credibility of your company in its business dealings. ✓

4.1 For the company

* It is essential that the other shareholders know how the company is performing and audited annual financial statements are an important mechanism for reporting to them. ✓

* Whoever prepares the company's statements may make errors (or even hide frauds) which the audit may detect. Thus the auditor's opinion on the fair presentation of the annual financial statements gives management greater assurance on the validity of the company's results. ✓

* Having the accounting records audited acts as a deterrent to employees attempting to defraud the company. ✓

* The company will also benefit in as much as lenders of money e.g. your bank, will be far more inclined to extend credit. ✓ They will almost certainly require audited financial information from you when considering your financial needs. ✓

* The company will benefit from the advice on such matters as systems and tax that the auditor can offer. This kind of advice becomes a positive by-product of the audit. ✓

4.2 For you

* Even though you are the majority shareholder and managing director it is still possible for your fellow directors or employees to "pull the wool over your eyes", particularly as, being an engineer, you know little about financial matters. ✓

* The audit will give some assurance that this is not happening as it provides you with an independent "view" of the state of your company, and you will receive reports on weaknesses in your company's controls from the auditor. ✓

4.3 A review engagement which is like a "watered down" audit does not provide the same level of independent assurance that an audit does. ✓ This will be explained in the review report given by the registered auditor carrying out the review so users of your financial statements may not be as confident about them as they would have been with an audited set of financial statements. ✓

Study unit 1.2: Assurance and non - assurance engagements

13.10 (30 marks 36 minutes)

1. What is a public interest score? (3)

Ans: 1. 1.1 A public interest score is the sum of the points allocated to certain attributes of a company or close corporation e.g. one point is allocated to every one million rand or part thereof, of turnover. The Companies Act 2008 requires that each company (and close corporation) calculate its public interest score annually. ✓

1.2 The public interest score is used as a gauge of the interest the public at large (society) has in the company or close corporation. ✓

1.3 In terms of the Companies Act 2008 (and Companies Regulations 2011), the entity's public interest score is one of the factors which determines whether the entity must have its annual financial statements audited or independently reviewed, e.g. all companies and close corporations with a PIS of 350 and above must be externally audited whilst a private company with a PIS of less than 100 need only undergo an independent review. ✓

2. State three matters which will be affected by company's public interest score. (2)

Ans: 2. 2.1 Whether the company is audited or reviewed and who must carry out the independent review. ✓

2.2 Which financial reporting standard the company must use to prepare its annual financial statements. ✓

2.3 The level of financial rescue practitioner who would be engaged, if the company needed financial rescue. ✓

2.4 Whether a private company must appoint a Social and Ethics Committee (Reg 43). ✓

3. Which of the following do not affect a company's public interest score:

3.1 location of the company

3.2 number of non-executive directors

3.3 number of directors

3.4 turnover

3.5 assets held in trust by the company

3.6 number of years in operation? (2)

Ans: 3. Location, the number of directors (executive and non-executive), and number of years in operation do not affect the public interest score. ✓

4. Public companies, both listed and unlisted as well as private companies and close corporations, must calculate their public interest score. True or false? (1)

Ans: 4. True ✓. All companies and close corporations must calculate their public interest score. ✓

5. The Memorandum of Incorporation can stipulate other criteria to be used when calculating the public interest score. True or false? (1)

Ans: 5. False. ✓ Public interest score criteria are set in Regulations 26 of the Companies Act and are not alterable. ✓

6. Calculate the public interest scores for the following companies, Tech (Pty) Ltd and Master (Pty) Ltd:

	<u>Tech (Pty) Ltd</u>	<u>Master (Pty) Ltd</u>
6.1 Turnover	R7.25m	R135.75m
6.2 Directors	4	11
6.3 Average employees for the year	62	201
6.4 Amounts owed to third parties	R1.6m	R19.2m
6.5 Individuals with direct or indirect interest in each company's shares	9	22
6.6 Charitable donations	R0.2m	R1.5m

Ans: 6. Tech (Pty) Ltd Master (Pty) Ltd

6.1 8 ✓ 136 ✓

6.2 N/A N/A

6.3 62 ✓ 201 ✓

6.4 2 ✓ 20 ✓

6.5 9 ✓ 22 ✓

Total 81 points ✓^ 379 points ✓^

7. What are the various thresholds (categories) set by the Companies Regulations 2011 for public interest scores? (2)

Ans: 7. Equal to or above 350 points^

Equal to 100 or above, but less than 350 points^

Below 100 points. ^

8. Once a public interest score has been calculated, it remains in effect for five years after which it must be re-calculated. True or False? (1)

Ans: 8. False ✓. Public interest score must be calculated annually. ✓

13.21 (18 marks 22 minutes)

References: - Jackson & Stent (2016: 1/13-1/14, 3/6 – 3/9))

- Study guide (Study unit 1.2 and 2.2)

1. All close corporations must calculate a public interest score. True or false? (1)

Ans: 1. True. (As required by the Companies Act regulations).

2. Calculate the public interest score for the following close corporations, Jax CC, Joes CC:

	<u>Jax CC</u>	<u>Joes CC</u>
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)

Ans:	<u>Jax CC</u>	<u>Joes CC</u>
2.1	2✓	10✓
2.2	39 (ave) ✓✓	181 (ave) ✓✓
2.3	-	-
2.4	18✓	74✓
2.5	N/A	N/A
2.6	N/A	N/A
2.7	4✓	12✓
	63 points✓^	277 points✓^

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)

Ans: False (but partially true). The decision as to whether a close corporation (CC) must be audited (other than voluntary), will depend on its public interest score. However, there is no circumstance where a CC is required to be independently reviewed. ✓✓

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

Ans: True✓. Companies Act Regulations require that CC's with a public interest score of 350 or more, must be audited. ✓

4.2 A CC with a public interest score of 250, which has prepared its financial statements internally, must be audited

Ans: True✓. Same Regulations as 4.1 above – key point – internal preparation. ✓

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)

Ans: False✓. The audit requirement for CC's with a public interest score between 100 and 350, falls away if the annual financial statements (AFS) are prepared by an independent professional accountant. ✓

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)

Ans: False. ✓ In terms of the close corporations act **all** CC's must appoint an accounting officer. ✓

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)

Ans: 6.1 In terms of Sec 90 of the Companies Act, a person who is a prescribed officer of a company (CC) **cannot** act as auditor of that company. ✓

6.2 The question then arises as to whether the accounting officer of a CC is a prescribed officer. ✓

6.3 In terms of Regulation 38, a person is a prescribed officer of a company/CC if that person ...

* "exercises general executive control over the management of the whole, or a significant portion, of the business and activities of the company" **or**✓

* regularly participates to a material degree in the exercise of general executive control over the management of the business of the company. ✓

6.4 Thus, in terms of Regulation 38, there would be no problem with the accounting officer of a CC performing the audit provided the role played by the individual was strictly that of accounting officer. ✓

6.5 In terms of the IRBA code of professional conduct, such a situation would probably be a breach of a registered auditor's independence. This is as a result of potential self-interest and self-review threats. ✓

6.6 In this situation, the auditor (accounting officer) would probably neither be independent in fact, nor appearance. ✓

Study unit 1.3: Auditing postulates

1.15 (28 marks 34 minutes)

Consider the following statements:

1. Assertions form the basis of the financial statements.
2. 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.
3. An unqualified opinion is in effect a certification of the accuracy of the financial statements.
4. An audit should only be conducted by an audit team which has the necessary technical competence.
5. Financial data is verifiable.
6. Internal controls reduce the probability of errors and irregularities.

7. To be appointed as auditor for a statutory audit, the auditor must be registered with a regulatory body.
8. In the absence of any contrary evidence, that which held true in the past will hold true in the future.
9. For the external audit function to be effective, co-operation with the client's directors/management is essential.
10. The professional status of the independent auditor imposes commensurate professional obligations on the auditor.

YOU ARE REQUIRED TO:

- a) explain the term postulate in the context of auditing. (3)

References: - Jackson & Stent (2016: 1/13 – 1/14);

- Study guide (Study unit 1.3)

Ans: 1. A postulate provides a basis or framework for thinking about problems and arriving at solutions. ✓ A postulate is a starting point for thinking about a discipline. ✓

2. In the context of auditing the postulates are the foundations on which the subject (discipline) is built. ✓

Study unit 1.4 The accounting profession

1.14 (12 marks 14 minutes)

YOU ARE REQUIRED TO select the correct answer for each of the following questions:

1. An engagement to express an independent opinion on whether the annual financial statements of a public company are fairly presented, will be carried out by:

- a. An internal auditor.

b. A registered external auditor.

- c. A forensic auditor.

- d. A government auditor.

2. A registered auditor who specialises in investigating alleged financial mismanagement, theft or fraud, is termed:

- a. A special purpose auditor.

- b. A regulatory auditor.

c. A forensic auditor.

- d. An investigative auditor.

3. The term "audit", in the context of the auditing and accounting profession, is defined in:

a. The Auditing Profession Act 2005.

- b. The Companies Act 2008.

- c. The Companies Regulations 2011.

- d. The Public Finance Act.

4. Auditing postulates can be regarded as the philosophical foundations of the discipline.

Which of the following is NOT generally regarded as auditing postulates:

- a. Financial data is verifiable.

- b. The application of generally accepted accounting practice, e.g. IFRS, will result in fair presentation.

- c. Internal controls reduce the probability of errors and irregularities.

d. The cost of an audit must be weighed against the benefit of the audit

5. The external audit of a company's financial statements provides:

- a. Absolute assurance.

- b. Limited assurance.

c. Reasonable assurance.

- d. Restricted assurance.

6. Which of the following is NOT regarded as a limitation of an audit of financial statements:

- a. The use of audit test checking.

- b. The inherent limitations of accounting and internal control systems.

- c. The application of judgement by management in the preparation of the financial statements.

d. The complexity of the applicable accounting framework.

7. Which characteristic does NOT distinguish a body of individuals as a profession:

- a. An attitude or outlook which is essentially objective.

- b. Mastery of a specialised body of knowledge.

c. A commitment to financial stability for its members.

- d. Acceptance of duties to society as a whole.

8. Whether an entity is required to have its financial statements externally audited is largely based on its public interest score.

The requirement that all companies calculate their public interest score, is contained in:

- a. The Auditing Profession Act 2005.

- b. The IRBA Rules.

c. The Companies Act 2008.

d. The Companies Regulations 2011.

9. Which of the following best describes the International Standards on Auditing (ISAs):

a. A detailed list of audit procedures.

b. A description of and discussion on the quality standards which the auditor must attain.

c. The standards which the auditor must attain and guidance on how this should be done.

d. Check lists which may be applicable to the various sections of the audit.

10. Which of the following best describes the assertions which are embodied in a set of financial statements:

a. Assertions are the directors' representations about the company's assets, equity, liabilities, transactions and events, and disclosures.

b. Assertions pertain to the assessment of the risk of material misstatement.

c. Assertions are the directors' representations about the company's assets and liabilities contained in the financial statements.

d. Assertions are the implied principles on which the financial statements are compiled.

11. A company which has a public interest score of 275 and which has its annual financial statements (AFS) compiled by an independent accounting professional

a. Must have its AFS independently reviewed.

b. Is not required to have its AFS independently reviewed or externally audited.

c. Must have its AFS externally audited.

d. Must have its AFS externally audited by an individual firm other than the accounting professional who compiled the financial statements.

12. The requirement that the auditor should remain unconvinced of the truth of a particular fact until suitable evidence to support the fact is provided, is regarded as the

a. Application of professional judgement.

b. Application of professional competence and due care.

c. Adoption of professional behaviour.

d. Adoption of professional scepticism.

Study unit 1.5 The Financial Statement audit engagement

4.9 Part a,b, & c (13 marks)

References: - Jackson & Stent (2016: 1/15 – 1/19);

- Study guide (Study unit 1.4)

The annual financial statements are a collection of assertions laid out in a particular format e.g. the statement of financial position, the statement of comprehensive income and their related disclosures.

YOU ARE REQUIRED TO:

a) construct a chart which reflects the assertions which relate to:

- i) trade debtors (receivables)
- ii) long term borrowings
- iii) interest paid
- iv) plant and equipment
- v) interest received. (7)

Ans:

ASSERTION	CLASSES OF TRANSACTIONS, ACCOUNT BALANCES AND RELATED DISCLOSURES				
	DEBTORS	LONG TERM BORROWINGS	INTEREST PAID	PLANT & EQUIP	INTEREST RECEIVED
CLASSIFICATION	^	^	^	^	^
COMPLETENESS	^	^	^	^	^
OCCURRENCE			^		^
EXISTENCE	^	^		^	
ACCURACY			^		^
CUT-OFF			^		^
ACCURACY, VALUATION AND ALLOCATION	^	^		^	
RIGHTS	^			^	
OBLIGATION		^			
PRESENTATION	^	^	^	^	^

b) explain why the assertions are important to the auditor when conducting an audit (3)

Ans: 1. The auditor is required to express an opinion on the audit client's AFS which, in effect, are a collection of assertions. ✓

2. The risk based approach to the audit required by the International Standards on Auditing (ISA) means that the auditor must assess the risk of material misstatement being present in the financial statements. ✓

3. A convenient (and recommended by the ISAs) method of doing this is to consider classes of transactions, account balances and related disclosures in terms of the assertions which apply to them. ✓ For example, the auditor will attempt to identify the risk that inventory which does not exist has been included in the inventory balance at year end. ✓

4. Once risk applicable to a specific assertion has been identified the auditor is in a position to respond to the risk appropriately. ✓

c) explain the following assertions relating to a class of transaction

i) completeness

Ans: The **completeness** assertion for a class of transaction represents that

1. **all** transactions which should have been recorded, have been recorded ✓ and

2. **all** related disclosures which should have been included in the financial statements have been included. ✓

ii) cut-off (2)

Ans: The **cut-off** assertion for a class of transaction represents that the transactions of that class have been recorded in the correct accounting period. ✓

Topic 2: Regulation of the auditor

Study unit 2.1 The Auditing Profession Act 2005

13.5 (18 marks 22 minutes)

References: - Auditing Profession Act of 2005

- Jackson & Stent (2016: 3/80-3/93)

- Study guide (Study unit 2.1)

You are currently engaged on the audit of Shippinglanes (Pty) Ltd, a company which offers its services to companies which import goods from overseas. Shippinglanes (Pty) Ltd which is located at the Durban harbour takes responsibility for clearing the imported goods through the harbour and through customs. They also arrange warehousing of cleared goods awaiting transportation to the purchasers. Shippinglanes (Pty) Ltd have a reputation for "getting things done".

Whilst conducting some tests of detail on a sample of payments you came across a payment to an entity called Import Express CC which was not supported by any documentation at all. A quick search through the payment records revealed a number of these payments, none of which were supported by any documentation. You traced the payments to the company's bank statements and were surprised to find that on the bank statements the amounts were recorded as cash withdrawals. Now somewhat suspicious, you raised the matter with Peyton Manning, the chief financial officer who responded as follows:

"About a year ago we started experiencing difficulties in getting our clients' goods cleared through customs promptly. Customs officials were un-cooperative and petty queries kept delaying things. After delays on a number of containers had occurred, we were approached by an official who indicated that for the payment of a fee, he could see to it that our "delays and petty queries" went away. As we were starting to feel some client dissatisfaction and as we have a reputation for "getting things done" we decided to pay the fee, which in comparison to the value of the imported goods is not material. Once we started to pay the fee, always in cash, things returned to normal, and in fact improved."

When asked why the payments were recorded as being paid to Import Express CC, Peyton Manning responded that:

"The financial director suggested that we do this as he wanted us to pass on the cost of these payments to the client whose imports were the subject of the fee. He feels that if we include on our invoice "Import charges paid to Import Express CC" clients are unlikely to query it."

YOU ARE REQUIRED TO discuss fully whether the above situation would constitute a reportable irregularity in terms of the Auditing Profession Act 2005.

Ans: 1. In terms of Sec 1 of the Auditing Profession Act 2005 (APA), a reportable irregularity means:

1.1 Any unlawful act or omission committed by ✓

1.2 Any person responsible for the management of Shippinglanes (Pty) Ltd which ✓

1.3 Has caused **or** is likely to cause material financial loss to the company or to any shareholder, creditor or investor **or** ✓

1.4 Is fraudulent or amounts to theft **or** ✓

1.5 Represents a material breach of any fiduciary duty owed (by the person responsible) to Shippinglanes (Pty) Ltd, its shareholders, creditors. ✓

2. Unlawful act

2.1 It seems reasonable to assume that the fee paid to the customs official is a bribe. ✓ The amount is paid in cash directly to the official for the purposes of getting imported goods through customs promptly. Since the "fee" was paid this has been achieved, and there is no supporting documentation. ✓^

This makes it an unlawful act. ✓ The customs official is a government official (SARS) and it is illegal in terms of the Prevention and Combating of Corrupt Activities Act, 2004 to pay a bribe to a government official. ✓ This is regardless of whether the company or the official initiated the bribe. ✓^

3. Breach of fiduciary duty

3.1 It could be argued on two counts that the directors of Shippinglanes (Pty) Ltd have breached their fiduciary duty to the company itself. This duty requires that the directors act in the best interests of the company:

* Count one: to engage in bribery, particularly in direct relation to the company's core business is irresponsible and places the reputation and future of the company at risk. ✓^

* Count two: to intentionally mislead their clients into believing they are paying a valid cost by charging the client a fictional amount paid on their behalf to a fictional company also has serious consequences for Shippinglanes (Pty) Ltd.

Should the clients discover that they are bearing the costs of bribes, the company again is likely to lose its reputation. ✓^

3.2 The arguments that Shippinglanes (Pty) Ltd felt that they had to pay the bribes to retain their reputation for "getting things done", or that the bribes were immaterial, or that as a result the company's performance improved, do not mitigate or justify or "legalise" the unlawful act or breaches of fiduciary duty. ✓^

4. Fraudulent or amounts to theft

4.1 There is no theft involved here, and it does not appear that SARS (customs) are being defrauded. They are still receiving all the required import duties etc. ✓^

4.2 There may be a sense that clients are being defrauded by being inappropriately charged. However, it is not necessary for there to be both fraud **and** breach of fiduciary duty for a reportable irregularity to have occurred, so whether clients are being defrauded or not is not central to the issue. ✓^

5. Committed by any person responsible for the management of the company

5.1 This requirement for the act to be reportable in terms of the AP Act is satisfied. The bribes and the invoicing are both being carried out by and with the full knowledge and consent of the chief financial officer and the financial director (in fact, it was the financial director's suggestion to introduce the Import Express CC deception). ✓^

6. Financial loss

6.1 For the unlawful act (bribe) to be reportable, it must have caused financial loss or must be likely to cause financial loss to the company, its shareholders etc. ✓^

6.2 It could be argued that these bribes cause no financial loss at all as Shippinglanes (Pty) Ltd have recovered the amounts from their clients. ✓^

6.3 However, should the bribery be revealed it is likely that financial loss will be suffered by the company through fines, penalties, legal fees, loss of business, etc. ✓^

7. Conclusion

7.1 There is little doubt that the requirements for a reportable irregularity are present. There is an unlawful act which is at least likely to cause financial loss. Even if the "financial loss" requirement is debatable, there is material breach of fiduciary duty and possibly fraud as well. ✓^

13.6 (Part (c) only) (6 marks)

References: - Auditing Profession Act of 2005

- Jackson & Stent (2016: 3/80-3/93)

- Study guide (Study unit 2.1)

BuilderBoy CC is a large construction company operating in Gauteng. The CC has a public interest score in excess of 350 (due mainly to the size of its labour force) and is therefore required to have its annual financial statements externally audited. You have been appointed as the designated auditor by the members of the CC who are not at all happy about having to be audited. During the course of the audit, one of the trainees came across some evidence which suggested to him that the members of the CC were paying some of their personal expenses through the CC but treating them as business expenses. Your initial thought was that this could be a reportable irregularity, but that you needed more evidence. Whilst gathering this evidence, Franco Steyn, the most senior member of the CC heard what you were doing and confronted you in an aggressive manner as follows:

"You have no right to concern yourself with this matter. Nothing has changed. We, as the members, have been doing this for years with no comeback. We make sure, amongst ourselves that each of the members can claim personal expenses in the same proportion as their member's interest and charge it as a business expense of the CC. No member is favoured over another member. This is a close corporation, not a company, and the members work together in the business. Just because the legislation says we must now be audited, doesn't change that. You don't need to apply your company audit rules here, we are a close corporation, so all of this reportable irregularity stuff does not apply to us, and you won't find any mention of it in the Close Corporation Act."

YOU ARE REQUIRED TO:

c) state the criteria which the designated auditor must satisfy before an unqualified audit opinion can be given. (6)

Ans: An unqualified opinion cannot be given **unless**

1. The audit has been carried out free of restriction. ✓

2. The designated auditor has satisfied himself of the existence of all assets and liabilities shown in the financial statements. ✓

3. Proper accounting records have been kept (in at least one of the official languages) and all information, vouchers and other documents, which in the auditor's opinion, were necessary for the proper performance of his duties, were obtained. ✓

4. The auditor has *not* had occasion to report a reportable irregularity (RI) to the IRBA. ✓

5. The auditor has complied with all laws relating to the audit of that entity. ✓
6. The auditor is satisfied as to the fairness of the financial statements. ✓

3.20 (35 marks 40 minutes)

References: - Auditing Profession Act of 2005

- Jackson & Stent (2016: 3/80-3/93)

- Study guide (Study unit 2.1)

You are the technical partner in the audit firm of Touchwood and Co. Some months previously your firm had been approached by an existing client, Hadlee Ltd, an unlisted public company, to provide an audit report on a set of financial statements at 31 December 2017. The financial year-end of Hadlee Ltd is 30 September but the company had applied for a substantial loan from Nedcorp Bank, who in turn had requested a set of audited financial statements at 31 December 2017. A strict reporting deadline had been set.

The engagement had come at a particularly bad time for the firm as both the audit partner (designated auditor) and the audit manager responsible for this client were away on holiday. However, as the September 2017 year-end audit had been completed without any problems, your firm had agreed to accept the engagement.

Martin Hughes, a second year graduate trainee accountant who, at the time, was involved on another audit client deadline, but who had worked on the September audit, was assigned to oversee the engagement and was allocated a graduate trainee accountant who had served a year of his contract and a student who had recently left school but was working for the firm part-time before going to university, to assist with the audit.

Martin Hughes had reviewed the working papers from the September audit and decided that the only way in which he could meet the tight deadline on the audit was to audit only those assertions for which he could obtain evidence quickly. He also chose not to worry about debtors and sales, despite a large increase in these figures, as extensive work had been done on them at the year-end. He had instructed the two audit staff to carry out detailed procedures on liabilities on the assumption that if Hadlee Ltd wanted to improve their financial statements for the purposes of the loan application they would understate liabilities. Wherever possible he had used the client's staff to obtain 3rd party evidence, and supply various certificates, e.g. bank confirmations, inventory certificates, to speed up the audit. The vast majority of the work had been delegated to the two audit staff so that Martin Hughes could return to the other deadline audit. Due to time constraints, instructions to the audit team had been verbal.

At the completion of the audit, Martin Hughes conducted a hasty review of what had been done, drafted an unqualified audit report and passed on the file to Joe Crowe, the only partner he could find. Joe Crowe glanced through the audit file, enquired "how it had gone" and signed the audit report. He personally handed the audited financial statements to the loans manager of Nedcorp Bank.

On the strength of the audited financial statements Nedcorp Bank loaned the money to Hadlee Ltd. Shortly thereafter Hadlee Ltd went insolvent and it was discovered that during the three months prior to 31 December 2017 the company had processed a large number of fictitious credit sales resulting in vastly overstated sales, debtors and profits at 31 December 2017.

Nedcorp Bank were unable to recover the loan they had made and decided to sue the auditors for the recovery of their losses.

YOU ARE REQUIRED TO discuss fully whether your firm would be liable to Nedcorp Bank.

Ans: 1. For Touchwood and Co to be liable to Nedcorp Bank it will be necessary to prove:

- 1.1 That the firm was malicious or negligent in the performance of their duties. ✓
- 1.2 That at the time of the negligence we knew of, or could have reasonably foreseen, reliance on our report. ✓
- 1.3 That after expressing our opinion, we represented in any way that it was correct. ✓
- 1.4 That Nedcorp relied on the financial statements. ✓
- 1.5 That as a result of that reliance, suffered loss. ✓

2. There is no suggestion of malice. ✓

3. Negligence therefore, will have to be proved. Our performance will be judged in the light of the firm's adherence to International Auditing Standards (see below). ✓

4. Compliance with IAS 220 - Quality control for audits of historical financial information and ISQC1 – Quality control for firms that perform audits and reviews.

4.1 Regardless of the fact that Hadlee Ltd is an existing client, our firm should still have carried out preliminary engagement activities to determine whether the firm was competent and had the capabilities, time and resources to do so (acceptance of specific engagements para 28 ISQC1) ✓^

4.1.1 Clearly the firm was not in a position to offer a satisfactory service due to a lack of skills available at the time that the engagement was conducted and the time constraints placed on the audit; this contributed directly to the subquality audit. ✓^

4.1.2 Although there was no reason to doubt the client's integrity at the time of accepting the special engagement, it was subsequently revealed that the client lacked integrity. ✓ This is proof that the preliminary procedure of reevaluating client integrity should have been carried out. ✓^

4.2 The engagement was not assigned to an engagement partner. Martin Hughes was left to his own devices and handed the completed file to the only partner he could find and who had nothing to do with the audit. ✓

4.3 The examination was not assigned to personnel who had the necessary technical capability and professional competence or time to fulfil their responsibilities with due care. ✓

4.3.1 It is doubtful whether a second year graduate trainee would be capable of overseeing this audit due to lack of experience and the importance of the engagement. ✓^

4.3.2 A trainee who had served 1 year of his contract and a school leaver would certainly not have the necessary proficiency especially when left unsupervised to conduct more complex procedures such as searches for unrecorded liabilities. ✓^

4.3.3 The strict reporting deadline provided insufficient time to perform an adequate audit. ✓

4.4 An engagement partner should take responsibility for the direction, supervision and performance of the audit. There was no direction or supervision as there was no engagement partner. ✓

4.4.1 Although Martin Hughes tried, there was no engagement partner to instruct the audit team on matters such as their responsibilities, risk issues, potential problems etc. ✓

4.4.2 Martin Hughes received no direction or supervision from any partner or manager in charge (they were on holiday). ✓

4.4.3 Although he gave verbal instructions and attempted to direct his staff, Martin Hughes provided no ✓ overall audit plan/budget/strategy ✓ or audit programme ✓

4.4.4 As he was not present at the audit, he would have been unable to provide adequate direction or supervision as the audit progressed, an absolutely essential requirement in view of the inexperience of the audit team. ✓✓

4.4.5 Martin Hughes' review of the audit file was totally inadequate in the circumstances ✓ ...

* a "hasty" review of a set of audited financials prepared by inexperienced staff is unacceptable. ✓

4.4.6 Mr Crowe's review was also inadequate; before the auditors report is issued the engagement partner, through review of the audit documentation and discussion with the engagement team, should be satisfied that sufficient appropriate audit evidence has been obtained to support the conclusions reached and audit report issued. ✓^ Had he done the review properly, not just a glance through the work papers and a vague enquiry of the audit team as to "how it had gone", he would have realised immediately that basic auditing standards had not been adhered to, e.g. no audit planning, no audit programme, insufficient evidence gathered. ✓^

4.4.7 Point 4.4.6 above point is even more significant in view of the fact that Mr Crowe was not the normal engagement partner for Hadlee Ltd and would have had little background knowledge of the client (he was the only partner available). ✓^

4.4.8 Although the audit partner in charge of this client was on holiday, he is still responsible for the overall quality of the audit. ✓ Another partner should have been specifically designated to take over his responsibilities in his absence and this should have been communicated to staff (e.g. Martin Hughes). ✓^

5. Compliance with ISA 300 – Planning an audit of financial statements, ISA 315 – Identifying and assessing the risks of material misstatements, ISA 320 – Materiality and ISA 330 – The auditors response to assessed risk.

5.1 The audit was not adequately planned and no overall audit strategy was developed. ✓

5.1.1 No meaningful identification and assessment of risk procedures were conducted - even though Martin Hughes had worked on the prior year audit he should have at least performed these procedures to have confirmed and updated his knowledge. ✓^

5.1.2 No assessment of the risk of material misstatement was carried out – had this been done, the risk of fictitious sales and debtors would have been identified. ✓^

5.1.3 Studying the prior audit papers is an important procedure but does not provide a meaningful understanding of the entity. ✓^

5.1.4 No materiality judgement was carried out, to assist in formulating the direction of the audit. ✓^

5.1.5 The internal control system was not evaluated or tested - had this been done the breakdown in, or override of, the internal control over sales and debtors, would have been identified in all likelihood. ✓^

5.1.6 The failure to carry out these procedures resulted in a totally inadequate audit strategy and response. ✓^ Where a substantial loan is to be applied for, based on the audited financial statements, the risk of manipulation of the financial statements would automatically be regarded as high and possibly, a significant risk i.e. one requiring special audit attention. ✓^ In this situation the response to risk at financial statement level and at assertion level was totally inadequate. ✓^

6. Compliance with IAS 500 – Audit Evidence

6.1 Sufficient (quantity) and appropriate (relevant and reliable) evidence was not obtained. ✓

6.1.1 Only the assertions which could be audited "quickly" were considered. ✓

6.1.2 Debtors and sales, despite large increases, were ignored. ✓

6.1.3 The decision to audit liabilities is sound but it is unlikely that the inexperienced team would have the knowledge to obtain relevant and reliable information on completeness of liabilities particularly in view of the fact that the financial statements were manipulated. ✓

6.1.4 The reliability of 3rd party confirmations is questionable where they were obtained by client staff. ✓

6.1.5 The reliability and sufficiency of internally generated certificates for important assertions (e.g. inventory) is also questionable. ✓

6.1.6 No existence or valuation verification of any assets was conducted. ✓

7. Knowledge of reliance

7.1 There can be little doubt that our firm had knowledge that reliance would be placed upon the audited financial statements, as this was an engagement specifically undertaken for this purpose (as opposed to the recently completed annual audit). ✓

7.2 Mr Crowe actually handed the audited financial statements to Nedcorp Bank, thereby representing to their "correctness". ✓

8. Loss as a result of reliance ✓

8.1 It would appear that Nedcorp Bank did rely upon the audited financial statements and suffered loss as a result of that reliance. ✓

8.2 The bank did call specifically for these audited financial statements but will still

need to show that they had relied upon them. ✓

Study Unit 2.2: The Companies Act, 2008

13.19 (Part (b) & (d) only (25 marks)

References: - Companies Act of 2008

- Jackson & Stent (2016:3/51 – 3/54)

- Study guide (Study unit 2.2)

Canyon (Pty) Ltd is a private company in the paint wholesaling business. John Wayne the newly appointed chief executive officer, is keen to improve the company's corporate governance and has approached you for some advice on various aspects of the Companies Act 2008 which directly affect governance. Currently the company's public interest score is about ninety and the company's annual financial statements are subject to independent review.

However John Wayne informs you that he wants the company's annual financial statements to be externally audited annually, and an audit committee to be appointed. He tells you that the directors have agreed to have the current year's financial statements audited voluntarily, but that he wants to make the annual external audit a requirement in terms of the company's Memorandum of Incorporation. He believes that an external audit is very beneficial and that it should not be dependent on the company's public interest score.

With regard to appointing an audit committee, John Wayne requires that the audit committee be constituted as required by the Companies Act 2008 and that its duties be at least those which are required by the Act.

For the voluntary audit of the current financial statements, the board of directors will appoint the auditor but for future years, the auditor will be appointed as laid down in the Companies Act. This is of course, assuming that the annual audit becomes mandatory in terms of the Memorandum of Incorporation.

John Wayne also tells you that since joining the company, he has been somewhat concerned about the attitude and performance of one of the directors, Doc Hudson. He wants to know whether Doc Hudson could be removed from his position as a director and if so, what procedures would have to be followed. John Wayne is aware that Doc Hudson will not resign his directorship. The company has six directors in total.

Canyon (Pty) Ltd's Memorandum of Incorporation is consistent with the Companies Act 2008 and contains no variations on quorums, notice periods, approval of resolutions, appointments of directors, etc. The company has twenty shareholders.

John Wayne has also given you a list of potential firms/individuals which the board is considering for appointment as auditor for the upcoming audit. The list is as follows:

1. Clint Westwood - a registered auditor and brother of Joe Westwood, one of the shareholders of Canyon (Pty) Ltd.
2. Financial Advisors Incorporated - a dynamic company, the shareholders of which are Luke Radebe CA(SA), Siya Nomvete, BComm LLB and Mathew Hoof CA(SA).
3. Jaqueline Salebi CA(SA) - the former administration manager/company secretary of Canyon (Pty) Ltd. She resigned from the company two years ago.
4. Aeron Colt - a registered auditor and sole practitioner.
5. Karloss, Kwiroshe and Co - an international firm of registered auditors. This firm successfully conducted a wage fraud investigation at Canyon (Pty) Ltd about six months prior to John Wayne's appointment as CEO.

YOU ARE REQUIRED TO:

b) describe to John Wayne the requirements applicable to appointing an audit committee and outline the duties of the audit committee in terms of the Companies Act 2008 (do not concern yourself with King IV). (15)

Ans: 1. To comply with the requirements of the Companies Act 2008:

1.1 Shareholders must appoint the audit committee at each annual general meeting. ✓

1.2 It must consist of at least three members. ✓

1.3 Each member must be a director of the company. ✓

1.4 Each member must satisfy the minimum qualifications prescribed by the Minister to ensure that the audit committee taken as a whole, comprises persons with adequate financial knowledge and experience. Regulation 42

requires that at least one third of the members of the audit committee have academic qualifications or experience in economics, law, accounting, corporate governance, etc. ✓

1.5 A member of the audit committee **must not** be:

* involved in the day to day running of the company or have been so involved at any time during the previous financial year or ✓

* a prescribed officer, or full time executive employee of Canyon (Pty) Ltd (or any related or inter-related company) or have held such post at any time during the previous three financial years or ✓

* a material supplier or customer of the company, such that a reasonable and informed third party would conclude that, in the

circumstances, the integrity, impartiality or objectivity of that member of the audit committee would be compromised or ✓

* a "related person" to any person subject to these prohibitions e.g. the wife of a full time executive employee of Canyon (Pty) Ltd. ✓

2. The duties of the audit committee are to:

- 2.1 Nominate a registered auditor for appointment as auditor by the shareholders (must be satisfied nominated person/firm is independent of Canyon (Pty) Ltd). ✓
- 2.2 Determine the auditors' fees and terms of engagement. ✓
- 2.3 ensure the appointment of the auditor complies with the Companies Act, Auditing Profession Act. ✓
- 2.4 Determine the nature and extent of any non-audit services the auditor may provide to Canyon (Pty) Ltd and pre-approve any agreement with the auditor for the provision of these services. ✓
- 2.5 Prepare a report to be included in the AFS which ...
- * describes how the audit committee carried out its function ✓
 - * states whether the auditor was independent of the company ✓
 - * comments in any way the committee considers appropriate on the financial statements, the accounting practices and internal controls of the company. ✓
- 2.6 Receive and deal with appropriately, any concerns or complaints relating to:
- * the accounting practices and internal audit of the company ✓
 - * the content or audit of the AFS ✓
 - * internal financial controls ✓ or
 - * any related matters ✓
- 2.7 Make submissions to the board on any matters dealt with in (2.6) above. ✓
- 2.8 perform other functions determined by the board. ✓

d) advise John Wayne on whether Doc Hudson could be removed from his position as a director of Canyon (pty) Ltd. (8)

Ans: 1. Clint Westwood: not suitable for appointment because in terms of the Code of Professional Conduct (COPC), he is not independent as he is the brother of one of the shareholders of the company. This relationship is likely to be a threat to his independence, (primarily familiarity) and would certainly be seen to impinge upon the independence of the opinion given by Clint Westwood in his capacity of auditor. ✓^

2. Financial Advisors Incorporated: not suitable for appointment as the company could not be registered with the IRBA and therefore cannot conduct audits. The reason that the company could not be registered with the IRBA is that for any incorporated practice to register as an audit company, all shareholders must be registered auditors; Siya Nomvete is a lawyer and obviously not qualified for registration with the IRBA. ✓^

3. Jacqueline Selebi: although she is a CA(SA) it is not clear whether she is a registered auditor. Furthermore in terms of the Companies Act, any person who has been the company secretary (prescribed officer) at any time during the preceding five years, is disqualified from appointment as auditor. ✓^

4. Aeron Colt: he qualifies for appointment as he is a registered auditor. However, whether he is suitable for appointment depends on whether in his professional assessment, he has the necessary time, skill and resources to audit a company of Canyon (Pty) Ltd's size.

Note: he is a sole practitioner. ✓^

5. Karloss, Kwiroshe and Co: this firm is likely to be the most suitable; it is international and will have the necessary resources. The fact that the firm conducted a successful investigation at Canyon (Pty) Ltd is also a positive factor and in no way disqualifies them from appointment. Furthermore they would be suitable as a long term appointment if the shareholders vote to have an annual audit. ✓^

Study Unit 2.3: Ethical Principles regulating the profession

3.5 (33 marks 40 minutes)

References: - Jackson & Stent (2016: 2/3 – 2/12)

- SAICA Handbook 2015/2016 in SAICA Code of Professional Conduct

- Study guide (Study unit 2.3)

Each year Greenway and Zondeki, a large auditing firm, runs a two week program for prospective trainee accountants who are interested in joining the firm. As you are studying towards becoming a chartered accountant, you applied to join the program and were accepted. On one of the days Ashwell Zondi, a partner of the firm, conducted a workshop on professional ethics. His introduction was as follows "Greenway and Zondeki strives to obtain the highest levels of professional ethics. We will be taking you out to audit clients during this program to assist with basic audit procedures and we expect you to comply with the fundamental principles of professional ethics as laid down by the SAICA Code of Professional Conduct. You have all studied this Code and should be familiar with the principles of objectivity, confidentiality and professional behaviour."

At this point one of the students interrupted "Whilst I understand that compliance with the Code is really important, can we assume that as we are not actually trainee accountants, we are not bound by the Code of Professional Conduct?"

Once Ashwell Zondi had responded to this question he continued.

"We are going to talk about the importance of independence, particularly in respect of assurance engagements such as the audits we will be taking you on. As you know, the auditor (the firm and the members of the audit team) must be, and must be seen to be, independent of the client. There are many situations which can threaten this independence and these are categorised into self-interest threats, self-review threats, advocacy threats, familiarity threats and intimidation threats. The following situations could face an audit firm like Greenway and Zondeki.

Situation 1

A large audit client has not paid its audit fees for two years. The client company has expanded quickly but is illiquid. The amount owed is substantial and after repeated requests that the fees be paid, the directors of the company have offered to settle the debt by issuing shares in the company to each of the partners of the audit firm with a total value equal to the amount of the fees owed.

Situation 2

As part of its social responsibility program, one of Greenway and Zondeki's audit clients has offered to pay the university fees of all trainee accountants employed by Greenway and Zondeki who are studying by distance learning through Unisa towards an accounting qualification. The only conditions are that students must be unable to pay their own fees and that if the trainee accountant fails a year, the full amount must be repaid to the client company by the trainee, within 24 months.

Situation 3

Rudolf Nel the senior-in-charge of the Quickies (Pty) Ltd audit, completes his training contract in December 2018. In April 2018 Quickies (Pty) Ltd offered him the position of financial accountant at the company from January 2019. The existing financial accountant is due to retire at the end of 2018. Quickies (Pty) Ltd's financial year-end is 31 October.

YOU ARE REQUIRED TO:

a) explain in your own words, in the context of an audit engagement, the fundamental principles of objectivity, confidentiality and professional behavior. (6)

Ans: Objectivity: This principle requires that members of the audit team maintain an impartial attitude, are fair and do not allow prejudice or bias to cloud their judgment in matters relating to the audit. ✓

Confidentiality: This principle requires that members of the audit team respect the confidentiality of information obtained during the course of the audit. This means that such information should not be disclosed or used for personal advantage or for the advantage of a 3rd party unless: ✓

* there is a legal duty to do so ✓

* there is a professional duty to do so or ✓

* specific authority has been granted (by the client) to disclose or use the information. ✓

Professional behaviour: This principle requires that members of the audit team:

* comply with relevant rules and regulations ✓

* and that they do not behave in a way which brings discredit to the profession. ✓

* act in a way which adversely affects the good reputation of the profession. ✓

* the audit team includes the students. ✓

b) discuss how Ashwell Zondi would have responded to your fellow student's assumption that "as we are not actually trainee accountants we are not bound by the Code of Professional Conduct." (3)

Ans: 1. Technically you (the student) are correct. ✓

2. However, the COPC makes it clear that a "chartered accountant" must take reasonable steps to ensure those working under his supervision, comply with the code. ✓ (This is the principle of joint and vicarious liability). Failure to do this obviously presents a threat of non-compliance by the firm. ✓ The partners of Greenway and Zondeki would therefore be held responsible for any person (such as the students) who breaches the Code. ✓ You are regarded as being under the firm's supervision. ✓

c) explain

i. why the concept of independence is more important in respect of assurance engagements than it is in respect of non-assurance engagements. (3)

Ans: 1. In an assurance engagement (such as an audit) a chartered accountant reports on financial information prepared by the client with the intention of enhancing the credibility of the information (making it more reliable from the perspective of a user). ✓

2. If the chartered accountant is not independent (and not seen to be independent) of the client, a user is unlikely to accept that the credibility of the information has been enhanced. ✓ The client and the chartered accountant will be seen as one. ✓

3. In the case of a non-assurance engagement, the chartered accountant does not enhance credibility of information but rather sets out to perform a predetermined task (such as compiling financial information) without expressing an opinion thereon. ✓ A user of the information does not require an independent opinion on the information and does not make a distinction between the chartered accountant and the chartered accountant's client. ✓

ii. the terms "self review threat" and "familiarity threat". Give one example for each threat. (4)

Ans: A "self-review threat" is a threat to a chartered accountant's independence which arises when the chartered accountant is evaluating information with which he is directly connected. (The assurance team is reviewing or auditing its own work). ✓

Example. The audit firm audits a client's financial statements which have been drawn up from accounting records written up by the audit firm itself. ✓ A "familiarity threat" occurs when a firm or member of the assurance team becomes too sympathetic to the client's interest because of a close relationship with the assurance company's shareholders, directors, officers or employees. ✓ Example. The manager in charge of the audit of a company is married to the financial accountant of the client. ✓

Note: Other examples are acceptable provided they illustrate the threat

d) state whether each of the situations given in the question would give rise to a threat or threats to the auditor's independence.

Where a threat(s) arises you must

i) categorise the threat or threats

ii) explain why you believe independence would be threatened or, if you believe independence has not been threatened, your reasons therefore.

Ans: Situation 1

1. Yes, independence would be threatened and on two counts. ✓

2. Overdue Fees could give rise to a self-interest threat. ✓

Explanation: If there are already substantial fees outstanding, the firm may not put the necessary resources and time into any future audit work because the partner/manager does not expect the fee to be paid promptly, if at all. ✓ This external factor may create bias which will affect audit performance. (Professional competence is threatened). ✓

3. The issue of shares to the partners would amount to a self-interest threat. ✓

Explanation: 3.1 Being shareholders in an audit client amounts to the partners having a direct financial interest in the audit client. ✓

3.2 The firm would not be independent in mind or appearance e.g. because he has a personal investment in the client, the partner in charge of the audit may "turn a blind eye" to matters which he may otherwise have followed up more diligently. ✓

3.3 The auditor may not hold shares in an audit client. ✓

Situation 2

1. Yes, independence would be threatened in a number of ways. ✓

2. This arrangement could give rise to a self-interest and/or intimidation threat in respect of the trainee. ✓

Explanation: A financially needy trainee accountant who is receiving money from a client becomes dependent on that client. ✓

2.1 Acting out of self-interest, the trainee, not wanting to jeopardize the financial support, may overlook certain matters on the audit which he or she may otherwise take further action on. ✓

2.2 On the other hand the client may "threaten" the trainee with withdrawal of the financial support (if the trainee does not act as the client wishes) giving rise to an intimidation threat. ✓

3. Where a trainee accountant fails a year, he or she becomes a debtor of the client (the fees paid must be repaid) which amounts to direct financial involvement. ✓

Explanation: Although this situation may not give rise to an obvious threat to independence, it is unlikely that the trainee (or the firm) will be seen to be independent (appearance). In addition, will a trainee who owes an audit client money, be totally impartial (in mind)? ✓

4. From the perspective of the firm, this amounts to indirect financial involvement with a client which could give rise to a self-interest or intimidation threat. ✓

Explanation: In effect the audit client is funding the audit firms' employees. This situation is highly beneficial to the audit firm, and may result in the audit firm treating the audit client favourably, and likewise providing the audit client with some power over the firm, ie the client threatens to stop the arrangement. ✓^

Note: It could be argued that if the trainee is not actually a member of the audit team for this specific client, the threat to independence (for that trainee) is reduced. However, the arrangement would still severely compromise the firm's independence and should not be agreed to.

Situation 3

1. Yes, independence would be threatened. ✓

2. This situation would give rise to (potential) self-interest, intimidation and familiarity threats. ✓

Explanation: 2.1 The threat is that Rudolf Nel will, whilst conducting Quickies (Pty) Ltd's audit for the year end 31 October 2018, viewed himself as an "employee" of Quickies (Pty) Ltd and may not wish to act in a manner which may jeopardize his appointment as financial accountant (self-interest) e.g. he may overlook contentious audit issues. ✓^

2.2 As it is likely that the client's accounting staff, as well as other senior staff will be aware of the pending appointment of Rudolf Nel, it is probable that they will not treat Rudolf Nel as an "independent auditor" during the current year's audit, seeing him rather as one of them (familiarity). ✓^

2.3 There is also the possibility that Quickies (Pty) Ltd could place pressure on Rudolf Nel to overlook contentious issues on the audit by "threatening" not to appoint him as financial accountant. ✓^

Note: After Rudolf Nel takes up the position of financial accountant, some threat to the audit team's independence will remain, most likely a familiarity or intimidation threat. Having been the senior on the audit, Rudolf Nel may be friendly with the audit team or may be able to intimidate junior members of the team.

Mark allocation	Situation 1	(5)
	Situation 2	(8)
	Situation 3	(4)

3.10 (Part (b) only) (30 marks)

References: - Jackson & Stent (2016: 2/10 – 2/12)

- SAICA Handbook 2015/2016 in SAICA Code of Professional Conduct

- Study guide (Study unit 2.3)

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 firm's 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.

Ans: Situation 1

1. This situation is not clear cut but does give rise to potential threats to our firm's objectivity/independence. ✓
2. Our firm will have to evaluate whether the fact that one of our partners has a close family relationship with an employee of an audit client, will impair the independence of the audit (and the objectivity of the audit team) either in fact and/or appearance. ✓^
3. In making this decision, the need to consider the following
 - 3.1 Whether Kate Kildair, in her capacity as a member of AgriSpec Ltd's corporate finance division "is in a position to exert direct or significant influence over the financial statements". ✓ As corporate finance is not part of the accounting section and as Kate Kildair does not hold a senior management position, she is unlikely to be in a position to "exert influence". ✓
 - 3.2 Although Ken Kildair is not the engagement partner and not considered to be part of the audit team, audit related tax issues on the AgriSpec Ltd audit are referred to him. ✓ Decisions/transactions taken by the corporate financial section frequently have tax implications which may affect the financial statements, so a possibility does exist that tax implications of corporate finance decisions/transactions into which Kate Kildair has had material input, could be referred to Ken Kildair. ✓ If this were to happen, a self-interest threat would exist. ✓
 - 3.3 Furthermore if Kate Kildair obtained advice from her father (formally or informally) on the tax related issues pertaining to a corporate finance transaction which would affect the financial statements, a self-review threat could arise. ✓^
4. Whilst these threats do not appear to be so significant that we cannot perform and be seen to perform an independent audit, safeguards should be put in place e.g. ✓
 - * AgriSpec Ltd's governance structures should be notified of the family relationship and the approval of the audit committee (public company) should be obtained. ✓
 - * Any tax related matters arising from transactions into which Kate Kildair has had input, should be referred to other tax personnel. ✓

Situation 2

1. In terms of the Code, this situation will present a self-review threat to independence as our audit team will, in all probability, be "expressing an opinion" on accounting work that has been carried out by our firm. ✓
2. Whilst the Code does not prohibit assigning temporary staff to audit clients, it requires that the following safeguards be put in place. ✓
 - * The assigned audit staff may not make any management decisions or exercise authority to commit the client. ✓
 - * The company must acknowledge its responsibility for supervising the assigned staff. ✓
 - * The assigned audit staff must not be part of the audit team. ✓
3. However, in this instance none of these safeguards is appropriate. ✓
 - 3.1 The chief accountant is part of management and he will be required to make numerous decisions and exercise authority. ✓
 - 3.2 The chief accountant is not an employee who is "supervised", he is a "supervisor" of the accounting function. ✓
 - 3.3 The request that the audit manager be assigned is clearly inappropriate and even assigning a non-audit team would not reduce the threats to an acceptable level due to 3.1 and 3.2 above. ✓
4. In addition, as Cruz Ltd is a public company, it is required to have an audit committee. ✓ The audit committee is obliged by the Act to decide on whether our firm should be allowed to carry out non-audit services and to report on its assessment of the auditors independence. ✓ It is unlikely that the committee would be satisfied with this proposal. ✓
5. To achieve the required level of audit independence, the client should be advised to obtain temporary accounting personnel from elsewhere. ✓

Situation 3

1. Again this is one of those "professional conduct" situations which is not clear cut and has no definite answer. There are ethical considerations but the interpretation of the threats and their significance could vary widely! ✓
2. The threats to non-compliance with the fundamental principles arise because ✓
 - 2.1 Sam Sandman is the senior partner of Rexx (Pty) Ltd's auditors. ✓
 - 2.2 Sam Sandman is the chairman of the board of a company which has made a loan

to Rexx (Pty) Ltd for a material amount of money, and which was approved by that board. ✓

2.3 The only link between Rexx (Pty) Ltd and Poziers (Pty) Ltd is actually Sam Sandman, so it is reasonable to assume he was instrumental to setting up this business transaction. ✓

3. Even if Sam Sandman believes that he acted independently, would it appear so?

3.1 Is there an element of "self-interest"? e.g. did Sam Sandman set up/have the loan approved as a favour so as to retain the audit? ✓

4. Is there a future threat of non-compliance with the principle of confidentiality? For example, if Sam Sandman becomes aware through his audit connection that Rexx (Pty)

Ltd is experiencing financial difficulties which Rexx (Pty) Ltd would want to keep confidential and which may affect the recoverability of the loan or the interest payments,

would he inform the Board of Poziers (Pty) Ltd? Being "connected" to both Rexx (Pty) Ltd and Poziers (Pty) Ltd sets up a potential conflict of interest for Sam Sandman. ✓[^]

5. It may of course be argued that although these threats exist, they are insignificant. Their significance will be affected by safeguards which were implemented before the transaction was approved or which can still be implemented, e.g. ✓

5.1 Did Sam Sandman notify both boards of his connection to both Rexx (Pty) Ltd and Poziers (Pty) Ltd, or did he perhaps abstain from voting on the decision to make the loan? ✓

5.2 Sam Sandman was not the designated partner of the Rexx (Pty) Ltd audit and will not be part of the audit team. ✓

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.

Ans: Situation 4

1. I would advise Sam Sandman not to take the engagement (but see 10 below). ✓

2. The situation of giving a second opinion presents significant threats of non-compliance with the fundamental principles of the COPC by the chartered accountant giving the second opinion. ✓

3. This seems particularly likely in this situation as it appears the directors want a specific opinion to satisfy their own requirements, and that they are not being entirely honest or transparent. ✓

* They do not want our firm to contact their existing auditors. ✓

* They want the opinion urgently. ✓

* Are prepared to pay whatever our firm wishes to charge (sounds a bit like a bribe as well!) ✓

4. A threat to our professional competence and due care is presented. ✓ We are not the auditors and cannot obtain information from the existing auditors so how are we going to know if we are being provided with the same evidence and facts as the existing auditor. ✓ If we give an opinion without being aware of all the facts, our opinion may be discredited and we will be seen to be incompetent. ✓

5. This is a distinct possibility as the directors are clearly looking for a particular opinion and may supply us with only the evidence which leads to that opinion. ✓

6. This situation also presents a threat to our objectivity; if we are not given access to the existing auditors (Thorpe and Co) we are limited in our scope and thus cannot give an independent opinion. ✓

7. As we are not sure of the directors motives for getting a second opinion and cannot work with the existing auditors, there is a threat to our compliance with the principles of integrity and professional behaviour. ✓

* Getting a second opinion (which the directors clearly want to be different from the first opinion) may be an attempt to discredit the existing auditors. ✓

* A different opinion given by us may be perceived as a criticism of Thorpe and Co, unfairly casting them as incompetent. ✓

8. The fact that the opinion is "urgently" needed, threatens our competence and due care, as the job may be rushed to satisfy the client and get the big fee! ✓

9. The opportunity to charge whatever we like may result in our firm breaching the principles of integrity and professional behaviour. Firstly, it may be seen as accepting a bribe (especially if our opinion satisfies the directors), and secondly, we may be charged with charging inappropriate fees. ✓

10. The only way in which this engagement could be accepted is if suitable safeguards are put in place e.g. ✓

* Calvin Ltd allow full access to existing auditors. ✓

* Written motivation provided by the directors for the second opinion. ✓

* Adequate time allowed to carry out the assignment and normal fee charging agreed to. ✓

3.12 (25 marks 30 minutes)

References: - Jackson & Stent (2016: 2/10 – 2/23)

- Study guide (Study unit 2.3)

- SAICA Handbook 2015/2016 in SAICA Code of Professional Conduct

1. Kingston Jones, a chartered accountant in public practice, was found guilty of bribing a government official in the provincial traffic department in connection with a speeding fine he had received.

Does this amount to a breach of the SAICA Code of Professional Conduct? Discuss. (4)

Ans: 1.1 The question here is whether the COPC relates to Kingston Jones' behaviour outside of his practice. ✓

1.2 The fundamental principle of integrity requires that a chartered accountant be honest in all professional and business relationships. Is it implied that this extends to honesty in all aspects of his life? ✓

1.3 The fundamental principle of professional behaviour requires a chartered accountant to comply with relevant laws. Does this mean relevant only to his business dealings? ✓

1.4 This fundamental principle also states that the chartered accountant must avoid any action which he knows may discredit the profession. ✓

1.5 Furthermore being a member of the accounting profession creates a responsibility to act in the public interest. ✓

1.6 Bribing a traffic official is a form of corruption and is neither an act "in the public" interest or an act which would reflect positively on the profession, as honesty is an essential feature of the profession and (theoretically at least) a government official works within the public interest. ✓^

2. Harvey Goosen a chartered accountant in public practice, was approached by one of his clients to sign a statement reflecting expenses incurred by the client. The statement was to be used by the client to obtain a reduction in taxes payable to the local authority under which his business fell. As he was not giving an opinion on the statement, Harvey Goosen glanced briefly at it, checked the additions and signed it in his capacity as a chartered accountant. The statement was false.

Could Harvey Goosen be found guilty of breaching the SAICA Code of Professional Conduct? Justify your answer. (3)

Ans: 2.1 Whilst it does not appear that Harvey Goosen has been intentionally dishonest in signing a false statement (which would be a breach of the fundamental principles of integrity and professional behaviour), he has failed to recognise a threat to his compliance with the fundamental principle of professional competence and due care. ✓^

2.2 Even though he is not giving an opinion on the statement, he should have realised that: ✓

* The statement could be false (the client stands to benefit from it). ✓

* His signature will convey a level of "certification"/assurance to the local authority (signed by a CA(SA)). ✓

2.3 Harvey Goosen has not acted diligently or exercised sound judgement in applying professional knowledge and skill and thus is in breach of the fundamental principle of professional competence and due care. ✓

3. Raj Reddy a chartered accountant, was surprised one morning to see that an electronic funds transfer of R500 000 had been made into his firm's bank account. His secretary informed him that two days earlier when Raj Reddy had been out, one of the firm's clients, Benny Marks, had phoned and requested the firm's banking details so that he could make the transfer. The secretary had provided the banking details as requested and Benny Marks had indicated that he would phone Raj Reddy "in a day or so". Later that morning Benny Marks phoned Raj Reddy and requested that Raj Reddy take custody of the money (R500 000) until further notice.

Discuss the action which Raj Reddy should take with regard to the R500 000 so as to comply with the Code of Professional Conduct. (6)

Ans: 3.1 This situation requires that Raj Reddy comply with Section 270 – Custody of client assets. Failing to do so may constitute a threat to his compliance with the fundamental principles of integrity, professional behaviour and objectivity. ✓

3.2 Raj Reddy must therefore put the following safeguards in place:

* Satisfy himself, by discussion with Bennie Marks and or other means, that the money (R500 000) is not from an illegal source. ✓

* Determine why Bennie Marks wishes to place the money in the custody of Raj Reddy's firm and to what purposes the money must be put. ✓

* If satisfied, Raj Reddy must promptly transfer the money out of the firm's bank account and into an account ✓

-in an entity registered in terms of the Banks Act 1990 ✓

-designated as a client account under the control of Raj Reddy's firm, e.g. Reddy client Trust account. ✓

* If Raj Reddy, for any reason, does not wish to hold these funds, the money should be transferred back to Bennie Marks immediately. ✓

* Proper up to date detailed records of the money held in trust and any movements on the balance (e.g. interest, withdrawals) must be recorded and the records must be available for inspection. ✓

4. Zuma and Patterson is a firm of chartered accountants in public practice operating in a small country town. They offer many kinds of financial service, conduct two audits and sell property. During the current year they received, inter alia:
- 4.1 fee income calculated as a percentage of the selling price of a farm which they sold for a client.
- 4.2 15% of the value of an insurance claim paid to a client. Zuma and Patterson had prepared the claim submitted to the insurers on behalf of the client
- 4.3 audit fees from the two audits. These fees are calculated at 1% of the audited net profit after tax for the year. This basis applied to both clients.

Discuss whether the basis on which each of these fees was charged, satisfies the requirements of the SAICA Code of Professional Conduct? (6)

Ans: 4.1 All of the fees mentioned are contingent fees, i.e. they are based on the outcome of a transaction or service. ✓

4.2 Zuma and Patterson should, in terms of Sec 290 – Contingent Fees, recognize that with all contingent fees there is a self-interest threat to their independence and that safeguards must be put in place. ✓

4.3 With regard to the sale of the property, the normal method of remuneration for the selling agent is a percentage of the selling price. ✓ Zuma and Patterson should have agreed the percentage they would charge with the client before the sale was made. They appear not to be in breach of the COPC. ✓

4.4 With regard to the insurance claim, this is not a "regulated method of charging" and does not appear to be commensurate with the value of the service offered, and is not a defensible basis of charging. ✓^

4.5 However, the client may have agreed to this basis, in which case Zuma and Patterson must be quite sure that: ✓

*The fee equates fairly to the skill and time involved in providing the service ✓

*They do not compromise their objectivity and integrity by falsifying the amount claimed to increase their fee ✓

*The client understands exactly the basis of charging and is satisfied with it. ✓

4.6 With regard to the basis of charging audit fees, the firm is in breach of the COPC. ✓ The COPC states categorically that a contingent fee cannot be charged for assurance engagements, as the self-interest threat to the chartered accountant cannot be adequately addressed by other appropriate safeguards. ✓^

4.7 Assurance engagement fees should be charged on a defensible basis relating to the time and expertise employed on the audit. There is no justification for linking the audit fee to the net profit! ✓^

5. Skip Skoombie, a chartered accountant in public practice, operates a small practice which offers assurance services and general business advice to small enterprises. As he does not bother to keep up to date with the tax legislation, he refers all of his clients' tax matters to a friend who runs a tax practice. Sometimes he tells his client that he is doing so but sometimes he doesn't. For every client he refers to his friend, Skip Skoombie receives a fee which his friend determines. **Discuss Skip Skoombie's actions in terms of the SAICA Code of Professional Conduct. (6)**

Ans: There are a number of COPC considerations:

- 5.1 In terms of Section 130 – Professional competence and due care, all chartered accountants are obliged to maintain professional knowledge at a level required to ensure that clients receive competent professional service, so firstly Skip Skoombie should be considering whether he is in breach of this requirement by not bothering to keep up to date. ✓[^] For example, if he does not keep up to date he may well fail to pick up tax issues which should be referred to his "tax expert". ✓
- 5.2 In terms of Sec 130, he is entitled to obtain advice and assistance externally to carry out engagements satisfactorily, but is this a realistic long-term solution, as his clients may be losing out over tax issues which Skip Skoombie has not even recognised as a potential benefit for his clients? ✓[^]
- 5.3 In terms of Section 140 – Confidentiality, Skip Skoombie should not be disclosing client information to 3rd parties without the client's permission. So in the cases where he does not tell the client that he is referring tax work to a friend, he would be in breach of the COPC. ✓[^]
- 5.4 In terms of Sec 240 – Fees and other types of remuneration, Skip Skoombie may receive a referral fee from his friend for the tax work he refers, but this presents a self-interest threat to his compliance with the fundamental principles of objectivity and professional competence. ✓[^]
- 5.5 To reduce this threat to an acceptable level, Skip Skoombie should disclose in advance, in writing, the arrangement to obtain a referral fee. He does not do this. ✓[^]

Study Unit 2.4: Quality Control of audit work

5.7 (33 marks 40 minutes)

References: - SAICA Student Handbook Volume 2A ISQC par 18, 20,26,29, 32, 48

- Study guide (Study unit 2.4)

You are a member of the Quality Control Committee of a large audit firm, Art Andersunn and Co. Part of the committee's responsibility is to determine whether prospective clients are acceptable and whether existing clients should be retained. Being a large practice, numerous potential clients are brought to the committee for consideration and the following list includes a number of recent such cases where the **audit** appointment is available.

1. Trigger Happy Ltd, a company which hires out mercenaries to foreign governments involved in conflict and anyone else who is interested. The company is not listed on any stock exchange.
2. Bossman Ltd, a listed company (with a substantial audit fee), whose chairman is an outspoken critic of the King IV Report on Corporate Governance. His stance is that business is tough and that all the "transparency, disclosure and fairness required by King simply weakens the company as it gives competitors insights they shouldn't have and that business is not supposed to be fair."
3. Nicotar (Pty) Ltd, a company which manufactures cigarettes.
4. Bluevex Ltd, a public company which owes its current auditors R754 000 in audit fees. The company's audit committee claims that the current auditors have overcharged.
5. King Couriers Ltd, a company which has on two previous occasions sued its auditors and on both occasions the auditors (different firms) have admitted negligence and settled out of court.
6. Skweeze (Pty) Ltd, a chain of retail shops which sells pornographic materials and runs escort agencies. The company is a subsidiary of a listed company in the entertainment sector. The holding company auditors have declined the audit.
7. La Paint (Pty) Ltd, a large interior decorating business which is owned by the wife of Art Andersunn and Co's partner in charge of the Taxation department.
8. Interworld Ltd, a prestigious, international corporation with operations worldwide and its head office in Johannesburg.

YOU ARE REQUIRED TO:

- a) **discuss what an auditing firm sets out to achieve by implementing policies and procedures relating to the acceptance of new clients as required by ISQC1. (4)**

Ans: 1. In terms of ISQC1, such policies and procedures are carried out to provide the firm with reasonable assurance that it will only undertake an engagement where the firm ... ✓

* is competent to perform the engagement and has the capabilities, including time and resources to do so. ✓

* can comply with relevant ethical requirements. ✓

* has considered the integrity of the client, and does not have information that the client lacks integrity. ✓

2. From a practical perspective, an audit firm carries out these procedures so as not to make a bad business decision e.g. taking on a client which will not pay its fees or which will negatively affect the reputation of the audit firm. ✓[^]

- b) **comment on how information about a prospective client can be obtained. (4)**

Ans: Information about a prospective client can be obtained in various ways:

1. Communicating with the previous auditor, or in the case of a group, other auditors involved in the audit of group companies. ✓
2. Discussion with the client's audit committee, senior financial personnel. ✓

3. Enquiry of the firm's bankers, legal counsel, etc. ✓
4. Searches of various databases, e.g. on the internet. ✓
5. Review of documentation, public, or made available by the client, e.g. group reports. ✓
6. Enquiry of the firm's partners and employees as to any relationships with the prospective client, and the analysis of any consequences which may arise. ✓

c) **comment on the matters to which your committee should give consideration in deciding on whether to accept the above audit appointments. (25)**

Ans: Trigger Happy Ltd.

- 1.1 The activities of a company such as this may as a result of an Act of Parliament, be illegal. ✓
- 1.2 One of the major practical reasons for conducting preliminary engagement activities is to determine whether there will be any negative consequences for the firm taking on a particular client. ✓ The practice of hiring out mercenaries and being involved in war activities, is morally questionable and is probably not something which: ✓
 * The staff of the firm or other ✓
 * Clients of the firm would be particularly keen for Art Andersunn & Co to be associated with. ✓
 It is therefore, an unwise business decision. ✓
- 1.3 Another aspect to consider would be whether we would be able to actually render our professional service. In a business like this, there is likely to be shady (secretive) dealing between parties, undisclosed movements of funds etc. Limitations on our scope would be inevitable and it would be a breach of professional behaviour to take on work which we know we won't be able to do properly. ✓^
- 1.4 It may also be argued that the integrity of the directors of this type of business is questionable. ✓

Topic 3: General Principles of assurance engagements

Study Unit 3.2: Internal Control

4.19 (12 marks 14 minutes)

References: - Jackson & Stent (2016: 5/3 - 5/19, 7/1 – 7/19)

- Study guide (Study unit 3.2)

Hysbak (Pty) Ltd is a large company which manufactures all kinds of lifting equipment e.g. elevators, hydraulic jacks. Each of the following procedures or conditions takes place or exists at the company:

1. Any employee who is found guilty of unauthorised use of company assets or theft, is dismissed immediately.

Ans: Control environment. ✓

2. Expensive spares and components are kept in a secure area in the warehouse.

Ans: Custody control (physical control). ✓

3. All employees working on accounting applications on the company's local area network are subject to user identification, password and user profile controls.

Ans: Access controls and segregation of duties (user profile) ✓

4. The buying clerks are required to sign all purchase orders (in the designated block) and before sending the order to the supplier, must have the order authorised by the chief buyer (who must also sign in the designated block).

Ans: Isolation of responsibility, ✓ segregation of duties ✓ and authorisation. ✓

5. Management adopt a management philosophy which places emphasis on leadership, sound judgement and ethical behavior.

Ans: Control environment. ✓

6. The production manager approves all overtime hours to be worked before they are worked.

Ans: Authorisation. ✓

7. The company conducts regular inventory cycle counts. All differences between physical inventory and recorded inventory quantities are carefully followed up.

Ans: Comparison and reconciliation ✓ (in this case between actual and theoretical inventory)

8. All company cheques must be signed by two authorised signatories.

Ans: Custody control (protecting the cash in bank). ✓

9. The senior creditors clerk reconciles each creditors statement with the creditors account in the creditors ledger on a monthly basis. Selected reconciliations are reperformed by the financial accountant, before payment is made. All reconciliations reperformed are signed by the financial accountant.

Ans: Comparison and reconciliation ✓, division of duties and isolation of responsibility. ✓

10. Receiving clerks are required to count goods received and must sign all GRNs they make out.

Ans: Comparison/reconciliation ✓ (goods against order/supplier delivery note) and isolation of responsibility. ✓

YOU ARE REQUIRED TO indicate for each of the above procedures/conditions (1 to 10) whether it relates to control environment or control activities. Where your answer is control activities indicate into which category (or categories) of activity it falls (i) to (v).

Two of the components of internal control (in terms of ISA 315 (Revised)) are **control environment** and **control activities**. Five possible control activities are listed below (i) to (v): segregation of duties

- (ii) isolation of responsibilities
- (iii) access/custody controls (physical controls)

- (iv) authorisation and approval
- (v) comparison and reconciliation

Study Unit 3.3 Audit Evidence

4.2 (16 marks 19 minutes)

References: - Jackson & Stent (2016: 5/20 - 5/23)

- Study guide (Study unit 3.3)

The auditor's ultimate objective is to be in a position to express an opinion on the annual financial statements prepared by the directors. To be in a position to do so the auditor must gather sufficient appropriate audit evidence.

1. How is audit evidence, to draw reasonable conclusions on which to base the auditor's opinion, obtained? (2)

Ans: Audit evidence is obtained by performing

- 1.1 Risk assessment procedures. ✓
- 1.2 Substantive procedures. ✓

2. What do "further" audit procedures comprise (consist of)? (1)

Ans: Further audit procedures comprise

- 2.1 Tests of controls. ✓
- 2.2 Substantive procedures including tests of detail and substantive analytical procedures. ✓

3. Explain briefly the term risk assessment procedures. (2)

Ans: Risk assessment procedures are those procedures used to obtain an understanding of the (client) entity and its environment, including its internal control to identify and to assess the risk of material misstatement, whether due to fraud or error, at the financial statement and assertion level. ✓^

4. If the auditor is unable to gain sufficient appropriate audit evidence, what are the consequences? (2)

Ans: It will depend on the extent to which sufficient appropriate audit evidence cannot be gathered and which assertions and account headings are affected. Ultimately though if the auditor is unable to gather the evidence required the auditor will not be able to give an unmodified audit opinion (except for) or may have to disclaim an opinion. A disclaimer will be required where the auditor has not gathered sufficient appropriate evidence to reduce audit risk to an acceptable level. ✓^

5. Is there a connection between the audit strategy, audit plan and the gathering of evidence? Explain. (3)

Ans: 5.1 Yes, there is a strong connection. The audit strategy is the "overall" approach which the auditor will implement to complete a successful audit. It encompasses determining the scope, timing and direction of the audit. ✓^
 5.2 Within the audit strategy will be the audit plan. This lays out the nature, timing and extent of the audit procedures to be carried out. ✓
 5.3 Audit evidence is gathered by carrying out the procedures in the audit plan (which is developed in conjunction with the audit strategy). ✓

6. Do analytical procedures conducted by the client on their own financial information, qualify as audit evidence? (2)

Ans: 6.1 Yes. ✓ This will qualify as audit evidence, but the extent to which the auditor uses it will depend on, inter alia, how reliable it is bearing in mind that the evidence is produced by the client and therefore is by definition "less reliable". ✓^
 6.2 The auditor will also consider the extent to which it is relevant to the audit objective. ✓

7. Why does the auditor generally consider evidence supplied from sources outside the entity as more reliable than evidence supplied by the client itself? (1)

Ans: Such evidence is considered more reliable because it is (usually) independent evidence. ✓

8. The auditor can decide on the sufficiency of audit evidence. Why then is only enough evidence to express "reasonable assurance" gathered, and not enough evidence to "certify" the financial statements? (3)

Ans: No matter how much evidence is gathered, an auditor can never certify the financial statements as correct for the following reasons (inter alia): ✓

- 8.1 Even if the auditor was able to test every transaction in the accounting records, he or she will still not be 100% certain that every single transaction was accounted for, or every single asset or liability was included in the records. Internal controls are always limited. ✓^
- 8.2 More importantly there are numerous account headings in the financial statements which are subjective/based on estimates. e.g. all asset accounts affected by allowances. ✓^
- 8.3 The audit is permeated by judgement and even though more testing may be carried out, it will not necessarily be sufficiently relevant and reliable and may not address every possible manner in which misstatement may occur in an account heading. ✓^

Users of the financial statements understand that the financial statements are not "100% correct" and are prepared to accept and base decisions on amounts and disclosures which are considered by the auditor to be "fair". ✓

4.6 (18 marks 22 minutes)

References: - Jackson & Stent (2016: 5/20 - 5/28)

- Study guide (Study unit 3.3)

During the audit of Posters (Pty) Ltd, a large stationery retailer, the following evidence has been obtained.

1. The warehouse manager told you that no inventory at year-end was held by Posters (Pty) Ltd on consignment (for other parties)
2. The credit controller provided you with a photocopy of a confirmation of balance from one of the company's customers (debtor) in Israel.
3. A list of items of plant and equipment which your senior-in-charge of the audit had compiled reflecting the serial numbers and description of items of plant and equipment which he had selected from the fixed asset register and which he had physically inspected at year-end.
4. An original work-in-progress certificate from the independent contractors currently involved in the construction of additional warehousing for Posters (Pty) Ltd provided for you by the financial accountant.

YOU ARE REQUIRED TO:

a) discuss the factors you would consider in assessing the reliability of the above evidence for audit purposes. (12)

Ans: 1. Inventory on consignment

1.1 Nature

As this is oral evidence, it is less reliable as the warehouse manager could easily deny this at a later stage. ✓^

1.2 Source

On the face of it, the warehouse manager is a senior person in the organization and therefore should be regarded as reliable. ✓^

1.3 However, professional scepticism does not allow the auditor to simply accept that the warehouse manager is "telling the truth" and his evidence would have to be corroborated. ✓^

2. Photocopy

2.1 Source

* The source of the evidence (essentially internally generated) is not very reliable, the original confirmation could have been altered to create the photocopy handed to you. ✓^

* The credit controller should be a reasonably reliable person, but he has provided evidence about an account heading for which he is, as the credit controller, responsible (he is not independent) ✓^

2.2 Nature

* On the positive side there is a document which has been presented and which can be filed with the auditors working papers. ✓^

* Although it is ostensibly a 3rd party document, it has passed through Posters (Pty) Ltd, and has lost its independence; it should have been sent directly to us, the auditors. ✓^

* A photocopy is satisfactory as a "temporary working document" but an original confirmation would be far better. Corroborative evidence would improve the "reliability" of the photocopy and thus the quality of the evidence that is provided by the 3rd party. ✓^

3. Plant and Equipment

3.1 Nature

As this is documentary evidence it should be regarded as reliable, it can be retained and cannot be refuted at a later stage. ✓^

3.2 Source

This document provides evidence for the existence and accuracy, valuation and allocation (allowance for depreciation/impairment) assertions. ✓^ Although it is based on the company's records it is independent evidence obtained by the audit team itself and is therefore reliable. ✓^ It is very reliable for the existence assertion, but less reliable for the valuation assertion as the audit senior will probably not be an "expert" on evaluating the condition of the equipment. ✓^ Further evidence will be sought. In effect, the inspection procedures provide reliable evidence about the existence of inventory but less reliable evidence about its valuation. ✓^

4. Work-in-progress certificate

4.1 Nature

The reliability of this evidence is enhanced by the fact that it is a written (documented) certification and is an original, as opposed to a copy. ✓^

4.2 Source

The providers of the evidence are independent of the client, and assuming no suspicion of collusion exists, the certificate can be regarded as reliable provided the auditor has satisfied himself as to the competency of the contractors to provide the evidence which the auditor needs, e.g. are the valuation methods used by the contractor consistent with International Financial Reporting Standards. ✓^

4.3 Note that the providers of the certificate were not "engaged" by the auditors to provide an independent valuation of work in progress. The certificate may be slightly less reliable because it has passed through the hands of the client and not come directly to us (the auditors) but this is strongly mitigated by the fact that it is an original document and any changes to it would be obvious. ✓^

c) explain the term "corroborative evidence". Give two examples. (The examples need not relate to Posters (Pty) Ltd.) (4)

Ans: Corroborative evidence

1. Corroborative evidence is evidence which supports or supplements other evidence. ✓^

2. Normally a single piece of evidence is not absolute proof in itself and may be evidence gathered about one assertion but which corroborates or supports another assertion. ✓^

3. A single piece of evidence may also not be sufficiently reliable in itself, either in terms of its source or nature, and will thus have to be corroborated by other evidence. ✓^

4. Examples:

4.1 Your client owns a number of heavy duty trucks which your client's operation manager informs you are operating at a remote location. It is not practical or feasible to physically inspect the vehicles to gather evidence as to the existence of the trucks. Information to **corroborate** the evidence provided by the client's operation manager as to the existence of the trucks could be obtained by inspecting licences (normally a "rights" procedure) confirming the payment of driver's wages, inspecting repair bills for the trucks, inspecting

insurance contracts, etc. ✓^

4.2 The financial accountant might inform you that the impairment allowance for inventory for the current year has been reduced because of the improvement in goods handling controls in the warehouse. ✓^ This may be corroborated by discussion with the warehouse manager, observation of goods handling and inspection of the manual of (new) handling procedures. ✓^

4.7 (20 marks)

References: - Jackson & Stent (2016: 5/20 - 5/28)

- Study guide (Study unit 3.3)

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 one example for each type of test (1 to 7 above). Your example can be a substantive test or a test of controls. (7)

Ans: 1. Inspection

1.1 Inspection consists of examining records, documents (physical or electronic files), or tangible physical assets. ✓

1.2 Substantive or test of controls. ✓✓

1.3 Example: * Inspect a lease agreement to determine whether it has been signed by an authorised signatory (testing the control which requires that all lease agreements be authorised/approved by, say, the financial director). ✓^

* Inspect the date on a supplier's delivery note to confirm that goods received close to the year-end have been accounted for in the correct financial period (testing cut-off). ✓^

2. Observation

2.1 Observation consists of looking at a process or procedure being performed by the client's staff. ✓^

2.2 Normally a test of control but could be substantive. ✓

2.3 Example: * Attendance at the annual inventory count to observe the performance of the counters (may be part of substantiating quantities). ✓^

* Observing a receiving clerk accepting goods being delivered by a supplier (test of controls). ✓^

3. Inquiry

3.1 Inquiry consists of seeking information of knowledgeable persons inside or outside the entity. Enquiries may range from formal written enquiries addressed to third parties, to informal oral inquiries addressed to persons inside the entity. ✓

3.2 Substantive or test of controls. ✓✓

3.3 Example: * Inquiring of the warehouse controller as to the methods of identifying obsolete or damaged inventory (part of "substantiating" the inventory impairment allowance). ✓^

* Inquiring of the orders clerk as to what procedures he actually follows when an order is received from a customer (testing whether the order clerk carries out the prescribed controls). ✓^

4. Recalculation

4.1 Recalculation consists of checking manually or electronically the arithmetical accuracy of documents or records. ✓

4.2 Substantive or test of controls. ✓

4.3 Example: * Casting (and recalculating deductions etc) the payroll for a particular month. ✓^

* Recalculating depreciation on plant and equipment. ✓^

Note: There will often be a control procedure (either manual or electronic) which checks any calculations/arithmetic. If the auditor performs recalculations and finds them to be correct, he gathers evidence that the control is working, and is substantiating the amounts affected by the calculation.

5. Analytical procedures

5.1 Analytical procedures consist of the analysis of significant ratios and trends and the resulting investigation of fluctuations and relationships that are inconsistent with other relevant information or which deviate from predicted amounts. It can be described as evaluating financial information through analysis of plausible relationships among both financial and non-financial information. ✓

5.2 Substantive. ✓

5.3 Example: * Ratio analysis is conducted on the gross profit and compared to prior year ratios. ✓^

* The current years bad debts are analysed and compared to prior years. ✓^

6. Reperformance

6.1 Reperformance involves the auditor independently executing (carrying out) procedures and controls which were originally performed

as part of the entity's internal controls. ✓

6.2 Substantive or test of controls. ✓

6.3 Example: * Reperforming the bank reconciliation at the financial year-end. ✓^

* Reperforming the age analysis of debtors balances. ✓^

Note: Reconciling the bank (cashbook and bank statement) is a control activity. If the auditor reperforms the reconciliation and finds it to be correct, he has some evidence that the control is working and is also substantiating the amount at which the "bank account" is reflected in the AFS.

7. External confirmation

7.1 External confirmation involves obtaining a direct written response from a third party to a request/query from the auditor to that third party. ✓

7.2 Usually substantive but where a third party forms part of an internal control procedure, this control procedure could be tested by obtaining confirmation from the 3rd party that the control is functioning. ✓

7.3 Example: * Obtaining a bank confirmation (balance etc) (substantive) ✓^

* Confirming a debtor's balance (substantive) ✓^

* Before making any payments to its contractors, a construction company must obtain written consent from an architect/quantity surveyor approving the work carried out by the contractor. The auditor could test this control by confirming a list of payments made to contractors directly with the architect/quantity surveyor.

4.11 (15 marks 18 minutes)

References: - Jackson & Stent (2016: 5/20 - 5/28)

- Study guide (Study unit 3.3)

Each of the procedures described below is directly relevant to one of the assertions listed below the procedure.

YOU ARE REQUIRED TO identify the assertion to which each of the procedures listed above (1 to 10) is directly relevant. Give a brief explanation for your choice. You are not required to explain why you did not select the other assertions.

1. A trainee on the audit team selected a sample of items of equipment entered in the fixed asset register and made a list of the description and the unique asset number of each item selected. He then went to the factory and matched each asset number on his list to the asset number stamped on the item of equipment and agreed the description of the item to his list.

1.1 **rights:** plant and equipment

1.2 **existence:** plant and equipment

1.3 **classification:** plant and equipment.

Ans: Existence (1.2). ✓ The auditor is gathering evidence that items of equipment which are recorded in the fixed asset register (which will be reconciled with the plant and equipment account in the general ledger) do actually exist, i.e. plant and equipment is not overstated by the inclusion of nonexistent items. ✓^

2. Whilst the trainee was in the factory he selected a small sample of items of equipment which were not on his list (see procedure 1), and wrote down a description and the unique asset number stamped on each item. On returning to the audit office, the trainee inspected the fixed asset register to determine whether the items on this list were entered in the fixed asset register.

2.1 **existence:** plant and equipment

2.2 **accuracy, valuation and allocation:** plant and equipment

2.3 **completeness:** plant and equipment.

Ans: Completeness (2.3). ✓ The trainee has changed the direction of testing. He is seeking evidence that items of equipment which do "exist" in the client's factory are actually included in the plant and equipment account, i.e. the plant and equipment account is not understated. (Understatement of plant and equipment is not usually a medium or high risk which is probably the reason that the trainee extracted only a small sample.) ✓^

3. A trainee selected a sample of purchases recorded in the purchase journal for the month prior to year-end and he obtained the supporting documentation for each purchase e.g. supplier invoice, supplier delivery note and client goods received note. Once he had obtained these, he inspected the dates on the documentation to determine whether the goods purchased had been received prior to the year-end.

3.1 **classification:** purchases

3.2 **cut-off:** purchases

3.3 **accuracy:** purchases

Ans: Cut-off (3.2). ✓ The trainee is gathering evidence that the purchases (transactions) recorded in the purchase journal were received before the financial year-end and have thus been recorded in the **correct accounting period**. ✓^

4. The trainee selected a sample from the purchase journal for the last three months of the year (since the previous interim audit). He obtained the supporting documentation and inspected it to determine whether the documents were made out to the audit client and that the goods purchased were of a type used by the company.

4.1 **completeness:** purchases

4.2 **classification:** purchases 4.3 **occurrence:** purchases.

4.3 **occurrence:** purchases

Ans: Occurrence (4.3). ✓ The trainee is gathering evidence that the purchases (transactions) recorded in the purchase journal are transactions which have actually occurred **and** which pertain to the client (they are not purchases for any other party). ✓^

5. The trainee selected a number of creditors accounts from the list of trade accounts payable at the financial year-end. He obtained the supporting documentation for the transactions making up the balance owed, e.g. creditors statements, supplier invoice, etc, and inspected them to determine whether they were made out to the audit client, and that the documentation was in respect of goods (or services) used by the company.

5.1 **obligation:** trade accounts payable

5.2 **completeness:** trade accounts payable

5.3 **valuation:** trade accounts payable.

Ans: Obligation (5.1). ✓ The auditor is gathering evidence that the amounts included in the trade accounts payable are in respect of obligations which the client has to pay to the creditor, i.e. the balance does not include amounts which are payable by (obligations of) other parties. ✓^

6. The trainee selected a number of foreign trade creditors from the list of trade accounts payable at year-end. He then obtained the amount owed to the creditor in the foreign currency and the applicable currency exchange rate at the financial year-end. Using the spot rate and the amount owed in the foreign currency, he compared the amount he had computed to the amount listed on the trade accounts payable list.

6.1 **accuracy:** purchases

6.2 **accuracy, valuation:** trade accounts payable

6.3 **completeness:** trade accounts payable.

Ans: Accuracy, valuation (6.2). ✓ The amount owed to the foreign creditor must be valued at the exchange rate prevailing at the financial year end. The creditor would have been initially raised at the exchange rate prevailing at the transaction date. As the rates at year-end and at transaction date are likely to differ, the auditor reperforms the conversion to confirm that the foreign creditor is correctly valued at year-end. ✓^

7. At the conclusion of the year-end inventory count, a senior on the audit team and the client's warehouse manager worked their way through the warehouse, noting (recording) any items of inventory which were damaged and/or non-saleable.

7.1 **accuracy, valuation and allocation:** inventory

7.2 **existence:** inventory

7.3 **completeness:** inventory.

Ans: Accuracy, valuation and allocation (7.1). ✓ Inventory must be valued at the lower of cost or net realisable value. Inventory which has been "impaired" must be written down, i.e. the value of inventory is reduced by the obsolescence/impairment allowance. This procedure produces some evidence to assist in establishing whether the impairment allowance is "fair". ✓^

8. A trainee obtained a list of imported goods-in-transit which had been included in the inventory balance at year end. By discussion with the financial manager and inspection of relevant shipping documentation, he established when the risks and rewards of ownership of the imported goods passed to the client.

8.1 **rights:** inventory

8.2 **existence:** inventory

8.3 **completeness:** inventory.

Ans: Rights (8.1). ✓ Inventory in transit can only be included in the AFS if the client has the rights of ownership to the inventory. Thus the auditor must establish when the risks and rewards of ownership transfer to the client. ✓^

9. The client has a (computerized) inventory masterfile. Amongst other information, the masterfile contains a "cost field" and a "most recent selling price" field for each item. Using audit software, a trainee compared these two fields to identify any items of inventory for which the amount in the "most recent selling price" field was less than the amount in the "cost" field.

9.1 **accuracy:** sales

9.2 **accuracy:** purchases

9.3 **accuracy, valuation and allocation:** inventory.

Ans: Accuracy, valuation and allocation (9.3). ✓ As discussed above, inventory must be valued at the lower of cost or net realizable value. This procedure will produce a report of any inventory items for which the cost exceeds the selling price. To arrive at the appropriate "value" of inventory these items will have to be written down to their net realisable value. ✓^

10. The manager on the audit of a listed company, carefully read through the accounting policy notes in the annual financial statements pertaining to long term borrowings to satisfy himself that they were relevant and understandable.

10.1 **presentation:** long term borrowings

10.2 **occurrence:** long term borrowings

10.3 **classification:** long term borrowings.

Ans: Presentation (10.1). ✓ The manager is determining whether the disclosures relevant to long term liabilities are relevant and understandable in the context of the requirements of IFRS or IFRS for SMEs. ✓^

Study Unit 3.4: Risk assessment and audit procedures

4.20 (21 marks 25 minutes)

References: - Jackson & Stent (2016: 7/8 - 7/17)

- Study guide (Study unit 3.4)

In terms of ISA 315 (Revised), an important component of a company's internal control is its risk assessment process. This may be a highly structured documented process as might be found in a large listed company or a less formal process as might be found in a small to medium sized private company. Either way, a risk assessment process is of little value if the risks identified are not addressed. Many of the risks faced by a wide variety of companies are very similar and are addressed by the introduction of basic internal control activities. Business risks are assessed not only as regards the business as a whole e.g. the risk of foreign competition, but also at operational level within the various business cycles.

Britelites (Pty) Ltd, a medium sized retailer of decorations and light fittings has implemented the following control activities (amongst others) to address risks which they face in the various business cycles.

YOU ARE REQUIRED TO discuss the risk(s) which each of the internal controls implemented by management and listed above, is intended to address.

1.The purchase application software will not produce a purchase order unless the order is made out to a supplier listed on the approved supplier masterfile. (3)

Ans: 1.1 This control procedure is intended to address the risk that the company buyers will purchase products which do not meet Britelites (Pty) Ltd's requirements as regards quality, price and reliability. Before a supplier is placed on the approved supplier list, management would have to evaluate their suitability as a supplier. ✓^

1.2 This control procedure also contributes to addressing the risk that buyers act "fraudulently" by such means as channeling orders to their own (sideline) businesses (at expensive prices etc), place orders with suppliers for kickbacks or collude with suppliers to benefit themselves. Again when evaluating potential suppliers, management would have considered the ethics/honesty of the supplier. ✓^

2.To gain access to the warehouse, warehouse employees must place their thumb on a biometric reader. If the thumbprint is authorized, the turnstile is activated. (2)

Ans: 2.1 This control is intended to reduce the risk of unauthorised employees entering the warehouse and will be part of the controls designed to protect the company's inventory from theft or damage. ✓^

3.To effect monthly payments to creditors by electronic funds transfer, both the financial accountant and the financial director must enter their unique passwords before the payment will be transferred. (2)

Ans: 3.1 This control procedure is implemented to protect the company's cash (asset) from being stolen or used for invalid purposes. ✓^

3.2 The control must be used in conjunction with a control procedure which requires the financial accountant and financial director to satisfy themselves as to the validity of the payment (e.g. scrutiny of supporting documentation). ✓^

4.Comprehensive enquiries relating to a proposed (new) customer's creditworthiness are carried out by the credit manager. (2)

Ans: 4.1 This control procedure is implemented to address the risk of the company suffering loss because a customer to whom credit terms were extended, does not pay for goods purchased from Britelites (Pty) Ltd. ✓^

5.Inventory cycle counts are conducted on different sections of the warehouse at the end of every month. (2)

Ans: 5.1 This control is to identify differences between actual inventory (physical) and recorded inventory, which can then be followed up to ascertain the reason for the difference. ✓^

5.2 It is one of the controls used to detect theft of inventory or misallocation of inventory (placed in incorrect location). ✓^

5.3 It also contributes to maintaining the accuracy of the perpetual inventory records as differences may be caused by problems in the recording (issue or receipt) of inventory. ✓^

6.Adjustments to the inventory masterfile arising from differences in quantities identified by the cycle count must be

6.1 entered on properly designed, preprinted sequenced masterfile amendment forms, by the warehouse controller

6.2 signed by the warehouse controller and

6.3 signed by the financial accountant after scrutiny of the supporting documentation. (4)

Ans: 6.1 There are a number of internal controls covered here and the overall intention is to address the risk of unauthorised masterfile amendments being put through (usually) to cover up shortages in inventory brought about by theft. There are also some lesser risks addressed. ✓

* Properly designed pre-printed masterfile amendment forms facilitate the accurate and complete entry of amendments onto the system reducing the risks of entry rejections or errors in the inventory file. ✓^

* Sequenced hardcopy master amendment files (MAFs) provide each document with a unique number. This allows for subsequent follow up and reduces the risk of a MAF being lost or not entered (computer will sequence test). ✓^

* Having the warehouse controller sign, isolates responsibility for the amendment and reduces the risk of someone unauthorised preparing the adjustment (financial accountant will check for the correct signature). ✓^

* Having the financial accountant sign after checking the supporting document reduces the risk of unauthorized, inaccurate or incomplete adjustments being made to the records. ✓^

7.At the end of each working week, a clerk in the accounting department sequence tests the dispatch notes and matches each dispatch note to a sales invoice. (2)

Ans: This internal control is intended to reduce the risk of a dispatch of goods to a customer not being raised as a sale and thus resulting in a loss to Britelites (Pty) Ltd ✓^

7.1 Missing dispatch notes will be identified by the sequence test and can be followed up. ✓^

7.2 Dispatch notes for which there is no sales invoice, will be identified by the matching exercise and the failure to make out an invoice can be rectified. ✓^

8. When a credit note is made out for a customer, it must be

8.1 made out by the accounting department

8.2 cross-referenced to the original sales invoice and

8.3 presented to the financial accountant with the signed goods returned note, original sales invoice and any customer documentation. (4)

Ans: 8.1 The intention of these internal controls is to address the risk of credit notes being made out for: ✓^

* Goods that were not returned ✓^

* Goods which were returned but which did not meet the requirements for valid returns e.g. goods must be returned within 30 days of sale to the customer ✓^

* The incorrect goods (description, quantity, price). ✓^

8.2 Having the accounting department make out the credit note (as opposed to the receiving department) is good division of duties as it makes it harder to pass an invalid credit note. ✓^

8.3 Having the credit note cross-referenced to the original sale and presented with the goods returned note and supporting documentation enables the accountant to satisfy himself that the credit note is valid, accurate and complete for subsequent entry into the books. ✓^

Study Unit 3.5 Materiality

6.14 (Part 1,3,4 & 5 only) (11 marks)

References: - Jackson & Stent (2016:7/22-7/32);

- Study guide (Study unit 3.5)

1. Discuss materiality in the context of the preparation and presentation of financial statements. (4)

Ans: 1.1 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 misstatements. ✓

Expressed slightly differently, if the misstatement is something which the user "should know about" then it will be material. ✓

1.2 Judgements about materiality are made in the light of surrounding circumstances, and are affected by the size or nature of a misstatement, or a combination of both. ✓ In effect this means that there is no "one size fits all" for materiality and that there are both qualitative and quantitative aspects to materiality. ✓

1.3 Judgements about matters that are material to users of the financial statements are based on the *common* financial information needs of users as a group and not on the needs of specific individual users. ✓ If the financial statements are prepared for a specific user group e.g. a financial institution, and not for general use, specific needs would be considered. ✓

6. Explain the difference between using the concept of materiality at the planning stage of the audit and at the evaluating stage of the audit. (2)

Ans: 3.1 Using the concept of materiality at the planning stage amounts to the auditor setting materiality limits or levels which provide a basis for planning and conducting risk assessment procedures as well as further audit procedures. ✓ Unless the audit team has an idea of what amount is considered material, they will be unable to identify and address "material" misstatement. ✓

3.2 Using the concept of materiality at the evaluation stage amounts to the auditor setting amounts by which the auditor believes an account heading in the financial statements can be misstated by uncorrected misstatements before it will affect the user. ✓ The auditor measures uncorrected misstatements against the final materiality limit to determine whether the financial statements will require qualification if the misstatement is not corrected. (There will also be a qualitative evaluation at this stage.) ✓

7. Identify five factors to be considered when quantifying "planning" materiality. (3)

Ans: 4.1 The use of preset guidelines (benchmarks). ✓

4.2 The importance of specific information to users (relating to an account heading). ✓

4.3 Legal or regulatory requirements applicable to the account heading. ✓

4.4 The key disclosures in relation to the industry in which the entity operates. ✓

4.5 The opinions, views and expectation on materiality of those charged with governance and the audit committee. ✓

4.6 Historical information – prior year materiality limits. ✓

8. Distinguish between planning materiality and performance materiality. (2)

Ans: 5.1 Planning materiality is an overall guideline to the audit and is the auditor's judgement as to the amount of misstatement in the financial statements which a user of the financial statements can "live with". ✓

5.2 Performance materiality is the amount (or amounts) set when the auditor plans tests on *specific* account balances or classes of transactions, to provide a guideline as to the extent (and nature) of tests on the relevant account heading. ✓

Study Unit 3.6: Audit Risk

6.4 (20 marks 24 minutes)

References: - Jackson & Stent (2016:7/4-7/7);

- Study guide (Study unit 3.6)

1. What is the link between audit risk and the assertions? (2)

Ans: 1.1 Embodied in the financial statements, are what are termed the assertions of the directors, which are in effect, their representations about the company's assets, equity, liabilities, transactions and events and disclosures. ✓

1.2 Audit risk is the risk that the auditor will express an inappropriate opinion on the financial statements when the financial statements are materially misstated. ✓

1.3 To keep audit risk at an acceptable level the auditor identifies and assesses the risk of material misstatement in the financial statements by considering account headings in terms of the assertions applicable to them and formulates an appropriate audit strategy and audit plan to respond to the risks relating to the assertions. ✓^

2. Distinguish between the risk of material misstatement at financial statement level and at assertion level. Illustrate with an example. (3)

Ans: 2.1 Risk at the financial statement level is the risk which affects the financial statements as a whole, and which may filter down into the account balances and totals which make up the financial statements. ✓

2.2 Risk at assertion level is the risk that affects account balances and transactions and their related disclosures, i.e. the assertions relating to these account balances. ✓

Example: A lack of integrity on the part of management will be a risk at **financial statement level**, as it may give rise in a general sense to the risk of material misstatement by manipulation of the financial statements. It is not a risk specific to an assertion but has the potential to affect numerous assertions applicable to classes of transactions, account headings and their related disclosures.

For a company which sells diamonds, a risk of misstatement of the **accuracy, valuation and allocation** assertion applicable to its inventory will be present. It is obvious and specific and arises from the fact that placing a value on a diamond due to its varied characteristics is inherently risky

3. How does the auditor respond to a high level of risk at financial statement level? (3)

Ans: Responses may include

3.1 Assigning staff with appropriate experience and high level skills. ✓

3.2 providing more supervision and careful review. ✓

3.3 introducing elements of unpredictability into the audit. ✓

3.4 emphasising the need for professional scepticism by the audit team. ✓

3.5 changing the way the audit was carried out compared to prior years. ✓

3.6 changing the nature, timing and extent of testing. ✓

4. How would your assessment of risk differ for the following situations

4.1 management is assessed as lacking competence.

4.2 management is assessed as competent but lacking integrity. (3)

Ans: 4.1 Both situations 4.1 and 4.2 will increase our assessment of the risk of misstatement at the financial statement level. ✓

4.2 However, the lack of integrity presents a greater risk of misstatement because management may attempt to manipulate the financial statements. ✓

4.3 Where there is intention to manipulate, the risk of fraudulent financial reporting is present, and there are numerous ways in which it can be done. This makes it very difficult for the auditor to reduce audit risk to an acceptable low level. ✓

4.4 If management lacks integrity, they may also be misappropriating assets one way or another which compounds the auditor's problem. ✓

4.5 Where management are not competent but honest, they are more likely to make obvious errors and be quite happy to work with the auditors rather than deceiving them. ✓

5. An immaterial account balance cannot attract audit risk. True or false? Justify. (2)

Ans: **True.** ✓

5.1 Audit risk is concerned with the auditor missing material misstatements, i.e. misstatements which could influence a user. ✓ Thus if the account balance/heading is immaterial it cannot contain material error in the context of the financial statements as a whole. ✓

6. The assessment of the risk of material misstatement at assertion level will affect the audit plan but not the audit strategy. True or false? Justify. (2)

Ans: **False** ✓

6.1 Both the audit strategy and the audit plan are affected by the assessed risk of material misstatement at assertion level. ✓

6.2 The auditor must respond to risk at both financial statement and assertion level by setting a suitable audit strategy and plan. ✓ For example, where there is a high risk of misstatement relating to the valuation of say, work-in-progress, (assertion level) the audit **strategy** may be to engage an (external) expert and the audit **plan** will be the detailed procedures which both the auditor and the expert conduct to obtain sufficient appropriate evidence pertaining to the accuracy, valuation and allocation assertion. ✓

7. Suggest two factors which may increase the risk relating to the rights assertion for property, plant and equipment. (2)

Ans: Rights

7.1 Where there is doubt about whether the risks of ownership have passed for a leased asset which has been capitalised. ✓

7.2 Where a historical claim to land has been made to vacant land supposedly owned by the company. ✓

7.3 Where the client has not complied with mortgage bond requirements and its right to the property is placed in jeopardy. ✓

8. Suggest three factors which may increase the risk relating to the accuracy, valuation and allocation assertion for property, plant and equipment. (3)

Ans: Accuracy, valuation and allocation

8.1 Plant and Equipment has been imported during the year. Increased risk that the cost at which it is recorded is misstated by inclusion/exclusion of various import costs etc, and the application of incorrect exchange rates. ✓

8.2 Technological advances which may render existing plant obsolete resulting in the understatement of impairment allowances. ✓

8.3 Revaluations of property or plant and machinery by the client (risk of overstatement). ✓

8.4 Where improvements and repairs have been effected to plant and equipment and the distinction between the two is difficult to establish. (Could also be regarded as a risk related to classification.) ✓

8.5 The estimation of the useful life of the asset is complicated. ✓

Topic 4: The audit process

Study Unit 4.1 Stages of the audit process

5.6 (15 marks 18 minutes)

References: - Jackson & Stent (2016: 6/6 - 6/8)

- Study guide (Study unit 4.1)

You firm has recently completed the audit of Parka (Pty) Ltd for the financial year end of 31 March 2018. This was the first financial year for which your firm was appointed as auditors for his large manufacturing company.

The following procedures/activities were undertaken during the course of the audit process:

YOU ARE REQUIRED TO indicate during which stage each of the procedures/activities listed above (1 to 15) will have taken place. Give a brief explanation for your choice.

1. Audit team members conducted a physical inspection of the company's plant and equipment to identify any impairment of the asset.

Ans: Responding to risk – carrying out a further audit procedure. ✓^

2. A discussion was held between your firm's senior partner and the previous auditor of Parka (Pty) Ltd to determine whether the previous auditor was aware of any professional reason why your audit firm should not accept the audit.

Ans: Preliminary engagement activity – determining whether our firm wishes to establish a professional relationship with Parka (Pty) Ltd. ✓^

3. The engagement partner evaluated the suitability, for the 31 March 2018 audit of Parka (Pty) Ltd, of your firm's newly adopted materiality guidelines.

Ans: Planning – establishing planning materiality. ✓^

4. Senior members of the audit team met with the audit committee to discuss instances of fraud at Parka (Pty) Ltd of which the audit committee might have been aware.

Ans: Planning – conducting a risk assessment procedure (presence of material misstatement due to fraud). ✓^

5. The senior partner of your audit firm met with management at Parka (Pty) Ltd to discuss inter alia, whether the preconditions for an audit were present.

Ans: Preliminary engagement activity – part of agreeing terms of the engagement. ✓^

6. A trainee on the audit team obtained certificates of balances at 31 March 2018 from all long term creditors.

Ans: Responding to risk – carrying out a further audit procedure to address risk associated with liability assertions. ✓^

7. The audit manager visited the company's website which contains extensive information about the company's organizational structure, board of directors, management personnel, social and environmental programmes etc.

Ans: Preliminary engagement activity and risk assessment procedure – gathering information which may assist in deciding whether the firm wants to establish a professional relationship with Parka (Pty) Ltd, and which may provide a better understanding of the client. ✓^

8. The engagement partner took a decision to work closely with the company's internal audit division on a number of audit related matters.

Ans: Planning – establishing the audit strategy. ✓^

9. The audit manager considered whether all material events which occurred after year-end up to the date of the audit report were identified and appropriately dealt with.

Ans: Concluding stage – evaluating treatment of post balance sheet events. √^

10. The audit manager compiled a schedule allocating members of the audit team to specific audit areas according to the experience and expertise required to carry out the audit procedures.

Ans: Planning – establishing the audit strategy, allocation of resources. √^

11. The audit senior set the performance materiality limits for the audit of the major account headings.

Ans: Planning – materiality and planning further audit procedures required to gather sufficient appropriate evidence. √^

12. Members of the audit team selected a sample of journal entries on which to conduct a combination of tests of controls and substantive tests.

Ans: Responding to risk – carrying out planned "further" audit procedures to address the risk of material misstatement arising from the passing of unauthorised or incorrect journal entries.

√^

13. The head of your firm's computer audit division met with Parka (Pty) Ltd's IT director to familiarize himself with the company's IT system and determine whether your firm's audit software was compatible with Parka (Pty) Ltd's system.

Ans: Planning – establishing audit strategy (use of audit software) and conducting risk assessment procedures (to an extent). √^

14. The audit manager scrutinized all the minutes of directors meetings for the year ended 31 March 2018 and noted all information and resolutions of audit importance.

Ans: Planning – conducting risk assessment procedures by gathering information which provides a better understanding of the client and of the consequences of decisions taken by the directors on the financial statements. √^

15. The audit manager made arrangements with Parka (Pty) Ltd's production manager for the audit team to be given a guided tour of the company's manufacturing facility.

Ans: Planning – planning a risk assessment procedure which provides a better understanding of Parka (Pty) Ltd and its manufacturing process. √^

The audit process can be broken down into four stages i.e.

*the preliminary stage

*the planning stage

*the responding to assessed risk stage

*the concluding stage.

Study Unit 4.2 The Preliminary Engagement Stage

13.15 (Part (a) only (8 marks)

References: - Jackson & Stent (2016: 6/9 - 6/13)

- Study guide (Study unit 4.2

You are a manager at Hills and Co, a large auditing firm in Durban. Nancy Naiker, one of the partners, has called a meeting of selected staff members in the firm to discuss a new client engagement which the firm has accepted.

Technet (Pty) Ltd, the new client, is a large computer services firm which specialises in the implementation of computer networks. As would be expected, its own financial and related systems are fully integrated and make use of leading edge technology.

The new engagement came about as a result of a friendship which developed between Nancy Naiker and Daniel Buys, the managing director of Technet (Pty) Ltd. Hills and Co are to perform the audit function and certain company secretarial services for Technet (Pty) Ltd. Technet (Pty) Ltd's public interest score requires that the company's annual financial statements be externally audited. The company has fifteen ordinary shareholders. No audit committee has been appointed.

Daniel Buys has informed Nancy Naiker of his intention to raise additional finance amounting to R5 000 000 for the company, by issuing further ordinary shares. The company's only authorised share capital is 100 000 ordinary shares of no par value. However, these shares have already been issued in full. Daniel Buys has therefore asked Hills and Co for advice in this regard and would like further advice on any Companies Act requirements relating to the issue. It is intended that the directors of Technet (Pty) Ltd will be offered shares. None of the directors currently hold shares. The company's MOI prohibits shareholders' meetings from being held electronically.

Nancy Naiker has, with the consent of Daniel Buys, already communicated with Ben Bean, the previous auditor and has had a satisfactory reply to her request for details of any factors which should be considered in deciding whether or not to accept the appointment. The main reason for the change of auditors at Technet (Pty) Ltd is that Ben Bean will be emigrating to England at the end of the year.

YOU ARE REQUIRED TO:

a) briefly describe the preliminary engagement activities which Hills and Co would have carried out before accepting the audit engagement of Technet (Pty) Ltd. (8)

Ans: Preliminary Engagement Activities

1. Pre-conditions for an audit

1.1 Our firm would first have confirmed whether the following pre-conditions for an audit are present the ...

* financial statements are prepared in terms of an acceptable financial reporting framework, e.g. IFRS and ✓

* auditor is satisfied that management understands and acknowledges its responsibilities. ✓

As his is a well established company which has previously been audited, it should

not be at all difficult to establish that the pre-conditions are present but the confirmation must still be sought. ✓

2. New client investigation

2.1 Hills and Co would have considered whether there were any reasons that the firm should not be associated with Technet (Pty) Ltd. ✓

2.2 Hills and Co would also have assessed from communication with Ben Bean and perhaps other sources, whether there are any practical reasons for not taking on Technet (Pty) Ltd e.g. poor auditor/client relationships, problems collecting audit fees, or unethical business practices. ✓

3. Comply with ISA 220 "Quality Control for an audit of financial statements"

In terms of this statement Hills and Co would have

3.1 Evaluated the integrity of the principle owners, key management and those charged with governance. ✓

3.2 Determined whether the firm is competent to perform the engagement. Does the firm have the necessary time and resources? Does it have personnel who have knowledge of Technet (Pty) Ltd industry, regulatory and reporting requirements? ✓

* Hills and Co is a large practice, so should have adequate competencies and resources. However, the integrated financial systems used by Technet (Pty) Ltd, may require computer skills which are beyond the current capabilities of Hills and Co, so Nancy Naiker would have been well advised to clear this aspect with the partner in charge of computer audit, prior to accepting the engagement. ✓

3.3 Assessed whether the firm can comply with ethical requirements. In this case the firm will have to assess whether the relationship between Nancy Naiker and Daniel Buys (the MD) will give rise to a "familiarity" threat to the firm's independence which cannot be safeguarded against. ✓

4. Establish the terms of engagement

4.1 Nancy Naiker would have formalised the terms of engagement in an engagement letter. ✓

Note: The engagement letter should make clear that the company secretarial services required by Technet (Pty) Ltd are separate from the audit and would be separately billed. ✓

Study Unit 4.3 The Planning Stage

a. (18 marks 22 minutes)

References: - Jackson & Stent (2016: 6/13 - 6/20)

- Study guide (Study unit 4.3)

The first two stages in the audit process can be described as the preliminary stage and the planning stage. Planning can be further broken down into the following activities:

1. Establishing the (preliminary) audit strategy and materiality
2. Planning risk assessment procedures
3. Conducting risk assessment procedures
4. Planning "further" audit procedures and "other" procedures.

YOU ARE REQUIRED TO identify in which of the two stages mentioned in the question, each of the above activities or procedures will take place. When you select the planning stage you must identify the activity within planning into which the procedure falls. If the activity or procedure does not take place in either of the stages mentioned, indicate which stage of the audit process it does fall into.

The following list includes a number of activities or procedures which are carried out during the first two stages of the audit process:

1. Conducting a tour of the clients manufacturing facility to familiarise yourself with the manufacturing process.

Ans: This would fall into the planning stage. ✓ This is a risk assessment procedure carried out to understand the business in the general sense or more specifically to understand internal controls relating to work in progress, finished goods etc. Once the auditor has an understanding of the manufacturing process, evaluation and assessing the risk of material misstatement in balances affected by the process can be undertaken e.g. there may be risk attached to the valuation of work-in-progress. ✓^

2. Drafting an engagement letter for the audit.

Ans: This is a preliminary engagement activity (final step). ✓

3. Conducting a debtors circularization.

Ans: This is not part of either of the stages, it is part of the evidence gathering process stage of the audit, i.e. responding to risk by conducting further audit procedures. ✓^

4. Deciding in principle upon the use of an expert to assist in the valuation of inventory as was done on the prior year's audit.

Ans: This is part of the planning stage ✓ – establishing the preliminary audit strategy. ✓^

5. Flowcharting (drawing a diagram of) the internal control system for sales.

Ans: This is part of the planning stage ✓ - it could be regarded as planning risk assessment procedures or conducting risk assessment procedures. The nature of the planned procedures to gather information about the internal control systems is "flowcharting" as opposed to obtaining narrative descriptions. The flowcharting exercise in itself could be used to identify weakness in the system as the flowchart is being constructed. ✓^

6. Considering the potential effect on the audit, of the King III report on corporate governance.

Ans: This would fall into the planning stage ✓ - establishing the (preliminary) audit strategy. ✓^

7. Evaluating the schedule of uncorrected misstatements for the current audit.

Ans: This is not part of either stage ✓ - it is part of the concluding stage. ✓

8. Deciding on the balance between tests of controls and substantive tests.

Ans: This is part of the planning stage ✓ - planning further audit procedures. ✓

9. Considering the appropriateness of the prior year's planning materiality level for the current year's audit.

Ans: This is part of the planning stage ✓ - you will consider the previous year's materiality limits in setting the current year's planning materiality. ✓^

10. Meeting with the audit committee members to discuss their opinions on the level of misstatement in the financial statements which would be acceptable to users of the financial statements.

Ans: This is part of the planning stage ✓ - establishing (preliminary) materiality. (In effect the amount of misstatement users will tolerate.) ✓

11. Setting up a schedule of meetings (dates, times, who to attend) with the chairman of each of the board committees (other than the audit committee) to discuss the work of the committee for the year under audit.

Ans: This is part of the planning stage ✓ - planning risk assessment procedures. ✓^

12. Engaging other firms of auditors to conduct extensive physical inventory counts at the client's numerous branches because of the likelihood of manipulation of the annual financial statements.

Ans: This is part of the planning stage ✓ - planning "further" audit procedures and can also be regarded as responding to assessed risk. ✓^

Study Unit 4.4 Putting the audit strategy and plan into action

5.16 (Part C only) (4 marks)

References: - Jackson & Stent (2016: 6/21 - 6/23)

-- Study guide (Study unit 4.4)

Magnetts (Pty) Ltd is a wholly owned subsidiary of Industrial Glues Ltd, a successful listed company. Your firm has held the appointment of auditor of Magnetts (Pty) Ltd for some years, but you have not worked on the audit before. Despite this, you have been placed in charge of the current year's audit due to a reorganisation of your firm's audit teams. Magnetts (Pty) Ltd manufactures a range of fixing devices at its factories in George and Cape Town.

The company's accounting system is resident on a local area network using software which was developed by the group's internal IT section. The applications were developed in-house because of the unique features the company has in costing and selling its products.

The holding company's board of directors places a great deal of emphasis on operational efficiency and as a result there is a strong control culture in the group companies, including Magnetts (Pty) Ltd. All group companies are required to appoint audit committees, one member of which must be a non-executive director of Industrial Glues Ltd. There is a comprehensive monthly management reporting system in place. The group also has an internal audit division which is headed by Max du Preez, a former IT partner of a "Big Four" auditing firm. Regular visits to subsidiary companies are scheduled and reports from Internal Audit are awaited by subsidiary company directors with some nervousness! However, senior personnel (and other employees) are well remunerated with generous bonuses paid for reaching financial targets and operational benchmarks.

In addition to the group internal auditors and computer division, subsidiary companies have access to the group's in-house legal council Richard Templeton, for advice on any legal matter which may concern the directors or staff. The company's factory employees are members of an industrial trade union and work closely with Magnetts (Pty) Ltd's Human Resources division to embrace fair labour practice.

Your audit firm which has its offices in Port Elizabeth, has always had a co-operative working relationship with the directors of Magnetts (Pty) Ltd. Having gathered the above background information, you are about to commence procedures to assess the risk of material misstatement in the financial statements.

YOU ARE REQUIRED TO:

(c) comment on your overall response to the risk of misstatement at financial statement level. (4)

Ans: 1. Due to the low assessment of risk at the financial statement level (as explained above) there appears to be no need to implement "drastic" measures. ✓

2. However, we still need to conduct the audit in an effective manner and in compliance with the standards and must therefore: ✓

2.1 Still assign staff with the necessary experience and skills (bear in mind that

- I have not worked on the audit before) ✓
 2.2 Provide the necessary levels of supervision ✓
 2.3 Embrace the necessary levels of professional skepticism ✓ and
 2.4 Put in place an audit plan which reduces the risk of material misstatement going undetected, to an appropriate level. ✓

Study Unit 4.5: Evaluation of audit findings

14.1 (16 marks 19 minutes)

References: - Jackson & Stent (2016: 6/23 - 6/25)

- Study guide (Study unit 4.5)

Consider each of the following statements separately and for each statement indicate whether it is true or false. Where you consider the statement to be **false** you must justify your choice.

1. The auditor forms an opinion on the financial statements based upon an evaluation of the conclusions drawn by members of the audit team on the audit evidence they have obtained.

Ans: True. ✓

2. When carrying out the evaluation and concluding stage of the audit, the auditor sets out to determine whether sufficient evidence has been gathered to satisfy the mandate for the audit agreed to with the client's audit committee prior to the audit.

Ans: False. ✓ There is no "audit mandate" agreed with the audit committee. The auditor sets out to determine whether sufficient appropriate evidence has been gathered to reduce audit risk to an acceptable level. ✓^

3. The risk that the auditor fails to evaluate the evidence gathered appropriately and as a result expresses an inappropriate audit opinion, is termed reporting risk.

Ans: False. ✓ There is no such term as "reporting risk". The risk of expressing an inappropriate audit opinion is termed audit risk. ✓^

4. Evaluating whether the audit has been conducted effectively and efficiently does not form part of the evaluating and concluding stage of the audit.

Ans: True. ✓

5. With regard to evaluating the accounting policies adopted in the preparation of the financial statements, the auditor is only concerned about whether these accounting policies are consistent with the financial reporting standards, e.g. IFRS.

Ans: False. ✓ The auditor will also be concerned with whether the accounting policies are **appropriate** for the company's business and that they are adequately disclosed in the AFS. ✓^

6. As part of the evaluation stage the auditor is required to determine whether all uncorrected misstatements (other than those which are clearly trivial) identified during the audit, result either individually or in aggregate in a material misstatement of the financial statements.

Ans: True. ✓

7. "Clearly trivial" and "not material" in the context of the auditor's evaluation mean the same thing, i.e. the terms are interchangeable.

Ans: False. ✓ ISA 450. A misstatement judged to be "not material" is judged against the materiality criteria for the audit, whereas a "clearly trivial" misstatement is so small and inconsequential when judged against any of the materiality criteria, i.e. material by nature, size or circumstance. ✓^

8. Because errors in narrative, for example, an incorrect description of an accounting policy relating to a significant item in the statement of financial position are qualitative not quantitative, they do not form part of the evaluation of uncorrected misstatements.

Ans: False. ✓ All uncorrected misstatements (other than those that are clearly trivial), must be evaluated whether they are quantitative or qualitative. The definition (ISA 540) of misstatement includes misstatements in presentation or disclosure of an item in the financial statements, and "errors" in disclosure can lead to a lack of fair presentation. ✓^

9. On the audit of Busstop (Pty) Ltd, the auditor considers that an impairment write down for obsolete inventory of R600 000 should be made; the client has put through an impairment loss of R400 000. From the audit perspective this would be a factual misstatement and the auditor can insist that the financial statements be adjusted to increase the impairment write down.

Ans: False. ✓ Firstly, this would be a judgement/misstatement and secondly, the auditor has no power to insist that an adjustment be made. It is for the client to decide (the AFS are the responsibility of the client) and the auditor will respond accordingly to the client's actions, e.g. qualify the report if necessary. ✓^

10. When evaluating and concluding on the financial statements the auditor will evaluate, inter alia, whether the information presented in the financial statements is relevant, reliable, comparable and understandable, and that the terminology used in the financial statements is appropriate.

Ans: True. ✓

Topic 5: Engagements to review historical financial statements

Study Unit 5.1 The audit principles with regard to review engagements

15.17 (Part (a) only) (3 marks)

Your auditing firm has recently been engaged by the directors of Epsom (Pty) Ltd to compile a set of financial statements for the company for the year ended 31 March 2018 for use in a financial negotiation with a private investor.

The company compiles its financial statements in terms of the International Financial Reporting Standards for Small and Medium sized Entities.

The directors have agreed to allow you access to all documents, records and explanations which you may require to carry out the engagement.

The chief executive officer of Epsom (Pty) Ltd has also requested that once you have compiled the financial statements, you include an audit opinion or a review conclusion (whichever you consider to be appropriate) with the financial statements.

YOU ARE REQUIRED TO:

- a) **Comment on the chief executive officer's request that you include either an audit opinion or a review conclusion with the financial statements you are to compile. (3)**

References: - Jackson & Stent (2016: 19/2 -19/15)

- Study guide (Study unit 5.1)

Ans: 1. The chief executive's request cannot be accepted.

1.1 To be in a position to include an audit opinion or a review conclusion, an audit or review carried out in terms of the relevant standards must be carried out. We cannot simply issue an opinion or conclusion on the basis of having compiled the financial statements as a compilation engagement is in no way an assurance engagement. ✓✓

1.2 Furthermore it would be a serious breach of our professional standards relating to independence if we conducted an audit or review on a set of financial statements we compiled. ✓✓

1.3 In addition, if the client is seeking a level of credibility (assurance) to be added to the financial statements (which seems likely), it is not for our firm to decide which type of engagement would be "appropriate". We could advise, but the decision remains with the client. (Regardless of what the client decides, we **cannot** compile and audit/review the financial statements.) ✓✓

Study Unit 5.4 Evaluation, concluding and reporting

15.20 (Part (b) only) (4 marks)

You are a registered auditor in public practise and your firm has been engaged by parkbuild (pty) ltd a construction company, to review the companys annual financial statements for the year end 30 june 2018. Parkbuild (pty) ltd has a public interest score of 250 and its financial statements are externally compiled. The company prepares its financial statements in accordance with IFRS.

You conducted your engagement in terms of ISRE 2400 (Revised) — Engagements to review historical financial statements, and during your review it became apparent that the company had taken into account in the income statement, all of the expected profits on a contract the company had signed shortly before the end of June to erect a parking garage, as well as the full expected profits on another two contracts on which the company was working at year end. When you approached Ben Brown the financial director, he confirmed that the company has indeed taken the profits into account. Ben Brown informed you that these contracts were for parking garages built to exactly the same size and specifications for the same client and that on all previous similar contracts, Parkbuild (Pty) Ltd achieved its budgeted profit. For this reason the directors have decided to abandon the method which they had adopted in the past for recognizing profit and to take profit on the signing of the contract. Although it was not practical to calculate the total effects of the misstatement resulting from the adoption of this new method of recognizing profits, you are satisfied that the evidence you have obtained is sufficient to conclude that the financial misstatements are pervasively misstated.

YOU ARE REQUIRED TO:

- b) **comment on whether an independent reviewer has any duties with regard to what may appear to be a reportable irregularity identified during a review engagement. (4)**

References: - Jackson & Stent (2016: 19/13 -19/115)

- Study guide (Study unit 5.4)

Ans: 1. In terms of the Auditing Profession Act, a registered auditor has a duty to report a reportable irregularity at an **audit** ✓ client but not at a **review** client. ✓

2. However, in terms of Regulation 29 (of the Companies Act), the independent reviewer, regardless of whether he is a registered auditor, must report a reportable irregularity, **not** to the IRBA ✓ but to the Companies and Intellectual Property Commission (CIPC). ✓

3. Therefore, if the independent reviewer comes across what may appear to be a RI, he has a duty to seek evidence which will satisfy him either that a reportable irregularity **is** or **is not** taking place. ✓ If he is "satisfied" that a RI is taking place, a report must be made "without delay" to the Commission. ✓