

# Graded Questions on Auditing 2016



Gowar & Jackson



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# **GRADED QUESTIONS ON AUDITING**

**2016**

**GOWAR AND JACKSON**

## **GRADED QUESTIONS ON AUDITING : 2016**

H R GOWAR  
R D C JACKSON

B.Com.(Natal), C.A.(S.A.), C.F.A.(S.A.)  
B.Acc.(Natal), M.Com.(Rhodes), C.A.(S.A.)

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215 Peter Mokaba Road  
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[www.lexisnexis.co.za](http://www.lexisnexis.co.za)  
Telephone: 031 268 3111

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# **CHAPTER 1**

## **AN INTRODUCTION TO AUDITING**





**1.1****(20 marks 24 minutes)**

Like many disciplines, the practice of auditing, whether it be "internal auditing" or "external auditing", has a language all of its own. The following terms are frequently used and can be very confusing to non-auditors!

1. Auditee
2. Audit independence
3. Professional scepticism
4. Professional competence
5. Audit strategy
6. Internal auditor
7. External auditor
8. Audit committee
9. Postulates of auditing
10. Audit plan

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

**1.2****(10 marks 12 minutes)**

For each of the statements below select the most appropriate answer:

1. The external audit of a public company's annual financial statements is classified as:
  - 1.1 an insurance engagement
  - 1.2 an assurance engagement
  - 1.3 a non-assurance engagement.
2. The external audit of the financial statements of a private company which operates in the chemical industry will be conducted by:
  - 2.1 a registered auditor
  - 2.2 an environmental auditor
  - 2.3 an internal auditor.
3. Auditors provide users with different levels of assurance relating to financial statements:
  - 3.1 certification of the financial statements can only be given after a detailed audit of the financial statements
  - 3.2 reasonable assurance can be given where either a review or an audit has been carried out
  - 3.3 reasonable assurance can only be given when an audit has been conducted.
4. The important difference between a review and an audit is:
  - 4.1 the level of assurance which is provided
  - 4.2 a review is not an assurance engagement but an audit is
  - 4.3 independence is not an important requirement for a review engagement, but is for an audit.
5. When conducting the audit of the annual financial statements of a private company the auditor carries out:

- 5.1 only those audit procedures stipulated in the company's Memorandum of Incorporation pertaining to the annual audit
  - 5.2 only those audit procedures agreed to with the board of directors
  - 5.3 those audit procedures which the auditor himself deems to be necessary.
6. An engagement where a registered auditor is required to compile financial information for a client but is not required to express an opinion on the information, is classified as:
    - 6.1 a limited assurance engagement
    - 6.2 a non-assurance engagement
    - 6.3 a non-statutory assurance engagement.
  7. The auditor's opinion on the annual financial statements of a public company provides a high but not absolute level of assurance that:
    - 7.1 the company has a viable future
    - 7.2 management has conducted the affairs of the company efficiently and effectively
    - 7.3 the financial statements, are in all material respects fairly presented
    - 7.4 none of the above.
  8. A private company in the manufacturing sector with a public interest score of 300 is obliged, in terms of the Companies Act 2008:
    - 8.1 to have its annual financial statements externally audited
    - 8.2 to have its annual financial statements externally audited but only if the financial statements have been internally compiled
    - 8.3 to have its annual financial statements reviewed regardless of whether the financial statements have been internally or externally compiled.
  9. A **public** company in the construction sector is not required to have its annual financial statements externally audited:
    - 9.1 if its Memorandum of Incorporation stipulates that an external audit is not required
    - 9.2 if a special resolution is passed by the shareholders stipulating that an external audit is not required
    - 9.3 if more than 75% of the company's turnover is derived from government contracts for public works
    - 9.4 none of the above.
  10. One of the factors used to determine a company's public interest score is:
    - 10.1 the number of individuals who directly or indirectly hold a beneficial interest in any of the shares of the company
    - 10.2 the number of independent non-executive directors on the board
    - 10.3 the prior year's expenditure on social and environmental (public interest) programmes.

### 1.3

**(22 marks 27 minutes)**

The following are some of the key terms often used in describing an external audit:

1. Independence
2. Public Interest Score
3. Inquiry

4. Evidence
5. International Standards on Auditing (ISAs)
6. Opinion
7. Reasonable assurance

**YOU ARE REQUIRED TO:**

- (a) give, briefly, the meaning of each of the above terms. (16)
- (b) combine the above terms, plus any others you deem suitable, to give a brief description of the external audit function for a private company. (6)

**1.4 (32 marks 38 minutes)**

**PART A (12 marks 14 minutes)**

The auditing profession can be described as the “umpire of the business world”.

**YOU ARE REQUIRED TO** identify and discuss the similarities between an umpire in cricket (or a referee in soccer or rugby) and an auditor.

**PART B (8 marks 10 minutes)**

"Auditing is essentially a policing function. It therefore makes sense, in these times of increasing fraud and other crimes in the commercial and industrial world, for the auditing profession to work in conjunction with the commercial branch of the police or the Hawks."

**YOU ARE REQUIRED TO** discuss the above quotation.

**PART C (12 marks 14 minutes)**

You have recently commenced your auditing studies at university. Your best friend who studied graphic art and knows nothing about auditing and accounting has just started work for a listed clothing company in the fashion design department, says to you over lunch one day:

“Some guys arrived today for the audit - they come from some firm or company that sells external audits or something and apparently every business has to have one. I find it strange that we have to get an audit from someone outside the company because a little while ago some guys from our company were doing something with an internal audit. What on earth does this audit thing have to do with a clothing company?”

**YOU ARE REQUIRED TO** respond to your friend.

**1.5 (10 marks 12 minutes)**

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

**1. Individuals**

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

**2. Activities**

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

**YOU ARE REQUIRED TO:**

- a) identify which of the individuals listed above will be *employees* of the entity for which they are carrying out the activity. (2)
- b) match each *activity* to the *individual* most likely to carry out the activity. (8)

**1.6**

**(13 marks 16 minutes)**

An assurance engagement, whether it be an audit or a review, has five elements. The first of these is the “three party relationship”, and the second is the “subject matter”. Propcorp (Pty) Ltd owns a large shopping mall. Premises in the mall are rented out. The amount which shopowners pay as rent consists of a basic amount and a percentage of the shops' monthly turnover calculated according to the terms and conditions in their rental agreements. To satisfy itself that shopowners are paying the correct amount of rent, Propcorp (Pty) Ltd has engaged Hendricks and Co, a firm of registered auditors to perform an audit on the financial information (e.g. monthly turnover figures) provided by the shopowners in support of their monthly rental payments. In terms of the rental agreement, shopowners must allow Hendricks and Co access to their accounting records.

**YOU ARE REQUIRED TO**, in terms of the example given above

- a)
  - i. identify the three parties in this assurance engagement (3)
  - ii. describe the subject matter (1)
  - iii. identify and explain the other three elements of the assurance engagement. (6)
- b) discuss the importance of the clause in the rental agreement which allows Hendricks and Co access to the accounting records of the shopowners. (3)

**1.7**

**(10 marks 12 minutes)**

- 1. The objective of an assurance engagement undertaken by a registered auditor is to
  - 1.1 certify the correctness of the information which is the subject of the engagement.
  - 1.2 enhance the degree of confidence of the intended user in the information which is the subject of the engagement.
  - 1.3 compile the annual financial statements in terms of an appropriate accounting framework on behalf of the client.
- 2. A successfully completed review engagement provides a user with
  - 2.1 limited assurance
  - 2.2 reasonable assurance
  - 2.3 high but not absolute assurance.
- 3. The investigation and gathering of evidence where there has been alleged mismanagement, theft or fraud in a company is the major activity carried out by
  - 3.1 internal auditors
  - 3.2 special purpose auditors
  - 3.3 forensic auditors.
- 4. Not all types of auditor (e.g. registered, internal, government, etc) are required to
  - 4.1 be independent
  - 4.2 be registered with a professional body
  - 4.3 comply with the ethical requirement of confidentiality.
- 5. Non-assurance engagements are characterised by the fact that the registered auditor
  - 5.1 is not required to comply with any international standards
  - 5.2 can only charge fees for the engagement as stipulated in the Companies Act
  - 5.3 does not express an opinion or comment on the subject matter of the engagement.
- 6. A company is required to calculate its public interest score
  - 6.1 every five years
  - 6.2 every year
  - 6.3 every year but only if the company has more than 100 shareholders.
- 7. A company's public interest score is used as a factor in determining
  - 7.1 the number of directors the shareholders must appoint to the board of directors
  - 7.2 whether the company must be externally audited or reviewed
  - 7.3 whether the company must appoint an audit committee.

8. One of the factors used to determine a company's public interest score is
  - 8.1 the number of non-executive members on the board of directors
  - 8.2 the average number of employees for the financial year
  - 8.3 the sector of the economy in which the company operates, e.g. mining.
9. To be entitled to the use the designation CA(SA) an individual must be registered with
  - 9.1 the SAICA
  - 9.2 the IRBA *and* the SAICA
  - 9.3 the IRBA *or* the SAICA.
10. The assertions (excluding presentation and disclosure) relating to non-current assets reflected in the AFS are
  - 10.1 obligation, completeness and valuation
  - 10.2 rights, valuation and allocation, completeness, existence
  - 10.3 rights, accuracy, classification and completeness.

**1.8**

**(20 marks 24 minutes)**

Consider each of the following statements:

1. The reason that companies are audited is to catch directors who have defrauded the company in some way. (4)
2. Studying auditing is beneficial for individuals who have no interest in going into auditing as a career but who intend to become managers in business. (5)
3. The internal audit department of a public company is an important part of the company's corporate governance. (4)
4. The audit profession plays a vital role in society. (4)
5. The most important requirement for any audit, whether it be internal audit, external audit, a government audit, or a forensic audit is technical competence. (3)

**YOU ARE REQUIRED TO** state whether you agree or disagree with each of the statements given above. Give reasons for your choice. Consider each statement separately.

**1.9**

**(20 marks 24 minutes)**

A junior member on the audit team of 100 Ltd was, at the conclusion of the audit, requested to make sure that the audit working papers were all properly filed and finalised. What struck him was just how much information/evidence had been gathered on the audit. Having seen all of the evidence together he really felt that the audit team was in a strong position to certify the financial statements as correct, rather than just stating in the audit report that "in our opinion, the financial statements present fairly in all material respects ....."

He asked you his senior why, having done all this work, the financial statements had not been certified as correct.

**YOU ARE REQUIRED TO** explain in detail to your junior, why the financial statements cannot be certified. Include in your answer an explanation of the limitations of internal control, and the limitations of an audit.

**1.10**

**(24 marks 29 minutes)**

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

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

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

1. Peter Boston the registered auditor in charge of the Milkmaid (Pty) Ltd audit, made racist comments concerning the client's staff during an audit planning session. (2)
2. Preggy Pillay the registered auditor in charge of the audit of Rosebeds (Pty) Ltd, charged the client a fee for audit procedures which he knew had not actually been carried out. (2)
3. Fred Feathers the registered auditor in charge of the audit of Impendle (Pty) Ltd, failed to identify the misapplication by the client of an important accounting policy. The misapplication resulted in a material overstatement of the company's profit. (2)
4. Julius Zuma a registered auditor, arranged with some of his clients to pay the fees which he charged for his services, in cash. Any client agreeing to do so, was not charged VAT and was given a substantial discount. (5)
5. During the planning stage of the audit of Marketvest (Pty) Ltd, a company which invests money on behalf of its clients, Rocky Ranchod the registered auditor in charge of the audit, was given access to the investment strategy which the company intended to adopt. Rocky Ranchod noted the listed shares which Marketvest (Pty) Ltd intended to purchase and instructed his own stockbroker to immediately purchase a number of these shares for Rocky Ranchod's family trust. (3)
6. As the budget for the audit of Redbands Ltd would be exceeded and because he felt he had a competent audit team, Axel Mkize the registered auditor in charge of the audit, decided not to spend the necessary time on reviewing the workpapers of the audit team. (3)



**YOU ARE REQUIRED TO:**

- a) briefly explain each of the attributes or fundamental principles of ethical behaviour listed above (i) to (v). (7)
- b) identify with a brief explanation, which of the fundamental principles have not been complied with in each of the situations described in 1 to 6 above. (17)

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

**1.11**

**(22 marks 27 minutes)**

**PART A**

**(10 marks 12 minutes)**

A friend of yours has recently purchased some shares in a company, Mercprop Ltd, which is listed on the JSE. When you asked him whether he had investigated the company before purchasing the shares he replied "Not really, I chose Mercprop Ltd shares because I read in the newspaper that Mercprop is externally audited, which not all companies are, and that the auditors are Crockett and Tubbs, an international auditing firm, so it must be a good investment."

**YOU ARE REQUIRED TO** discuss whether you would agree with your friend's reasoning with regard to his purchase of shares in Mercprop Ltd.

**PART B**

**(12 marks 15 minutes)**

When announcing the winners at a "Miss World" competition or an "Oscar" presentation the master of ceremonies will often state that the counting of votes has been verified by a prominent firm of auditors.

**YOU ARE REQUIRED TO:**

1. explain why the organisers of such events engage independent auditors to verify the vote count. (6)
2. discuss in general terms the matters about which an auditor should be satisfied before accepting such an engagement. (6)

**1.12**

**(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)
- b) indicate which of the above statements (1 to 10) are regarded as postulates of auditing. Explain briefly each of the postulates you have identified. (15)
- c) for each of the above statements which you have *not* identified as a postulate, state whether the statement is true or false. Justify your choice. (10)

**1.13**

**(25 marks 30 minutes)**

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

1. The directors of a public company may replace the external audit of the company's annual financial statements with an audit conducted by its internal audit department provided the company has a correctly constituted audit committee. (2)
2. It is not the specific objective of the auditor, when conducting the annual audit of a company's financial statements, to discover or prevent fraud. (4)
3. An auditor can only express an opinion on the fair presentation of financial information if there are suitable criteria against which the financial information can be reliably measured. (3)
4. All auditors, whether they are internal auditors, external auditors, environmental auditors or forensic auditors, must be registered with the Independent Regulatory Board for Auditors (IRBA). (4)

5. Access given to the auditor to the accounting records, books and documentation of an audit client is a privilege and not a right. (2)
6. One of the important objectives of the external audit of a company is for the auditor to express an opinion on the company's compliance with the King III Report on corporate governance. (3)
7. The external auditor must comply with the International Standards on Auditing (ISAs) regardless of whether he is conducting the annual audit of a public or private company. (3)
8. The major reason that registered auditors cannot certify the annual financial statements as being 100 percent correct is that the cost of the audit would be too high. (4)

**1.14**

**(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 about 27 employees and that the expected turnover for the year is R24 million and that the only liabilities which the company has are current creditors of less than R1 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:

1. Must the company have an auditor and if so, is it an external or internal auditor the company must have? (10)
2. Even if we aren't required to appoint an auditor, can we still appoint one? Could I appoint you as the auditor? (4)
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)
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)

**YOU ARE REQUIRED TO** respond to Vincent Nzimande's questions.

**1.15**

**(10 marks 12 minutes)**

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

**List A**

- A1 The external audit of a public company .....
- A2 One of the major distinctions between a lawyer or doctor and an auditor .....
- A3 One of the postulates of auditing is that internal controls .....
- A4 A review of a company's annual financial statements .....
- A5 A professional accountant who wishes to use the designation CA(SA) .....
- A6 The audit opinion given on a company's annual financial statements .....
- A7 A professional accountant who wishes to offer audit services .....
- A8 Another of the postulates of auditing is that financial data .....
- A9 The representations of the directors contained in the financial statements are .....
- A10 An assurance engagement is defined as one in which a practitioner .....

**List B**

- B1 ..... expresses a conclusion designed to enhance the degree of confidence of the intended user.
- B2 ..... provides negative assurance only.
- B3 ..... must register with SAICA.
- B4 ..... referred to by the auditors as the assertions.
- B5 ..... must register with IRBA.
- B6 ..... is an assurance engagement.
- B7 ..... is not an assurance of the future profitability of the company.
- B8 ..... reduce the possibility of errors and irregularities.
- B9 ..... is the independent nature of the relationship with their clients.
- B10 ..... is verifiable.

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



## **CHAPTER 2**

# **CORPORATE GOVERNANCE, INTERNAL AUDITING AND AUDIT COMMITTEES**



**2.1****(30 marks 36 minutes)**

1. Corporate Governance is about principles not the law. Comment. (2)
2. Explain the difference between the “comply or else” approach and the “apply or explain” approach to corporate governance. (4)
3. Identify three reasons for South Africa **not** adopting a “comply or else” approach to corporate governance. (2)
4. Despite the King III Code of governance principles adopting the “apply or explain” approach, the JSE requires listed companies to follow a “comply or else” approach. True or False? Explain. (2)
5. Identify and give a brief explanation of the three key aspects of the King III Code. (6)
6. Explain how (each of) innovation, fairness and collaboration relate to sustainability. (6)
7. What is an integrated report? (2)
8. To which entities does the King III Code of governance principles apply? (2)
9. Explain the term “inclusivity of stakeholders.” (2)
10. Give four examples of stakeholders in a large company other than the shareholders. (2)

**2.2****(12 marks 14 minutes)**

**YOU ARE REQUIRED TO** select the most appropriate answer for each of the questions below.

1. The most important element of good corporate governance is:
  - 1.1 the audit committee
  - 1.2 the board of directors
  - 1.3 the combination of internal and external audit
  - 1.4 the company’s code of ethics.
2. Which of the following is **not** part of the structure of the Code of Governance Principles?
  - 2.1 Topics.
  - 2.2 Disciplinary procedures.
  - 2.3 Governance elements of the topics.
  - 2.4 Recommended practices.
3. The King III – Code of Governance Principles is based on which of the following approaches?
  - 3.1 Corroborate and comply.
  - 3.2 Comply or explain.
  - 3.3 Conclude and apply.



- 3.4 Apply or explain.
4. Which of the following is not a key aspect of the King III Report?
    - 4.1 Sustainability.
    - 4.2 Stakeholder activism.
    - 4.3 Leadership.
    - 4.4 Corporate citizenship.
  5. A good corporate citizen is best described as a company which
    - 5.1 Complies with the relevant laws and regulations pertaining to its business activity and does not seek to circumvent them.
    - 5.2 Fulfils its obligations, both legal and moral, in respect of its economic, social and natural environments.
    - 5.3 Does not engage in, or deal with other companies who engage in business activities which have negative social consequences.
    - 5.4 Embraces a code of ethics to protect its management and ownership.
  6. In terms of the ethics of governance, which of the following is **not** a moral duty which directors should exercise?
    - 6.1 Competitiveness.
    - 6.2 Conscience.
    - 6.3 Competence.
    - 6.4 Courage.
  7. The concept of triple bottom line reporting requires that companies report to shareholders on
    - 7.1 the economic, leadership and remuneration aspects of the company's performance.
    - 7.2 the economic, social and governance aspects of the company's performance.
    - 7.3 the economic, non-financial and environmental aspects of the company's performance.
    - 7.4 the economic, environmental and social aspects of the company's performance.
  8. Creating an ethical corporate culture is about
    - 8.1 developing a Code of Ethics.
    - 8.2 integrating ethical practices into the company's strategies and operations.
    - 8.3 assessing and reporting on ethical performance.
    - 8.4 all of the above.
  9. For a non-executive director to be classified as independent he must satisfy a number of requirements. Which of the following is an applicable requirement?
    - 9.1 He must receive no fees (other than expenses incurred for attending meetings).
    - 9.2 He must have been appointed by a chairman who himself was an independent non-executive chairman at the time of the appointment.
    - 9.3 He must not receive remuneration which is based on the profits made by the company for the financial year.
    - 9.4 He must at no stage have been the chief executive officer of the company.
  10. It is the duty of the board to rigorously review the independence of any independent non-executive director who has served for more than

- 10.1 3 consecutive years.
  - 10.2 5 consecutive years.
  - 10.3 9 consecutive years.
  - 10.4 10 consecutive years.
11. A company's combined assurance model is best described as
- 11.1 the mechanisms set up to promote co-operation and efficiency between the internal and external auditors.
  - 11.2 the relationship between the audit committee and the external auditor.
  - 11.3 the manner in which the company sets itself up to adequately address the significant risks which the company faces.
  - 11.4 the manner in which internal audit, the audit committee and the board are required to interact.
12. With regard to IT governance, which of the following is **not** specifically included as a component of a company's information security by King III?
- 12.1 Confidentiality
  - 12.2 Simplicity.
  - 12.3 Integrity.
  - 12.4 Availability.

## 2.3

**(27 marks 32 minutes)**

1. What is corporate governance? (2)
2. All companies, both public and private, must comply strictly with the recommendations of King III. True or False? (2)
3. What is a non-executive director? (2)
4. What is an independent non-executive director? Describe the requirements which such a director must satisfy to be regarded as independent. (5)
5. Should the chairperson of the board be an executive or non-executive director? Why?(2)
6. In terms of King III, the chairman of the board should be solely responsible for recommending individuals to the shareholders for appointment as a director. True or False. Justify? (2)
7. Is corporate governance a statutory requirement in terms of the Companies Act 2008? Justify. (2)
8. What is a remuneration committee? (2)
9. The directors of a public company must appoint an audit committee. True or false? Justify. (2)
10. What is the designation recommended by King III for the head of internal audit, and to whom should this person report? (2)

11. What is the internal audit charter? (2)
12. In terms of King III should the financial director be a member of the audit committee? Explain. (2)

**2.4 (20 marks 24 minutes)**

The Companies Act 2008 includes a number of sections which should strengthen or improve corporate governance. These include:

- Section 45 which places certain restrictions and requirements on the granting of loans by a company to its directors.
- Section 94(4) which makes it mandatory for public companies to appoint an audit committee.
- Section 94(7) which lays down the duties which the audit committee must carry out.
- Section 90(3) which requires that the name of the individual auditor responsible for the audit, be specified (the designated auditor).
- Section 92 which requires the rotation of auditors.
- Section 93(1) which ensures the auditors right of access.
- Section 93(3) which prevents the designated auditor from performing any non-audit services for audit clients which the audit committee has deemed he may not perform.
- Section 159 which stipulates some protection for “whistle blowers”.

**YOU ARE REQUIRED TO** comment on how each of the sections above might improve corporate governance.

**2.5 (21 marks 25 minutes)**

1. Distinguish between an executive and non-executive director. (2)
2. Would the following individuals qualify as *independent* non-executive directors in terms of the King III Report. Justify your answer.
  - 2.1 a partner of the law firm that acts as legal advisors to the company
  - 2.2 the company’s auditor
  - 2.3 the company’s recently retired chief executive officer
  - 2.4 a shareholder who holds 3% of the company’s shares. (4)
3. What is a board committee? (1)
4. What requirements should be satisfied in any board committee to make it successful? (5)

5. Does the Companies Act 2008 distinguish between executive directors and non-executive directors? (1)
6. May a board committee include a person who is not a director? Explain. (3)
7. When is it appropriate for a company to appoint a lead independent non-executive director (LID)? (2)
8. State whether the following are true or false in terms of the King III Code:
  - 8.1 The chairperson of the audit committee should be the chairperson of the board? (1)
  - 8.2 The CEO must chair the remuneration committee. (1)
  - 8.3 The nominations committee should consist of only non-executive directors. (1)

**2.6 (25 marks 30 minutes)**

1. Should the company secretary of a listed company be a member of the board? (2)
2. Is a non-executive director regarded as independent by virtue of the fact that he is not part of the day-to-day running of the company? (6)
3. Identify, with a brief explanation, the five moral duties which, in terms of King III, each director should discharge as a steward of the company. (5)
4. State whether each of the following statements is true or false:
  - 4.1 the chairman of the board should be a member of the audit committee provided he has the requisite knowledge. (.5)
  - 4.2 the chairman of the board should not be the chairman of the remuneration committee but may be a member of it. (.5)
  - 4.3 the chairman of the board may be the chairman of the nominations committee. (.5)
  - 4.4 the chairman of the board should be a member of the risk committee. (.5)
  - 4.5 the chairman of the board should determine the remuneration of the non-executive directors. (.5)
  - 4.6 the chairman of the board should be remunerated contingent upon the performance of the company. (.5)
5. What are the four ethical values identified in King III which underpin good corporate governance? Describe briefly. (4)
6. Explain the link between sustainability and good corporate governance. (2)
7. Suggest three factors which may threaten the sustainability of a large gold mining company in South Africa. (3)

**2.7 (20 marks 24 minutes)**

Claude Messi, the managing director of one of your firm's clients Milano (Pty) Ltd, a large textile manufacturing company, has completed your firm's standard corporate governance questionnaire. An extract from the questionnaire is shown below.

<b>Question</b>	<b>Response by managing director</b>
1. Are the positions of chief executive officer and chairperson of the board held by different people?	<i>Not applicable. We do not consider it necessary to have a “chairperson of the board”. Directors meetings are controlled by me.</i>
2. Number of directors 2.1 executive directors? 2.2 non-executive directors? 2.3 independent non-executive directors?	<i>There are five executive directors. There are two non-executive directors. None. We don’t consider that there is such a thing as an independent non-executive director. If you are a director you must be totally committed to the company, you can’t be “independent.”</i>
3. Are board committees appointed by the directors? 3.1 audit committee?  3.2 remuneration committee?  3.3 other committees (specify)?	<i>No. I appoint all committees to assist the Board. No, not necessary as we have an efficient internal audit department which reports regularly to me. Yes, a three man committee consisting of myself, the director of Human Resources and one of the non-executive directors. No other standing committees considered necessary. If we need a committee for a specific task I appoint it and chair it.</i>
4. To what extent does the board embrace the “triple bottom line approach to reporting?”	<i>This company is about making profits for our shareholders. We believe in reporting our profits not all the other soft issues.</i>
5. Does the company have a Code of Ethics in place?	<i>No. Employees know the rules here. Transgressions are dealt with by a properly constituted disciplinary process which answers to me.</i>

**YOU ARE REQUIRED TO** comment on the extent of Milano (Pty) Ltd’s compliance with the recommendations of the King Report III. Consider each of the responses by Claude Messi to the questions posed.

## 2.8

**(25 marks 30 minutes)**

Capestorm Ltd, a large manufacturing company, wishes to appoint a number of non-executive directors to their Board. In doing so they wish to comply with the recommendations of The King III Report on Corporate Governance. The existing Board is made up as follows :

Chairman and Chief Executive Officer	:	John Cape
Financial Director	:	Roddy Storm
Production Director	:	Zeb Matabane
Sales and Marketing Director	:	Jeff Ryder
Operations Director	:	Clint Westwood
Non-executive Director	:	David Brown*

\*David Brown represents his uncle Bill Brown who has a 28% shareholding in Capestorm Ltd. Bill Brown has the largest single holding in Capestorm Ltd. The following individuals are being considered for appointment :

Moss Mda	:	prominent local businessman who is active in community projects
Carter Brown	:	a recently retired engineer who had on the odd occasion been consulted by Capestorm Ltd
Andy Storm	:	a chartered accountant and son of Roddy Storm
Eric Redfern	:	a partner in Capestorm Ltd's audit firm (not the designated partner)
Peter Obden	:	the company's legal adviser since the company's inception
Raksa Vather	:	a consultant in Capestorm Ltd's line of business, who has no business relationship with Capestorm Ltd
Titus Sexwale	:	a businessman and chairman of the local Chamber of Commerce
Reg Gumede	:	the owner of a small business which supplies Capestorm Ltd with a number of components used in their manufacturing process. Reg Gumede's business is one of ten such small businesses which supply Capestorm Ltd as a part of the company's social and business development initiatives. Capestorm Ltd is his major customer
Mary Masters	:	the recently retired senior public relations manager at Capestorm Ltd. This is a senior executive role.

John Cape has asked you to advise him on "what should be done to get our Board right".

#### **YOU ARE REQUIRED TO:**

- (a) comment on the composition of the existing Board of Capestorm Ltd in terms of the recommendations of the King III Code. (5)
- (b) advise John Cape on how the board of directors of Capestorm Ltd should be reconstituted to satisfy the recommendations of the King III Code. Your answer should indicate inter alia, which of the individuals being considered, should be appointed. Justify your choice. (20)

## **2.9**

**(30 marks 36 minutes)**

The King III Code of governance principles places significant importance on risk management (governance).

1. Define risk management. (2)

2. Risk management is not really important in small or medium sized businesses, it's only important in listed companies which have a large number of shareholders. True or false? Justify. (3)
3. Who in a large listed company is responsible for:
  - 3.1 implementing the risk management plan? (.5)
  - 3.2 determining the levels of the company's risk tolerance? (.5)
  - 3.3 information technology (IT) governance? (.5)
  - 3.4 providing the board with independent assurance on risk management? (.5)
4. What is a company's risk philosophy? (2)
5. Identify four key risks facing the modern company. (2)
6. Risk assessment should take place once a year but prior to the commencement of the following financial year. True or false? Justify. (2)
7. In terms of principle 4.2 of King III, the board should set the levels of risk tolerance once a year. Suggest with a brief explanation, five factors which may be considered when assessing a company's tolerance for risk and loss. (5)
8. In terms of principle 5.2, the board should ensure that information technology is aligned with business objectives and sustainability and it is important for the board to "take responsibility for IT governance and set the direction management should follow". Identify four ways in which the board can achieve this. (4)
9. Describe four possible risk response options which the board/management may adopt. (4)
10. Outline the four matters the board should include in its report on the effectiveness of the company's risk management in the integrated report. (4)

## 2.10

(36 marks 42 minutes)

Shippit Ltd is a large shipping company with a good reputation listed on the JSE. The company's head office is in Durban. Cargo is shipped to and from all major harbours in Africa all around the world. Cargo is shipped in tankers (e.g. chemicals) and on container ships. The company has sound corporate governance structures in place which include effective risk management processes. Shippit Ltd has advanced integrated computer information systems in place, resident on both local and wide area networks.

Shippit Ltd categorises risk into the following risk types, as a starting point for determining suitable responses:

- Strategic** - risks that are inherent in the business strategies followed by the company.
- Market** - risks which affect the market for shipping services.
- Financial** - risks which have a direct effect on the financial aspects of the business.



- Operational** - risks arising from the operation of tankers and container ships.
- Legal** - risk of non-compliance.
- Organisational** - risk which may affect the overall smooth running of the organization.
- Reputational** - risks to the reputation of the company.

The following risks to Shippit Ltd's business have been identified:

1. the loss of a ship at sea.
2. substantial decline in world shipping markets.
3. threat of piracy at sea.
4. information technology system failure.
5. inability of customers to pay amounts owed for shipping services.
6. risk of Shippit Ltd not complying with the loan covenants in loans taken by the company.
7. exchange/interest rate fluctuation risks.
8. breaching international shipping regulations.
9. failure to react to significant advances/changes in the shipping industry.
10. damage to or theft from containers whilst under the control of Shippit Ltd.
11. loss of key staff throughout the company and
12. risks associated with an offer of a contract to transport toxic waste for dumping in third world countries.

**YOU ARE REQUIRED TO:**

- a) identify the category of risk type, as described in the question, into which each of the above risks will fall. Justify your choice. (12)
- b) suggest ways in which Shippit Ltd might respond to each of these risks to minimize its exposure to loss arising therefrom. (24)

Note: each risk (1 – 12) carries approx equal marks for both (a) and (b).

**2.11**

**(48 marks 56 minutes)**

Lebanon Ltd is a company listed on the JSE in the industrial/mining sector. The board regards sound corporate governance as very important and has ensured that the company has the necessary structures, policies and procedures in place. In general the board follows a policy of delegating duties to board committees which consist of well qualified and experienced directors.

The board has the following committees inter alia, in place:

1. audit committee. (7)
2. nominations committee. (6)
3. remuneration committee. (5)
4. health, safety and environment committee. (4)



The board is constituted in the recommended manner with regard to race, gender, skills and the balance between executive and non-executive directors. In addition, Joe January heads up a strong internal audit function and Karen Kramer is the company secretary.

Martin Mars is the company's credit controller, and Reg Ngubane is the group purchasing manager.

One of the cornerstones of the company's corporate governance is the management of risk. Much attention has been directed at implementing a "risk awareness" culture into all aspects of the business and risk evaluation and response is an ongoing activity.

**YOU ARE REQUIRED TO:**

- a) briefly discuss four key risks facing the modern company. (10)
- b) discuss the role, if any, which each of the committees listed above plays in the *management of risk* at Lebanon Ltd (marks in brackets above). (22)
- c) discuss the role, if any, each of the four individuals mentioned in the question, should play in the management of risk at Lebanon Ltd. (14)  
Mark allocation for (c)
  - Joe January (5)
  - Karen Kramer (2)
  - Martin Mars (3)
  - Reg Ngubane (4)
- d) indicate whether Lebanon Ltd is required to have a Social and Ethics Committee. (2)

**2.12**

**(38 marks 46 minutes)**

Deepgold Ltd is a large listed gold mining company with its head office in South Africa. It also operates in a number of other African countries. A number of these mines are in remote and/or underdeveloped countries and are operated under licence or mining rights agreements with local tribal or government authorities.

Mining operations in the company's mines in South Africa are all conducted at deep levels which is both extremely costly and dangerous. At these levels the inherent dangers of mining, such as poisonous gas emissions, flooding and rock falls are intensified and the extraction of ore, waste products including cyanide usage, and polluted water is extensive and can fall foul of the extensive environmental legislation with which mines must comply. The mines use vast quantities of water and electricity.

Deepgold Ltd has a very large workforce within South Africa and on their mines in other countries. At many of the mines in remote areas, the employees are the only people in the area and become communities within themselves. Unskilled labour is generally in reasonable supply but on remote mines obtaining skilled/management staff is difficult.

The latest annual report from Deepgold Ltd contains the following paragraph relating to the company's approach to sustainability reporting:

“Deepgold Ltd has adopted the principle of integrated reporting for its 2016 annual and sustainability reports. The overall aim of Deepgold Ltd’s reporting effort is improved communication with all stakeholders. Wherever feasible, information has been presented in terms of the Global Reporting Initiative guidelines and the JSE Socially Responsible Investment Index criteria. Our sustainability reporting and disclosure has been independently assured.”

**YOU ARE REQUIRED TO:**

- a) explain what is meant by each of the following statements taken from Deepgold Ltd’s annual report:
  - (i) Deepgold Ltd has adopted the principle of integrated reporting for its 2016 annual and sustainability reports. (3)
  - (ii) wherever feasible, information has been presented in terms of the Global Reporting Initiative guidelines and the JSE Socially Responsible Investment index criteria. (3)
  - (iii) our sustainability reporting and disclosure have been independently assured. (3)
- b) identify the stakeholders with which Deepgold Ltd is attempting to improve communication through its integrated reporting and indicate briefly why you consider each of these parties to be a stakeholder. (14)
- c) identify and briefly discuss the sustainability issues which you would expect Deepgold Ltd to report on in its integrated report. Structure your answer using the following headings.
  - (i). economic sustainability. (6)
  - (ii) environmental sustainability. (3)
  - (iii) people and communities. (6)

**2.13**

**(24 marks 28 minutes)**

In terms of Principle 1.3 of King III, the board is required to ensure that the company’s ethics are managed effectively. This means building and sustaining an ethical corporate culture. Furthermore an ethical corporate culture is not just about ethics within the company, it extends to all stakeholders and creating an ethical corporate culture requires a well designed and properly implemented *ethics management process*.

Petrochem Ltd is a listed company which has various fuel processing plants located in a number of port cities around the country. The board of directors takes its responsibilities relating to ethics management seriously and has developed a Code of Ethics which lays down the ethical values, standards and specific guidelines for the company in its dealings with internal and external stakeholders. Petrochem Ltd’s Code of Ethics is broken down into sections which deal with different stakeholders.

**YOU ARE REQUIRED TO:**

- a) identify eight categories of stakeholders which a company such as Petrochem Ltd will have. (4)

- b) identify three further aspects (other than having a Code of Ethics) of a properly implemented ethics management process which are required to create an ethical corporate culture. (3)
- c) discuss what should be done to ensure that Petrochem Ltd's Code of Ethics is not just a document but rather something which the company stands by in its dealings with its stakeholders. (8)
- d) give four examples\* of matters which could be included in the sections of the Code of Ethics which deal with ethical matters relating to
1. personal conduct of employees
  2. the local community
  3. employment practices
- (9)

\*Illustrative example for part (d)

Under the section relating to "personal conduct of employees" the code should include the company's policy in respect of the "receipt of gifts by employees from individuals outside the company" (e.g. from a supplier).

## 2.14

(40 marks 48 minutes)

You are a senior trainee in a firm of registered accountants. One of your partners Mornè Olivier has been approached by the chairman of Bulle (Pty) Ltd, a large textile manufacturer, to accept an appointment as a non-executive director of the company. There is no connection between Mornè Olivier or your firm and Bulle (Pty) Ltd. Mornè Olivier had been recommended to the chairman of Bulle (Pty) Ltd by a mutual friend. Before considering the appointment, Mornè Olivier informed the chairman that he would like to get an idea of the company's adherence to sound corporate governance requirements and particularly to King III. The chairman replied that he personally didn't know too much about "that stuff" but that Mornè Olivier could come to the offices and look through the minutes of directors' meetings if it would help. Mornè Olivier has sent you to "have a look" and report back. The company secretary provided you, inter alia, with the following minutes:

***Minutes of the second and final meeting of the Board of Directors for the financial year 2015 held at 9am on 15 May 2016 at the company's head office.***

### 1. Attendance

*\*quorum*

All directors either attended the meeting or tendered their apologies. As five directors were present, the quorum of four was met.

*\*chairperson:* Hennie Meyer, the chairperson of the board was present.

*\*other directors present*

- Wynand Nel : chief financial officer and deputy chairperson
- Frik Welsh : production director
- Akon Ndungane : non-executive director
- Lucas Watson : human resources director

*\*apologies*

- Barry Botha : non-executive director and Bulle (Pty) Ltd's major supplier
- Pieter Spies : non-executive director and 20% shareholder in Bulle (Pty) Ltd
- Danny Rewsow : marketing director

*\*also in attendance*

- Hennie Adams : internal audit manager
- Victor Hatfield : company secretary

## **2. Company Performance**

Hennie Meyer, in his capacity as chief executive officer, delivered his report on the company's performance for the year to date.

Copies of this report and all Board Committee reports have been lodged with the company secretary.

## **3. Board Committee Reports**

Reports from all Board Committees were tabled at the meeting.

**Audit committee** - Wynand Nel, in his capacity as chairperson, outlined the successes of the audit committee over the year which he attributed largely to the appointment to the committee at the start of the year of Barry Botha, whom he said had brought a wealth of experience to the committee. He also explained that much of the audit committee's time had been taken up reviewing the reports on the various compliance audits which he had instructed internal audit to carry out, based on a random selection of systems and cycles within the company. Hennie Adams, the internal audit manager, and third member of the three person audit committee, then outlined the discussions held with the external auditors pertaining to the upcoming audit of the annual financial statements for the 30 June 2016 year-end.

**Remuneration committee** – Due to the absence of Barry Botha, the chairperson of the remuneration committee, Lucas Watson the other member of the committee, took the meeting through the "Directors Remuneration" schedule to be included in the annual financial statements for the financial year 2016. Hennie Meyer congratulated Lucas Watson on the well laid out schedule.

**Operational Safety Committee** – Frik Welsh, in his capacity as chairperson of the committee, reported on the excellent safety record achieved for the year in the factory, which reflected significant reductions in work related injuries amongst the large labour force.

## **4. Resolutions – maintenance contract**

It was unanimously agreed by all of those directors present that the R10 million machinery maintenance contract be awarded to Akon Ndungane's company Wingz (Pty) Ltd for the next three years, as this company had provided excellent service in the past.

The Chairperson thanked everyone for their attendance at the meeting and closed the meeting at 10.35am.

**YOU ARE REQUIRED TO** critically evaluate Bulle (Pty) Ltd's corporate governance and compliance with the requirements of King III based on the information presented above. You may assume that the minutes are an accurate reflection of all the matters discussed at the meeting.

## **2.15**

**(20 marks 24 minutes)**

Internal auditors and external auditors are similar but have many differences. Giro Ltd, a listed company has an efficient internal audit department and is externally audited by Deloitte.

**YOU ARE REQUIRED TO** write brief notes which illustrate the differences between the internal and external auditors of Giro Ltd in respect of each of the aspects listed below:

1. Appointment
2. Removal
3. Remuneration
4. Reporting responsibility
5. Primary objective
6. Limitations on scope
7. Rotation of appointment
8. Basic approach to auditing.

## **2.16**

**(20 marks 24 minutes)**

Speed (Pty) Ltd, a large retailer of sporting goods with outlets in all major towns and cities in South Africa, has recently established an audit committee and internal audit department, headed up by Josh Kronveld a chartered accountant, and staffed by three suitably qualified internal auditors. The department reports to the audit committee. Josh Kronveld has received numerous requests for his department's services, which are listed below:

1. The manager of the company's largest retail outlet requested that one of the internal auditors be seconded to the outlet for a period of three months, as the outlet's accountant was to be away on maternity leave.
2. The financial director has requested internal audit to install the software for a new wage application, and control the conversion to the new system. Internal audit has the necessary expertise.
3. The warehousing manager has requested that internal audit evaluate the operational efficiency of the company's distribution system for the dispatch of goods from the central warehouse to the outlets.
4. The head office financial manager has requested internal audit to perform a surprise physical verification of the existence of fixed assets at two other large retail outlets, e.g. shopfittings, tills, furniture, office equipment including computer hardware.

5. The financial director has requested that internal audit perform an in depth analysis of the monthly trading returns submitted by the outlets to head office.
6. The managing director has requested that Josh Kronveld make a presentation to the Board on the laws and regulations that govern the company and its operations, highlighting any areas where laws or regulations are not being complied with.
7. The external auditors have requested that the members of the internal audit department, attend the financial year-end inventory counts on their behalf, at four of the company's retail outlets. The external auditors will have their own teams at the other outlets.
8. The Human Resources manager has requested that Josh Kronveld be present at the annual wage negotiations to ensure that company policy and labour law requirements are adhered to.
9. The financial manager has requested that in future, Josh Kronveld authorize the write-off of bad debts at the end of each month after investigation of each debtor's circumstances.
10. The chairman of the social and ethics committee has asked Josh Kronveld if his three qualified internal auditors could assist the local community college by lecturing on the college's evening auditing courses.

**YOU ARE REQUIRED** to indicate giving brief reasons, how Josh Kronveld should respond to each of these requests.

**2.17**

**(20 marks 24 minutes)**

Karbon (Pty) Ltd, a large manufacturing company, has recently established an internal audit department. The company has a properly constituted audit committee in place. As often happens when departments are established, there is some confusion as to exactly what the department should and should not be doing. Kieran Skay, the financial director is preparing for a meeting with the chief audit executive and not being particularly familiar with the role of internal audit, has asked you to provide him with a general overview of what internal audit is about and whether the following procedures/responsibilities should be undertaken by the internal audit department:

1. performing the monthly bank reconciliations on the company's bank account.
2. conducting surprise cash counts at the company's various manufacturing facilities. A material amount of cash is frequently on hand as metal off-cuts are sold to scrap dealers on a cash only basis.
3. performing inventory cycle counts every month as part of the company's internal control over their perpetual inventory.
4. investigating suspected instances of fraud within the company.

5. searching for (“head hunting”) suitable financial staff.
6. conducting a review of the extent to which the marketing department complies with the practices and procedures laid down by the company.
7. on a regular basis, to analyse and follow up on calls from suppliers as to the conduct of the company’s buying/purchasing personnel registered on the company’s “telephonic complaints hotline”.
8. reviewing the *draft* integrated report (which includes, inter alia, the financial statements) before it is given to the external audit team.

**YOU ARE REQUIRED TO:**

- a) provide Kieran Sky with an overview of the roles of an internal audit department to the extent that he will have a better understanding of what he is likely to be told by the chief audit executive. (5)
- b) indicate to Kieran Sky (giving brief reasons) whether the internal audit department should undertake the procedures/responsibilities listed above. (15)

**2.18**

**(20 marks 25 minutes)**

Jan Wessels the chief audit executive of Plaza Limited, a large industrial company, has been authorized by the audit committee to carry out, urgently, an investigation into the payroll department, as it is suspected that a substantial wage fraud has occurred in which senior members of the wage department (part of the finance division) may be involved.

The following staff members of the internal audit department are available to be placed on this assignment.

1. Eric Ngcobo: a former employee of the payroll department, who transferred to internal audit some four months ago.
2. Solomon Naidoo: a senior member of internal audit, whose father, Jay Naidoo, is the finance manager of Plaza Limited.
3. Harvey Green: who joined the internal audit department three months ago, immediately after completing his full-time studies in internal auditing at a university of technology. Harvey Green had come first in his class, and passed with distinction. He has made an impressive start to his career showing confidence and dedication and a good understanding of the role of internal audit.
4. Rose Miller: a well qualified middle-level member of the internal audit department. Although Rose Miller is a competent internal auditor, she finds it difficult to deal with unco-operative staff members.



5. Jim September: a former member of the external audit team, who had worked on the Plaza Limited audit for three years. A qualified chartered accountant, he joined the internal audit department of Plaza Limited at a senior level two years ago. His first assignment was to take charge of the post-implementation review of the company's current computerised payroll system which had been implemented at that time.
6. Chris Chess: a middle-level member of the internal audit department. Chris Chess is regarded as having a good understanding of the business of Plaza Limited, but has a reputation for not paying enough attention to detail.
7. Ben du Preez: a really dedicated internal auditor, but who lacks interpersonal skills and who has, on occasion, not respected the confidentiality of information gathered on audit.

**YOU ARE REQUIRED TO** indicate which two of the above listed internal audit department members should be assigned by Jan Wessels to this investigation. Full reasons as to why you have chosen them, and why you have rejected the others, must be given.

## 2.19

**(24 marks 29 minutes)**

Decisions (Pty) Ltd is a large advisory company. They offer personalized advice to over a million individuals, in the fields of tax and debt management. They are able to do this through their highly advanced computer systems, which run extensive algorithms. Consultants are on hand should customers have any queries. The audit committee is looking to appoint a new chief audit executive (CAE), as the current incumbent is retiring in six months time. Vuyani Bungu, the chair of the audit committee, has asked you to assist in the search for a new CAE. The human resources department has sent you a shortlist of candidates, and their characteristics.

- |                 |   |
|-----------------|---|
| Lennox Lewis:   | A member of the Institute of Internal Auditors for 15 years, his CV shows extensive experience, with 5 years as a senior internal auditor in his previous job. His referees describe his performance as average, with one describing him as a good talker who struggles in difficult or complex environments, as he finds it difficult to grasp such business models. |
| Brian Mitchell: | A CA(SA) with 10 years of experience as an internal auditor. He has excellent knowledge of advanced computer systems, and is a superb leader and 'people person'. His brother-in-law is Decisions (Pty) Ltd's information technology director.  |
| Welcome Ncita:  | MBA. Currently with a major bank, working in its information systems division. Before he obtained his MBA a year ago, he spent 6 years as a junior internal auditor at Decisions (Pty) Ltd.   |



- Cody Sanders: B.Com. Has spent the last 20 years in internal audit with a number of para-statal and had served as an advisor on a number of risk committees. A hard worker, he is quiet and unassuming, interested primarily in doing his job properly. He is well respected by his colleagues, but has never developed a profile outside of the numerous internal audit departments he has served in.
- David Haye: No formal qualifications, but 25 years experience in internal audit at a steel manufacturing company. A referee described him as quite difficult to work with, due to his "know it all" attitude and inability to take responsibility for difficult audits.
- Pernell Whitaker: B. Information Systems. A member of the Institute of Internal Auditors for ten years. Currently one of three senior members of Decisions (Pty) Ltd internal audit division, he is well respected for his business knowledge, independence and ethics. He relates well to staff at all levels.
- Digby Tobela: A member of the Institute of Internal Auditors for 12 years. Resigned from his previous role as the Chief Audit Executive of Pie & Chips (Pty) Ltd (a national food manufacturer with a number of retail outlets) after a number of highly confidential recipes were obtained by a competitor. No charges were ever brought against Digby Tobela but the rumour in the industry was that he was suspected of wrong doing, but sufficient evidence could not be gathered before he resigned.
- Jimmy Wilde: A CA(SA) who has worked with complex computer systems for 8 years, both in internal audit and in operations. He is fiercely independent, ambitious, and is prepared to ride over others to get what he wants. Although he communicates well, he is an autocratic leader.

**YOU ARE REQUIRED TO** state for each candidate, whether they would be suitable or unsuitable for appointment to the position of chief audit executive of Decisions (Pty) Ltd. Provide reasons to support your decisions. Your answer must convey that you are knowledgeable about the role of internal audit and the attributes the CAE should have.

**2.20**

**(30 marks 36 minutes)**

**PART A**

**(18 marks 22 minutes)**

1. What is an audit committee? (2)
2. The audit committee should not perform any management function. True or false? (1)
3. Who should appoint the audit committee of Motown Ltd a listed company? (1)
4. In terms of the Companies Act 2008, what are the requirements for membership of the audit committee? (4)

5. Should the chairman of the board be the chairman of the audit committee? (1)
6. How often should the audit committee meet? (2)
7. In addition to the appointed members of the audit committee, suggest other individuals who may be in attendance at audit committee meetings. (2)
8. Is it necessary for the members of the audit committee to be financially literate? Justify. (2)
9. Is the audit committee responsible for monitoring the ethical conduct of the directors? (1)
10. To whom should the audit committee report? (2)

## **PART B**

**(12 marks 14 minutes)**

The following functions should be carried out by the audit committee of a public company.

1. Reviewing material related party transactions.
2. Discussing the external auditors audit strategy and audit plan with the engagement partner.
3. Reviewing the company's black economic empowerment strategy.
4. Nominating a registered auditor for appointment as auditor of the company.
5. Acting as mediators in a labour dispute.
6. Monitoring the company's adherence to JSE reporting regulations.
7. Dismissing the financial controller for incompetence.
8. Taking responsibility for implementing new financial reporting software.

**YOU ARE REQUIRED TO** indicate whether you agree or disagree that the functions listed above should be carried out by the internal audit committee. Justify your answer for each function.

## **2.21**

**(22 marks 26 minutes)**

Hartford Ltd, a public company has never appointed an audit committee. As Harry Hart, the managing director says “we have had the same audit firm for 30 years and the relationship has worked well, they do lots of work for us, we pay them well, and we are just one big family. I can see absolutely no reason to have an audit committee to check up on our auditors. In any event, I will just appoint myself as chairman of the audit committee, or I will get the shareholders to include a clause in the company’s Memorandum of Incorporation which states that we don’t require an audit committee.”

**YOU ARE REQUIRED TO:**

- a) comment on Harry Hart's attitude to audit committees and his intended action regarding the audit committee to be appointed. (10)
- b) explain to him the consequences for Hartford Ltd of the sections in the Companies Act 2008 relating to audit committees. (12)

**2.22**

**(22 marks 26 minutes)**

At the beginning of the current financial year, Northwind (Pty) Ltd, a large manufacturing company, appointed an audit committee in an attempt to become more compliant with the recommendations of the King III report. As this is the first time such a committee has been in operation, the chief executive officer, Greg Green has from time to time during the course of the financial year, asked you whether certain matters should be referred to the audit committee for its approval/recommendation. The company has a small, but competent internal audit section and is externally audited. These matters are listed below:

- 1. an agreement was reached with the local trade union on wage rates for the upcoming year. (1)
- 2. the factory administration clerk was dismissed for his part in a wage fraud. (2)
- 3. Greg Green has requested a loan of R5m from the company to enable him to build a holiday home. (3)
- 4. the company intends taking SARS to court over a dispute relating to expenses which the company has claimed, but which SARS has disallowed. The amounts are material. (3)
- 5. an official complaint has been received by Greg Green from the external auditors who claim that the financial director Jay Naran, has instructed the financial manager not to allow access to certain financial information to senior members of the audit team. (2)
- 6. the company wishes to cancel a contract which they have with a supplier as a result of the supplier failing to meet the terms of the contract. (1)
- 7. the Human Resources department, after short-listing three candidates for the position of chief audit executive, has identified the applicant which they believe to be the most suitable. (3)
- 8. a director of Northwind (Pty) Ltd is alleged to have leaked confidential information about the company to the directors of Causeway (Pty) Ltd, a company with which Northwind (Pty) Ltd was involved in takeover discussions. (2)
- 9. the external auditors have presented a list of material unresolved audit matters arising from an interim audit to Jay Naran, the financial director. (2)
- 10. the marketing director has proposed that the company invest heavily in an expansion programme into Africa as he believes it is necessary for the sustainability of the company. (3)

**YOU ARE REQUIRED TO** indicate, giving reasons, what advice you would have given to Greg Green in respect of the above.

**2.23**

**(20 marks 24 minutes)**

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

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

- |    |                 |   |   |
|----|-----------------|---|---|
| 1. | Gambhir Gull    | - | Company secretary of JayB Ltd.  |
| 2. | Rod Dodger      | - | Professor of corporate law at Unisa and not connected to JayB Ltd in any way.   |
| 3. | Karl Zeiss      | - | Chairman and non-executive director of JayB Ltd.  |
| 4. | Terry Ticker    | - | Senior partner of Ticktock Inc, JayB Ltd's auditors. He is not the designated auditor, but does advise the company on taxation.   |
| 5. | Aaron Khumalo   | - | CA(SA), senior manager of JayB Ltd's BEE division.  |
| 6. | Klark Gayble    | - | CA(SA) an independent non-executive director of JayB Ltd.   |
| 7. | Theuns Jordaan  | - | Production director of MayB (Pty) Ltd, a subsidiary of JayB Ltd.  |
| 8. | Jennifer Jacobs | - | An industrial psychologist who has no connection with the JayB group, but is well known in business circles.  |
| 9. | Rod Grind       | - | CA(SA) and former chairman of JayB Ltd who retired four years ago. He holds 4% of the shares in JayB Ltd and his company Rodds (Pty) Ltd supplies JayB Ltd with certain manufacturing materials. Although he resigned his chairmanship he still holds a position of non-executive director of JayB Ltd. |

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

**2.24**

**(40 marks 48 minutes)**

You are a member of the "Governance and Regulation" department of your audit firm. The primary function of this department is to advise clients in respect of their compliance with matters of corporate governance, statute and financial reporting.

Your firm recently received a phone call from Matt Holland, the Chairman and Chief Executive Officer of Kaltron (Pty) Ltd, a large manufacturer of electronic equipment. He requested a meeting with you and your partner and at the meeting he raised the following matter with you:

“20% of the shares in Kaltron (Pty) Ltd are held by Aflens Ltd, a listed company. The Board of Aflens Ltd requires that we comply with the recommendations of the King III Report on corporate governance. Kaltron (Pty) Ltd needs to respond positively to this request as our link with Aflens Ltd provides significant benefits for the company. What I would like you to do is explain some of the terminology that is being used, such as the ‘inclusive approach to corporate governance’, integrated reporting and ‘triple bottom line’ reporting. We would also like you to comment and advise on certain aspects of our governance structures.”

A few days later (in response to your enquiries), Matt Holland provided you with the following information:

### ***Board of Directors***

“The Board consists of the following members:

- : Matt Holland
- : Brian Giggs (manufacturing director and deputy chairperson)
- : Steve Pienaar (marketing and research director)
- : Clinton Fortune (financial director)
- : Zeke Sepeng (non executive director) note 1
- : Will Klinton (human resources director)
- : Vish Sidhu (non executive director) note 2
- : Jane Lane (non executive director) note 3

Note 1: Zeke Sepeng, is the major shareholder of Gigabite (Pty) Ltd, Kaltron (Pty) Ltd’s largest customer.

Note 2: Vish Sidhu is the former financial director (and deputy chairperson) of Kaltron (Pty) Ltd having retired at the end of the previous financial year.

Note 3: Jane Lane is a partner in the legal practice which advises Kaltron (Pty) Ltd.”

### ***Board committees***

“We do make use of board committees but only to a limited extent. With respect to the committees you specifically asked about:

#### ***The remuneration committee.***

No need for a committee here. Executive remuneration is determined by myself and Will Klinton. We decide upon a percentage increase for the year and apply it to all executive directors.

Non-executive directors charge us as they deem fit in the same manner as any other professional service provider.”

#### ***The audit committee***

“I recently appointed our first audit committee. The current members are myself, Clinton Fortune, Steve Pienaar and Brian Giggs. I am the chairperson of the committee. Clinton Fortune is on the committee to advise on any financial matters which the committee might have to deal with. Steve, Brian and myself are computer scientists, definitely not accountants!”

### ***Internal Audit***

“We have an internal audit section. It is headed up by Dicky Butt, the Senior Internal Audit Clerk. He has two assistants and reports directly to the financial controller. To be perfectly honest, internal audit is regarded as rather low key and I suppose we will have to remedy this if we are to comply with Aflens Ltd’s request.”

### **YOU ARE REQUIRED TO:**

- a) explain the terms
  - \* inclusive approach to corporate governance (2)
  - \* integrated reporting (4)
  - \* triple bottom line reporting. (2)
- b) discuss the composition of the Board of Directors of Kaltron (Pty) Ltd in terms of the recommendations of the King III Code based on the information given above. (10)
- c) comment on Matt Holland’s contention that there is “no need for a remuneration committee” and indicate what Kaltron (Pty) Ltd will need to do to comply with the King III Code in respect of the remuneration of board members. (10)
- d) comment on the appointment and composition of the audit committee. (5)
- e) advise Kaltron (Pty) Ltd on what the company should do to enhance the status of the internal audit department. (7)



## **CHAPTER 3**

# **PROFESSIONAL CONDUCT AND ETHICAL CONSIDERATIONS**





**3.1****(14 marks 17 minutes)**

1. Why does the SAICA Code of Professional Conduct promote a conceptual framework rather than simply present a set of rules to which chartered accountants must adhere?(2)
2. Explain the conceptual framework approach to professional conduct. (4)
3. Which of the following are not fundamental principles of the SAICA Code of Professional Conduct? (3)
  - \* integrity                      \* tact
  - \* independence                \* professional behaviour
  - \* timeousness                  \* fairness
  - \* confidentiality               \* professional competence and due care.
4. A “self interest” threat may threaten a chartered accountant’s compliance with the fundamental principles. Identify four other types of threat. (2)
5. What is a “safeguard” in the context of professional conduct? (1)
6. Briefly describe the two broad categories into which safeguards fall. (2)

**3.2****(30 marks 36 minutes)**

1. The SAICA Code of Professional Conduct does not apply to chartered accountants in business, e.g. a financial director of a listed company.
2. The fundamental principle of objectivity only applies where a chartered accountant is on an assurance engagement.
3. Provided an auditor is independent in mind, he need not be independent in appearance.
4. For the purposes of the COPC, the immediate family of a chartered accountant in public practice consists of
  - 4.1 the spouse
  - 4.2 dependents.
5. Carter Repson, a chartered accountant in public practice, is not in breach of the Code if he takes a loan from Peoples Bank, a registered financial institution, of which he is the audit engagement partner.
6. Lolly Patrick has recently been appointed the advertising manager of Homeware Hut (Pty) Ltd. Her husband Peter Patrick is the auditor of the company. Peter Patrick is, as a result, automatically in breach of the independence requirements of the COPC. Homeware Hut (Pty) Ltd is required to have its annual financial statements externally audited in terms of its Memorandum of Incorporation.

7. Desai and Co – Registered Auditors (and chartered accountants) wish to advertise their services on television during the evening “soap opera” period. They are permitted to do so.
8. A chartered accountant who replaces another chartered accountant as the auditor of a company must determine whether there are any professional reasons for not accepting the engagement.
9. Chivanga and Skeate are about to be replaced as auditors of Province (Pty) Ltd, by de Villiers and Grant. Chivanga and Skeate are under no obligation to discuss the audit strategy and plans they had adopted on the prior year audit with de Villiers and Grant.
10. A firm of registered auditors may not accept a commission from an assurance client for referring the client’s products to other clients of the firm.
11. Gomez and Pillay – Registered Auditors (and chartered accountants) hold cash on behalf of clients. Provided the cash is separately identifiable, e.g. not placed in the firm’s own bank account, and the cash is treated and used for the purposes agreed with the client, Gomez and Pillay will be in full compliance with the Code in respect of a chartered accountant having custody over a client’s assets.
12. Where a chartered accountant in public practice is asked to provide a second opinion on financial information on which another chartered accountant has already provided an opinion, he or she should refuse to do so unless the chartered accountant who gave the first opinion agrees to the engagement.
13. John Jarvis CA(SA) is a chartered accountant in business. In general he is required to comply with the fundamental principles of the Code, but if doing so conflicts with the interests of his employer, he need not do so.

**YOU ARE REQUIRED TO** state whether each of the above is *true* or *false*. Justify your answer.

### 3.3

**(16 marks 18 minutes)**

The SAICA Code of Professional Conduct (ET) categorises threats to a chartered accountant in public practice, into five categories i.e. self-interest, self-review, advocacy, familiarity and intimidation. Consider the following unrelated situations:

1. Vish Bhogal has been the lead engagement partner on the audit of Kybher Ltd, a listed company, for the past five consecutive year-end audits. (2)
2. The audit firm of Ajax and Real are asked to provide internal audit services to Clarkson Ltd, one of its audit clients. (2)
3. Ngcobo and Zwane, an audit firm, has been requested by one of its audit clients to lend it (the audit client) two trainee accountants to work in its accounting department for a period of six weeks. (3)

4. Jessie James and Co, a firm of auditors, has been approached by Odeon (Pty) Ltd, a large audit client, to recruit a financial director on its behalf. (2)
5. The fee for the assignment mentioned in (4) above will be equal to 15% of the remuneration package of the financial director for 1 year. The remuneration package will be negotiated between your firm and the successful candidate. (2)
6. Flyfast (Pty) Ltd, a travel agency, offers Thyse Burger and Lewey Koen, the partner in charge and manager of its external audit team, free airline tickets to Europe to watch the Tour de France. The tickets are part of a Flyfast (Pty) Ltd sales promotion. (3)
7. Carter Brown, the senior-in-charge of the audit of Finansbank, obtains a loan from the bank to finance the purchase of his new BMW. (2)

**YOU ARE REQUIRED TO** identify, where applicable, the category into which each of the threats fall, and suggest appropriate safeguards which should be put in place, to reduce the threat to an acceptable level if possible.

### 3.4

**(30 marks 36 minutes)**

The conceptual framework approach to dealing with professional conduct issues requires that chartered accountants:

1. identify threats to their compliance with the fundamental principles of integrity, objectivity, professional competence and due care, confidentiality and professional behaviour.
2. evaluate the significance of the threat identified and
3. apply safeguards to eliminate or reduce the threat to an appropriate level.

**YOU ARE REQUIRED TO** complete the chart on the following page by filling in the blank columns. Where you identify the fundamental principles threatened, provide a brief explanation. List two safeguards for each situation.

<i><b>Example</b></i>	<i><b>Fundamental Principle Threatened</b></i>	<i><b>Safeguard</b></i>
<p><b>Self interest</b></p> <ol style="list-style-type: none"> <li>1. Walter Wiseman an audit partner owns 15% of the shares in Buttco (Pty) Ltd an audit client.</li> <li>2. Joe Zulu, an audit manager, has been offered a highly paid job at one of his audit clients.</li> </ol>		
<p><b>Self review</b></p> <ol style="list-style-type: none"> <li>1. Harris Ford, a partner in an auditing firm has been asked by a 3<sup>rd</sup> party to provide a report on a client's computerised sales system, which he and a team had recently designed and implemented.</li> <li>2. Clarence Kleyhans, who was the financial manager of Kambo Ltd recently resigned to go back into the profession. He was employed by the audit firm that holds the appointment of auditor of Kambo Ltd and because of his knowledge of the company it has been suggested that he be placed in charge of the audit.</li> </ol>		
<p><b>Familiarity</b></p> <ol style="list-style-type: none"> <li>1. The financial director of Travel Bug Ltd has offered to take the whole audit team on an all expenses paid weekend to an exclusive game lodge. He has stated that this will become a yearly event if the audit deadline is met.</li> <li>2. Marie Lopes, the audit manager on the audit of Topaz Ltd will shortly marry Bill Brown the financial director of Topaz Ltd.</li> </ol>		
<p><b>Intimidation</b></p> <ol style="list-style-type: none"> <li>1. The financial director of Rubdub Ltd has informed Rex Randolph, the engagement partner on the audit of Rubdub Ltd that unless the audit fee is reduced by 30%, his firm will be removed from the appointment of auditor.</li> <li>2. The financial director of ProTech Ltd is very aggressive, domineering and dismissive of the audit function and audit team.</li> </ol>		

**3.5****(30 marks 36 minutes)**

1. Under what conditions may a chartered accountant in public practice breach his duty of confidentiality to his client without contravening the Code of Professional Conduct? (2)
2. If a chartered accountant who is the financial manager of a company, discloses confidential information about the company to other employees at a social function of the company, can he be charged with a breach of the Code of Professional Conduct? (2)
3. Give three examples where a chartered accountant in public practice has a right or duty to disclose confidential information about a client (without the client's permission). (2)
4. Explain why the receipt of a referral commission by a chartered accountant in public practice may pose a threat to the fundamental principles of the Code of Professional Conduct. Provide an example to illustrate. (3)
5. What is "lowballing" and why is it considered to be unacceptable in the context of the auditing/accounting profession? (2)
6. Ron Quin a chartered accountant in public practice, was notified by one of his audit clients, Windfall (Pty) Ltd, that the company had appointed Reg Minnaar as the financial manager at Windfall (Pty) Ltd with immediate effect. Reg Minnaar had recently left Ballen (Pty) Ltd, a company which is also an audit client of Ron Quin. From having read the minutes of directors' meetings whilst conducting the recent audit of Ballen (Pty) Ltd, Ron Quin was aware that Reg Minnaar had been dismissed from Ballen (Pty) Ltd for fraud, but for various reasons had not been charged and had been allowed to resign. Ron Quin immediately sent an email to each member of the board of Windfall (Pty) Ltd notifying them that Reg Minnaar had been dismissed for fraud. Comment on whether Ron Quin has breached the Code of Professional Conduct. (4)
7. Joe Tick, a chartered accountant in public practice, wrote an article on personal tax for a popular magazine "Moneycents". Next to the article Joe Tick paid for a full page advertisement promoting his firm. Is the inclusion of the advertisement a breach of the Code of Professional Conduct? Explain your answer. (3)
8. May a firm of chartered accountants advertise:
  - 3.1 in the Yellow Pages directory? (1)
  - 3.2 on the internet site "Facebook"? (1)
9. Donnie Brasco, a highly competent chartered accountant was not made a partner of the audit firm by which he was employed on the grounds that he did not hold the same religious beliefs as the other partners and that this would affect the firm's relationship with a number of the firm's clients. Comment on this situation in terms of the Code of Professional Conduct. (3)
10. Krib Ltd (which is audited by Kissall Finesting Inc) have approached you, a chartered accountant in public practice to carry out a review of the salary structures including

directors emoluments within the company. They insist that you do not inform Kissall Finesting of the engagement because of the "confidential nature of salaries and directors emoluments". Would you agree to this? Explain your answer. (2)

11. Harbejahn Sing, a senior manager at the firm of Mowitt and Partners, was phoned by a partner from Downs and Co. He was told in confidence that Downs and Co were opening an office in East London. The partner offered Harbejahn Sing the position of senior manager in the new office with a promise of a partnership within two years. The partner from Downs and Co told Harbejahn Sing to keep "the offer quiet for the moment", which Harbejahn Sing agreed to do. Comment on this situation in terms of the Code of Professional Conduct. (3)
12. May a partner delegate, under normal circumstances, the signing of an audit report to his audit manager provided the manager is a chartered accountant? Justify your answer. (2)

### 3.6

**(33 marks 40 minutes)**

Each year Greenway and Zondeki, a large auditing firm, runs a two week programme 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 programme 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 programme 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 (ET). 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 programme, 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 2016. In April 2016 Quickies (Pty) Ltd offered him the position of financial accountant at the company from January 2017. The existing financial accountant is due to retire at the end of 2016. 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 behaviour. (6)
- 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)
- 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)
  - ii. the terms "self review threat" and "familiarity threat". Give one example for each threat. (4)
- 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.

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

### **3.7**

**(25 marks 30 minutes)**

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)



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)
  
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)
  
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)
  
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)

### 3.8

**(28 marks 34 minutes)**

The following situations relating to chartered accountants in public practice have arisen:

1. Mitchell Cord recently completed the audit of Summerhouse (Pty) Ltd, a manufacturer of exclusive furniture. The audit fee amounted to R180 000. Having recently bought a new house, Mitchell Cord proposed the following to Summerhouse (Pty) Ltd:
  - 1.1 Instead of invoicing Summerhouse (Pty) Ltd with a fee of R180 000, he would invoice the company an amount of R80 000 for the audit fees.

- 1.2 Summerhouse (Pty) Ltd would then supply Mitchell Cord free of charge with furniture for his new house with a cost value of R100 000.
- 1.3 Summerhouse (Pty) Ltd would not raise a sale in the company's accounting records and would write the amount of R100 000 off as part of the allowance for obsolete inventory. (8)
2. Randle String, assisted a client in tax litigation (non-assurance engagement) and charged his fee as a percentage of the taxation which he had saved the client. This basis of charging had been agreed prior to the service being rendered with the additional proviso that if the litigation ended unfavourably for Randle String's client, he would charge only a nominal fee of R100 to cover phone calls, postages and petties related to the case. The client won the case and saved a significant amount of tax. This resulted in Randall String charging a fee which the client considered to be exorbitant in relation to the advice he had given. (8)
3. Jannie Knott, a partner in a small country practice, negotiated the sale of an office building on behalf of a client. For this service he charged a fee of 1% below that normally charged by estate agents on the selling price of the building. (3)
4. Willie Windsor acts as an agent for the reputable Smartacc software. In terms of the agreement with Smartacc, Willie Windsor receives a 20% commission on the selling price of any accounting software he sells to his (both assurance and non-assurance) clients and 25% commission on any sales he might make to the general public. (4)
5. Ronald Reef has been engaged by Castel (Pty) Ltd for some years. However, the relationship between Ronald Reef and his client has become unpleasant as Castel (Pty) Ltd have failed to pay fees owed to Ronald Reef for his services. In an attempt to pressure the client into paying, Ronald Reef refused to return certain accounting books and records belonging to Castel (Pty) Ltd which he had in his possession. (5)

**YOU ARE REQUIRED TO** discuss each of the situations (1-5) above in terms of the SAICA Code of Professional Conduct.

### 3.9

**(30 marks 36 minutes)**

In the course of public practice, chartered accountants are frequently faced with ethical situations which may threaten their compliance with the fundamental principles of professional conduct.

The SAICA Code of Professional Conduct provides chartered accountants with guidance on a number of ethical issues, identifying the fundamental principles as well as potential threats to compliance therewith, which the chartered accountant may face. Safeguards to address the threats are also discussed. Consider the following unrelated situations:

#### ***Situation 1***

Marcus Login is the audit manager on the audit of Skyhi (Pty) Ltd, a company which manufactures hang-gliders. As they are both hang-gliding fanatics, Marcus Login and Fred

Spiral, the financial director of Skyhi (Pty) Ltd, have become close friends. As a result, Fred Spiral has arranged for Skyhi (Pty) Ltd to sponsor Marcus Login to attend the world hang-gliding championships. The sponsorship is for the next three years and covers all of Marcus Login's travel and equipment costs.

### ***Situation 2***

Bills and Co recently completed the audit of Xbox (Pty) Ltd, a company which has been in operation for the last three years. Due to liquidity problems, Xbox (Pty) Ltd has been unable to pay its audit fee for the current year although the amount is only R78 000. The financial director of Xbox (Pty) Ltd has suggested the following:

1. Bills and Co will invoice Xbox (Pty) Ltd an additional R22 000 in audit fees making the amount owed R100 000.
2. The amount of R100 000 will be converted into a long-term loan repayable in five years time. Interest at 10 percent per annum will be paid.

### ***Situation 3***

Davey Jones is a trainee accountant on the audit of Chickentogo (Pty) Ltd, a company which owns a number of fast food outlets. Davey Jones' wife is an estate agent. Whilst reading the minutes of the most recent directors' meeting, Davey Jones noted that Chickentogo (Pty) Ltd was intending to open a drive through fast food outlet in the area but would need to purchase two properties on which to locate the outlet. The minutes identified the properties as well as the amounts which Chickentogo (Pty) Ltd was prepared to pay.

Both amounts exceeded the market value of the properties as Chickentogo (Pty) Ltd were very keen to obtain these specific properties. That evening Davey Jones told his wife about this and the following day she lost no time in contacting the owners of the properties, telling them that she had heard rumours of interest in their properties and that she knew what the interested party would offer. She did not disclose the name of the company or the amounts, but promised to do so if the owners of the properties agreed to her negotiating the deal.

### **YOU ARE REQUIRED TO:**

- a) identify the fundamental principles on which the SAICA Code of Professional Conduct is based, and provide a brief explanation of each. (8)
- b) in the context of the chartered accountant's independence, explain the following threats
  - i. familiarity threats
  - ii. self-interest threats
  - iii. intimidation threats(5)
- c) identify the types of threat to Marcus Login's compliance with the fundamental principles of professional conduct, to which situation 1 above gives rise. Justify your answer. (8)
- d) discuss the scheme proposed by the financial director to settle the audit fee of Bills and Co as laid out in situation 2, in terms of the SAICA Code of Professional Conduct. (5)

- e) discuss the conduct of Davey Jones in terms of the SAICA Code of Professional Conduct (situation 3). (4)

### 3.10

(25 marks 30 minutes)

A chartered accountant in public practice will frequently be faced with situations or circumstances which pose a threat to his compliance with the fundamental principles of professional conduct. These threats are categorised as self-interest, self-review, advocacy, familiarity and intimidation threats. Consider each of the following unrelated situations:

1. The audit committee of Jasper Ltd, an audit client of Maxwell Turvy and Co, have informed the engagement partner that it would be in the interests of both Jasper Ltd and Maxwell Turvey and Co, that the audit report for the financial year currently under audit be unmodified (not qualified) as Jasper Ltd will shortly be entering into merger discussions with another large company. (6)
2. Gilbert Malan the manager of the audit team of Packhouses Ltd, a listed company, has come across confidential information at the audit which, once released to the public is likely to substantially increase the Packhouses Ltd share price. Gilbert Malan realises that if he gets his wife to purchase shares in Packhouses Ltd immediately, she could make a significant amount of money. (6)
3. Kallie Myburgh a recently qualified chartered accountant is in charge of the audit of Stoneware (Pty) Ltd. In 6 months time, on the retirement of the existing financial manager he will be appointed as the financial manager of Stoneware (Pty) Ltd. By the time he takes up the appointment he will have completed the current audit. Stoneware (Pty) Ltd are pleased to be appointing Kallie Myburgh as he has worked on the Stoneware (Pty) Ltd audit for a number of years and is popular with the company's management and other staff. (7)
4. Welders (Pty) Ltd a large industrial company, wishes to engage the firm which conducts the annual audit of its financial statements, to manage the implementation of a number of new financial accounting applications. The audit firm's responsibilities will include selecting the most suitable software packages as well as managing the implementation project. Welders (Pty) Ltd's financial director has indicated that the audit firm can charge whatever fee they wish, provided the implementation is complete by a specified deadline date. (6)

**YOU ARE REQUIRED TO** identify and discuss the threats to compliance with the fundamental principles of professional conduct which may arise from the situations described above. Your answer should include reference to the fundamental principles which are under threat, but you are not required to discuss the safeguards which should be put in place to respond to the threats.

### 3.11

(21 marks 24 minutes)

Roz Sabbatini CA(SA) a registered auditor, conducts the audit of Sportz (Pty) Ltd, as well as acting for the company in tax matters. In terms of its agreement with Sportz (Pty) Ltd,

Nedtrust Bank which has a substantial long-term investment in the company, requires that the company's annual financial statements are audited by a registered auditor and submitted to the bank. During the current year's audit of this client, Roz Sabbatini discovered that Kurt Curren, sole shareholder and managing director of the company, has been keeping an alternate set of accounting records which reflect the true situation whilst she has been auditing annual financial statements and submitting tax returns based on an incomplete (fraudulent) set of accounting records, e.g. not all sales have been accounted for.

When Roz Sabbatini confronts Kurt Curren with this evidence, he admits that he has done this for some years but indicates that he is not at all worried about it because he was only able to get away with it due to the inadequate audits which Roz Sabbatini had conducted over the years. He further states that should Roz Sabbatini report the matter to anyone, he, Kurt Curren, will simply state that she was a willing partner to the fraud and had benefited from the exorbitant fees which she had charged Sportz (Pty) Ltd and which the company had paid without query. On thinking about it Roz Sabbatini realised that Sportz (Pty) Ltd's willingness to pay her fees without query may have resulted in her overcharging on prior audits/assignments.

On scrutiny of correspondence of her past dealings with Kurt Curren and of prior audit working papers, Roz Sabbatini realises that she could indeed appear to have conspired with Kurt Curren as her audit documentation could be considered inadequate and she had not followed up on a number of queries raised by the (small) audit team and recorded in the audit documentation concerning the audit. Furthermore, a large percentage of her professional fees comes from work referred to her by Kurt Curren, and in relation to the quality of the documentation supporting this work, the fees could also appear exorbitant.

**YOU ARE REQUIRED TO** discuss fully the situation in which Roz Sabbatini finds herself in relation to:

- |      |   |      |
|------|---|------|
| (i)  | the IRBA Rules Regarding Improper Conduct | (5)  |
| (ii) | the SAICA Code of Professional Conduct    | (16) |

### 3.12

**(25 marks 30 minutes)**

1. Garth Naidoo is a newly qualified chartered accountant. At the audit he is currently working on, he is being pressured by the manager on the audit (an older and far more experienced chartered accountant) into signing off the audit programme for a section of the audit to which he was assigned although he has not completed the work, so that the budget for the audit can be met. When he protested, the manager informed him that should he not do as he was told, he (Garth Naidoo), would receive a very poor report at his next performance assessment which could lead to the termination of his employment contract.
2. Carl King a third year trainee accountant on the audit of Emex Ltd, discovered, by having access to the minutes of director's meetings, that Emex Ltd was considering changing its insurance brokers. That evening Carl King phoned his father an insurance broker, and told him about the possible change and suggested that he phone Richie Wrisk, the administration manager at Emex Ltd. He also told his father that Emex Ltd spent R123 000 on insurance premiums each month.

3. Curtis Rose and Co are the auditors of Fairways Ltd, a company which develops housing estates around golf courses. When Fairways Ltd develops a new estate, it offers a few plots to its professional advisors, such as its bankers, architects or attorneys at a discounted price (i.e. less than prices charged when the development is put on the market). If a plot is purchased by an advisor, no interest is charged (the market rate is charged on ordinary sales) *but* the amount owed must be settled within 12 months. For their latest development Fairways Ltd has offered a plot to Franklin Curtis, a partner of Curtis Rose and Co.
4. Blakey, Bell and Co, a firm of chartered accountants in public practice, offers a range of services to their clients including the investment of client funds on the money market. Tina Bell, the partner in charge of the money market funds, has been offered a higher rate of interest by the bank with which the funds are placed, if she can maintain the balance of the amount invested at a particular level. To achieve this level she decided to move all client monies and Blakey, Bell and Co monies into one account. This enabled her to earn the additional interest (which was credited to Blakey, Bell and Co) and to improve the firm's cash flow. For example, to meet the monthly salary bill she was able to draw funds from the money market rather than make use of the firm's bank overdraft facilities.

**YOU ARE REQUIRED TO:**

- a) discuss the situation in which Garth Naidoo finds himself in the context of the SAICA Code of Professional Conduct and indicate how he should act. (8)
- b) discuss whether Carl King has breached the SAICA Code of Professional Conduct. (5)
- c) discuss whether, in terms of the SAICA Code of Professional Conduct, Franklin Curtis may accept the plot offered to him by Fairways Ltd. (7)
- d) discuss whether Tina Bell has breached the SAICA Code of Professional Conduct. (5)

**3.13**

**(33 marks 39 minutes)**

The audit firm of Messi and Mudau has an extensive number of audit and other clients. The firm has an internal "ethics and governance" committee which meets frequently to consider any breaches or potential breaches of the ethical standards of the profession by its partners and employees (including trainee accountants). As a first year trainee you have been invited to sit on this committee to contribute your knowledge of the SAICA Code of Professional Conduct and to gain experience. The following matters have been presented for discussion:

***Matter 1: Actiontravel (Pty) Ltd***

The firm has recently completed the year-end audit of Actiontravel (Pty) Ltd, a company which organises tours to major sporting events around the world. The audit fee for the year is approximately R125 000 but has not yet been paid by Actiontravel (Pty) Ltd. To settle the account, the company has offered to give your firm five tour packages on one of its tours to a Formula 1 Grand Prix in Europe. The cost of a single tour package to a member of the public is approximately R25 000. If your firm agrees to this, Actiontravel (Pty) Ltd will include a



further two tour packages free of charge provided the packages are given to the manager and senior-in-charge of the audit team which carried out the audit of Actiontravel (Pty) Ltd.

### ***Matter 2: Wissles (Pty) Ltd***

Wissles (Pty) Ltd, an audit client of your firm, wishes to improve its corporate governance and has put the following proposals to your firm:

1. The senior partner of your firm Danial Messi, be appointed as a non-executive director of Wissles (Pty) Ltd and Chairman of the Board of Directors. (Danial Messi does not play any role on the audit of Wissles (Pty) Ltd).
2. Tom Boonin, the partner in charge of the audit (engagement partner) of Wissles (Pty) Ltd be appointed to a two member Remuneration Committee (the other member being Ted Fredd, Wissles (Pty) Ltd's Human Resources manager). Ted Fredd is not a director of the company. This committee would be responsible for setting and authorising the remuneration of all executives of the company.

### ***Matter 3: Burlyn Ltd***

Eliza Meiring, the manager on the audit of Burlyn Ltd, recently married Steve Meiring a CA(SA). By coincidence Steve Meiring has been employed by Burlyn Ltd as the company accountant. He will join the company on 1 May 2016, the first day of the new financial year. Eliza Meiring has commenced the 30 April 2016 year-end audit, and expects that it will be completed in mid June.

### ***Matter 4: Copycat (Pty) Ltd***

One of the firm's audit clients, Copycat (Pty) Ltd sells photocopy and other business machines. The sales manager of Copycat (Pty) Ltd has approached your firm with the following proposal in an attempt to increase its sales:

“Your firm supplies Copycat (Pty) Ltd with a list of all the firm's clients, the age and depreciated value of their existing business machines and the name of a specific person whom Copycat (Pty) Ltd can contact with a view to selling the clients new machines. For every sale made in this manner, your firm will receive a payment equal to 10% of the machine's selling price.”

The projections provided by Copycat (Pty) Ltd suggest that this could be a lucrative (profitable) venture for your firm.

### ***Matter 5: Advertising***

Your firm is considering an advertising campaign to promote the range of services it offers. As part of the campaign the partners wish to include a catchy phrase (slogan) which will appear, with the firm's logo, on all letterheads, advertisements etc. The following two phrases (slogans) have been submitted for the “ethics and governance” committee to consider:

1. Messi and Mudau “simply the best, better than all the rest”
2. Messi and Mudau “X-streme X-cellence”

**YOU ARE REQUIRED TO:**

- a) in respect of matter 1, discuss Actiontravel (Pty) Ltd's offer in terms of the SAICA Code of Professional Conduct. (7)
- b) in respect of matter 2, discuss Wissles (Pty) Ltd's proposal to improve its corporate governance in terms of
  - i the King Report (4)
  - ii the SAICA Code of Professional Conduct (4)
  - iii the Companies Act 2008 (3)
- c) in respect of matter 3, discuss whether it would be a breach of the SAICA Code of Professional Conduct for Eliza Meiring to continue in her capacity as manager on the 30 April 2016 year-end audit of Burlyn Ltd. (4)
- d) in respect of matter 4, discuss Copycat (Pty) Ltd's proposal in terms of the SAICA Code of Professional Conduct. (6)
- e) in respect of matter 5 comment on the appropriateness of each of the phrases which have been submitted, in terms of the SAICA Code of Professional Conduct. (5)

**3.14**

**(25 marks 30 minutes)**

Martin Fry, a chartered accountant in public practice, wishes to expand his client base. His activities in this regard are described below:

1. he has drafted and mailed a letter to selected medium and small business enterprises listed on a database of local businesses, to which he has access. He does not approach large companies. The letter informs its recipients as to the services which Martin Fry offers and goes on to explain that, while many other firms offer these services, none of them is able to compete with the discounted fee structure, extended credit terms or the truly outstanding quality of service which he gives. His fee structure and credit terms include:
  - 1.1 up to six months credit on outstanding fees,
  - 1.2 hourly rates for himself and his assistants which he claims he can prove are 20% below average rates charged within the accountancy profession,
  - 1.3 what Martin Fry calls his "bulk discount scheme" provides for discounts on hourly rates which increase on a sliding scale as hours worked on the engagement concerned increase, and his "2 for 1" scheme, engage him on two assignments but pay for only one.
2. where he has not received a response within two weeks he visits the business and briefly showing the receptionist a copy of the letter he sent earlier, claims that he has an appointment with the owner, or the directors. (Sometimes he is successful in getting an appointment and sometimes not).

He has been particularly successful in attracting new clients for the tax consultancy services which he offers. There are three main reasons for his success in this regard:



- 2.1 he is able to impress prospective clients as to his ability to reduce their tax expense by informing them of the names of some of his clients, the methods he uses and the amounts which he has saved these clients in taxes payable.
- 2.2 he further informs prospective clients that he is so confident of his ability to save them tax, that his fee for tax consultancy work is calculated as a percentage of the tax savings which he achieves for them. Where he does not achieve any tax savings, he guarantees not to levy a charge for his services.
- 2.3 the services which he offers are comprehensive as he takes care of all aspects of his clients' tax affairs including the preparation and submission of all necessary tax returns.

**YOU ARE REQUIRED TO** discuss the information provided above in the context of Martin Fry's compliance with the SAICA Code of Professional Conduct ET.

**3.15**

**(25 marks 30 minutes)**

Manoj Ravjee, registered with SAICA as a chartered accountant in business, is the recently appointed financial accountant at Raintech (Pty) Ltd, a water purification and irrigation company. The company is a wholly owned subsidiary of Hydroworks Ltd a listed company. One of his duties is to prepare the annual financial statements for submission to the holding company.

These annual financial statements are used in the calculation of bonuses which are paid to management at the subsidiary. On presenting the March 2016 figures to Willy Hagen, the financial director of Raintech (Pty) Ltd, Willy Hagen suggested to Manoj Ravjee that he go and work on the figures to reflect a far better annual profit, reminding him that the management bonuses depended on the profit reflected. On protesting that he could not manipulate the figures, Willy Hagen replied "I suggest you do as I say".

On his way back to his office Manoj Ravjee decided to discuss the matter with Dave Vance, also a chartered accountant employed by Raintech (Pty) Ltd. His response was "Manoj, just do it, you are not in the profession now. Hagen will fire you if you don't do what he says - just look on the bright side, our bonuses will also be bigger. Besides it's not as though you are stealing! In any event who will ever know – the auditors they send here are always pretty inexperienced and you can tell them anything you like!"

**YOU ARE REQUIRED TO:**

- a) discuss the situation in which Manoj Ravjee finds himself in relation to the SAICA Code of Professional Conduct. (12)
- b) discuss Dave Vance's attitude to professional ethics. (8)
- c) discuss the action Manoj Ravjee could take assuming that he is not prepared to comply with Willy Hagen's instructions. (5)

Rendal Miller is a partner in Botha and Nquni, a large audit firm. Phil Kumalo, a newly appointed partner at the firm, is concerned about a number of ethical matters which he has encountered since joining the firm.

1. Phil Kumalo was invited to join Rendal Miller and a number of clients for dinner some weeks ago. One of the topics of conversation was that Rendal Miller's wife, Anna had recently inherited 16 000 shares in Bondai. Ltd. (This company has 10 million shares in issue and these shares are currently quoted on the Johannesburg Stock Exchange at R20 per share). Rendal Miller, because of his position as engagement partner on the audit of Bondai. Ltd, had been able to entertain the clients with gossip and information about the company and its directors. (8)
2. While carrying out planning activities for the audit of Dowd (Pty) Ltd, Phil Kumalo had asked Martina Chest who had been the engagement partner on this audit for the previous three years, for guidance as to the budget for the upcoming audit. Martina Chest had replied that she merely increased the audit fee by the consumer price index each year, to take account of inflation. On discussing the matter with the financial director of Dowd (Pty) Ltd, he (the financial director) indicated that:
  - \* he was never quite sure what he was being charged for, as the fee notes he received provided very little detail and gave no indication as to how fees were calculated, but
  - \* he was expecting a reduced fee because improvements in the accounting system during the year which was currently under audit should result in less involvement of senior audit staff and the completion of the audit two weeks earlier than in prior years. (6)
3. While performing certain tax services for Nelson Naidoo, a client of Botha and Nquni, Rendal Miller had advised Nelson Naidoo to consult Mike Raw, an investment broker, about retirement planning. In response to a question from Nelson Naidoo as to the commission that Rendal Miller would receive from Mike Raw, Rendal Miller had indignantly denied that he received any reward for referring clients to Mike Raw. Phil Kumalo has since learned that Mike Raw pays Botha and Nquni a 5% commission on all investments placed with him as a result of referrals by Botha and Nquni staff and partners. (4)
4. At a partners meeting Rendal Miller informed the other partners that he had been approached by the financial director of Webcam (Pty) Ltd to provide a second opinion of some financial information which it was submitting to the bank. Webcam (Pty) Ltd is not a client of Botha and Nquni and the first opinion had been provided by its auditors. Rendal Miller told the meeting that he had talked the matter through with the financial director of Webcam (Pty) Ltd and provided an opinion acceptable to the financial director. He also told the meeting that he had not charged a fee for this service, as he was "working on the financial director to recommend to the shareholders that Botha and Nquni take over the audit of Webcam (Pty) Ltd." Webcam (Pty) Ltd's public interest score requires that the company have its annual financial statements externally audited. (12)

**YOU ARE REQUIRED TO** discuss the matters described in points (1) - (4) above in relation to the SAICA Code of Professional Conduct (ET).

As you have a sound knowledge of the SAICA Code of Professional Conduct, you have been asked to comment on the following unrelated situations which have arisen at your audit firm.

1. One of the firm's audit clients, Iron Ware Ltd, provides educational bursaries for the children of its employees including children of senior management. The company now wants to introduce a programme to assist bursary students who graduate, to find employment. The company has requested your firm to offer training contracts to students who qualify with a Bachelor of Commerce degree. The Iron Ware Ltd group is a major client of your firm. (5)
2. Another major audit client of your firm is Megasure Ltd. Jack Johnson, whose wife runs a catering business called Jack Spratt CC, is the manager on the audit. Megasure Ltd spends a significant amount of money on internal business related entertainment, and is about to put its catering contract out for tender. Whilst reviewing the minutes of a directors meeting, Jack Johnson came across the amount which the directors regarded as a reasonable tender price. That night he discussed the tender with his wife and suggested that she submit a tender in the name of Jack Spratt CC. Although Jack Johnson was a member of Jack Spratt CC he instructed his wife (the only other member of the CC) not to use his name in any correspondence and under no circumstances to reveal that she was his wife. He also told her to tender just below the expected amount and agreed to get as much information as he could about Megasure Ltd's catering expenditure. The following day he instructed a trainee accountant on the audit team to comprehensively analyse the company's catering expenditure, although this work was not necessary for audit purposes. (12)
3. SupaRugby (Pty) Ltd is also an audit client of the firm. Along with other companies, the company has the rights to manufacture and distribute SupaRugby merchandise. The company has a number of exciting business opportunities and its financial director has approached your firm to enter into a joint venture with it in the form of a private company, to develop these opportunities. Your firm's contribution to the joint venture will be for the partners to invest an initial R5m as start up loan capital, to provide advice on the financial systems and to carry out the annual audit on the joint venture company. (The company's Memorandum of Incorporation will require an annual audit). All the shares in the joint venture company will be owned by SupaRugby (Pty) Ltd, and the board of directors of the joint venture company will be made up of directors of SupaRugby (Pty) Ltd and two of your firm's partners. (5)

**YOU ARE REQUIRED TO:**

- (a) briefly explain each of the fundamental principles of the SAICA Code of Professional Conduct. (8)
- (b) discuss each of the above situations (1 – 3) in terms of the SAICA Code of Professional Conduct. (22)

You are the technical manager in the firm of Jean, Michelle and Jarre. The firm has fifteen partners and a wide range of clients. The following matters have arisen and your advice has been sought.

**1. Client : Cauldron Ltd**

Your firm makes use of laptop computers on audit. Junior trainees are not given their own laptops. However, the senior-in-charge has just phoned you to report that the junior trainee accountant who was supposed to look after her (the senior's) laptop overnight, had left it in his car. During the night the car had been broken into and the laptop stolen. He further informs you that there was some highly confidential client information stored on the computer and that the audit information stored on the laptop represented over one hundred hours of audit time which was now lost.

**YOU ARE REQUIRED TO** identify and discuss the issues which arise out of this situation. (6)

**2. Client : Firebrand (Pty) Ltd**

The financial director of Firebrand (Pty) Ltd, a chartered accountant, has decided to leave the company. He also holds thirty percent of the shares in Firebrand (Pty) Ltd and the other directors, who are all non-accountants, agreed to purchase his shares. The financial director carried out a valuation of his shares which he presented to his fellow directors. Not knowing anything about valuations these directors in their private capacities, engaged your firm to pass an opinion on whether the valuation was fair. The partner who is the designated auditor on the audit of Firebrand (Pty) Ltd will give the opinion on the financial director's valuation. You are aware that the valuation is an extremely sensitive issue.

On discussing the financial director's valuation with him it became abundantly clear that all of the subjective decisions affecting the valuation had been taken with only his interests in mind; this had resulted in an inflated value being placed on his shares. When your partner raised this with him he responded as follows: "These directors have no idea of a fair valuation, if you say my value is fair they will pay it - valuations are subjective. If you need me to pay you a fee for your time I will be happy to do so."

**YOU ARE REQUIRED TO:**

- a) discuss briefly whether your firm should have accepted this engagement in the first place. (4)
- b) discuss how your partner should respond to the financial director. (5)

**3. Client: Mechtech (Pty) Ltd (London Office)**

Your firm was approached by its associate London office to carry out a special investigation into the affairs of a South African engineering company, Mechtech (Pty) Ltd. The investigation was in connection with a proposed takeover of Mechtech (Pty) Ltd by a client of your firm's London office. Your report is to be made in strictest confidence to your firm's London office. (Your firm is not the auditor of Mechtech (Pty) Ltd.)

You were given access by the directors of Mechtech (Pty) Ltd to all information you required including permission to hold discussions with the company's auditors Kruger and Kahn. By the time you had completed your investigation you were satisfied that Mechtech (Pty) Ltd was party to a number of illegal transactions relating to government contracts and that Kruger and Kahn were aware of this but had chosen to ignore it.

**YOU ARE REQUIRED TO:**

- (i) discuss whether you should report Kruger and Kahn's involvement to your London associate. (3)
- (ii) explain whether you should discuss the matter with Kruger and Kahn and whether you have any duty to report them to any authority. (4)
- (iii) comment on whether you have a duty to report Mechtech (Pty) Ltd in terms of Sec 45 of the Auditing Profession Act. (2)

**3.19**

**(15 marks 18 minutes)**

Reg Randle has recently been appointed financial director of Jemsports Ltd, a sporting goods retailer. His appointment resulted from the dismissal of the previous financial director, John Dukes, who was removed after a fraud in the creditors payments section had been uncovered. The fraud involved payments being made to fictitious creditors over a period of 18 months and amounted to an estimated R5m. Although he was in no way involved, John Dukes was dismissed as the fraud was only made possible by the very casual approach to internal controls which prevailed in the financial accounting department.

Aware that you are knowledgeable about auditor's liability, Reg Randle has approached you to establish whether the auditors of Jemsports Ltd could be successfully sued for the recovery of the R5m on the grounds that they, the auditors, should have detected the fraud.

**YOU ARE REQUIRED TO** discuss the matters you would raise in advising Reg Randle as requested.

**3.20**

**(30 marks 36 minutes)**

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

One of the audit clients which Tobias Timm took over was Yummyfoods (Pty) Ltd. In addition to the audit appointment, Tobias Timm was also to act for the company in tax matters, submitting the necessary returns and handling queries. Yummyfoods (Pty) Ltd manufactures foodstuffs which it supplies to hawkers, spaza shops and small supermarkets. The shares in the company are owned by seven individuals but only one of them, Pieter Pasta is active in the business. He is one of two directors and is the major shareholder. Primarily

because the other shareholders are not active in the business, the company's Memorandum of Incorporation requires that the annual financial statements be externally audited.

Having commenced the audit of the current financial year, 28 February 2016 (Theodore Fox had completed the 2015 audit), Tobias Timm became convinced that Yummyfoods (Pty), Ltd was not accounting for all of its cash sales (hawkers and spaza shops pay cash whilst supermarkets are granted credit and invoiced accordingly). On raising this with Pieter Pasta, he just smiled and suggested that Tobias Timm talk to Theodore Fox about it. Although a little puzzled, Tobias Timm decided to do so.

On contacting Theodore Fox, Tobias Timm started to explain his problem but was interrupted by Theodore Fox who said,

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

**YOU ARE REQUIRED TO:**

- a) discuss Theodore Fox's attitude to the fundamental principles of professional conduct judged in the light of his statement to Tobias Timm. (22)
- b) discuss the impact which the fundamental principle of *confidentiality* will have on the action taken by Tobias Timm arising from the situation described above. (8)



## **CHAPTER 4**

### **BASICS**

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

### **COMPUTERISED ENVIRONMENTS**

- : INTRODUCTION**
- : GENERAL CONTROLS**





#### 4.1

(16 marks 19 minutes)

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. What constitutes sufficient evidence? (1)
2. What constitutes appropriate evidence? (2)
3. Explain briefly the term risk assessment procedures. (2)
4. If the auditor is unable to gain sufficient appropriate audit evidence, what are the consequences? (2)
5. Is there a connection between the audit strategy, audit plan and the gathering of evidence? Explain. (3)
6. Do analytical procedures conducted by the *client* on their own financial information, qualify as audit evidence? (2)
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)
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)

#### 4.2

(16 marks 19 minutes)

1. Two sources of audit evidence are suggested by ISA 500 – Audit Evidence. Describe each of them briefly and comment on their *reliability*. (4)
2. How is the sufficiency and appropriateness of audit evidence expressed in relation to audit risk? (2)
3. Give five factors which may influence the auditor in judging the sufficiency and appropriateness of audit evidence. (3)
4. Assuming that the auditor has used the correct procedures to obtain audit evidence from 3rd parties, can it be said that the evidence so gained is in itself, reliable, relevant and sufficient? Explain. (2)
5. Is persuasive evidence acceptable to the auditor or should it be rejected? Explain. (2)
6. If the auditor selects specific items from a population for testing because they display a unique characteristic, can the results of the test be projected over the population for the auditor to draw a conclusion on the population? Justify. (3)

**YOU ARE REQUIRED TO** select the *most appropriate* answer for each of the following questions:

1. In terms of ISA 500 – Audit Evidence, the auditor is required to obtain
  - 1.1 relevant and appropriate evidence
  - 1.2 sufficient appropriate evidence
  - 1.3 reliable and sufficient evidence
  - 1.4 relevant, reliable and corroborative evidence.
2. Which of the following factors will **not** influence the auditor is determining whether he has gathered the necessary evidence to support his audit opinion?
  - 2.1 the time spent on gathering the evidence
  - 2.2 the source of the evidence gathered
  - 2.3 the persuasiveness of the evidence gathered
  - 2.4 the quantity of evidence gathered.
3. Which of the following factors should **not** influence the auditor's decision on how much evidence he must gather pertaining to a particular assertion?
  - 3.1 the inherent risk applicable to the assertion
  - 3.2 the hours in the budget allocated to the audit of the account heading to which the assertion relates
  - 3.3 the materiality of the account heading to which the assertion relates
  - 3.4 the auditor's experience gained on previous audits of the client company's financial statements.
4. When deciding on the appropriateness of audit evidence gathered the auditor will consider:
  - 4.1 the relevance and reliability of the evidence
  - 4.2 which member of the audit team gathered the evidence
  - 4.3 the reliability and confidentiality of the evidence
  - 4.4 the time spent on gathering the evidence.
5. When deciding on the reliability of audit evidence gathered, the auditor will consider:
  - 5.1 the extent (quantity) of the evidence gathered
  - 5.2 the relevance of the audit evidence
  - 5.3 the nature of the evidence gathered
  - 5.4 the nature and source of the evidence gathered.
6. Which of the following evidence pertaining to the existence of the client's inventory, would be considered to be the most reliable by the auditor?
  - 6.1 an oral representation as to the existence of inventory from the operations director
  - 6.2 a physical inspection of the client's inventory by the audit team
  - 6.3 a written representation from the warehouse manager as to the existence of inventory
  - 6.4 an invoice from the supplier of the inventory reflecting the quantity and description of the good supplied.
7. A piece of evidence obtained on one section of the audit which supports another piece of evidence on another section of the audit is described as

- 7.1 corroborative evidence
  - 7.2 persuasive evidence
  - 7.3 significant evidence
  - 7.4 concurring evidence.
8. Which of the following is not an assertion in the context of auditing?
- 8.1 occurrence
  - 8.2 accuracy
  - 8.3 completeness
  - 8.4 materiality.
9. Which of the following is **not** an assertion relating to current liabilities?
- 9.1 completeness
  - 9.2 obligation
  - 9.3 validity
  - 9.4 existence.
10. Which of the following is **not** an assertion relating to presentation and disclosure?
- 10.1 existence
  - 10.2 classification and understandability
  - 10.3 accuracy and valuation
  - 10.4 completeness.
11. The term “further audit procedures” includes:
- 11.1 risk assessment procedures
  - 11.2 tests of controls
  - 11.3 substantive tests
  - 11.4 substantive tests and tests of controls.
12. Which of the following is **not** a test of controls?
- 12.1 inquiry
  - 12.2 observation
  - 12.3 analytical procedures
  - 12.4 inspection.

#### 4.4

**(15 marks 18 minutes)**

1. Does the auditor perform risk assessment procedures, tests of controls and substantive procedures on every audit? Justify. (3)
2. What is a dual purpose test? (2)
3. Describe two situations where an auditor would perform limited tests of controls. (2)
4. Explain why the audit of a bank or similar large business entity will have to include extensive tests of controls. (2)
5. Analytical procedures can be used as risk assessment procedures and as tests of controls. True or false? Justify. (2)

6. Are computer assisted audit techniques (CAATS) classified as substantive procedures or tests of controls? Justify your answer. (2)
7. Tests of controls may indicate that certain internal controls are not operating effectively. This may lead the auditor to make alterations to the planned substantive tests. How might the auditor alter the planned substantive tests? (2)

#### 4.5

**(20 marks 24 minutes)**

1. If an auditor does not understand the assertions he will not be able to gather the necessary audit evidence to support the audit opinion. True or False? Justify. (3)
2. The greater the risk of misstatement in an account balance the greater the amount of evidence must be gathered about **all** the assertions pertaining to that account heading. Comment. (3)
3. A proper set of accounting records will generally provide sufficient information for the auditor to form an opinion on the fair presentation of the financial statements. True or False? Explain your answer. (3)
4. What does the phrase “appropriateness of audit evidence” mean? (2)
5. Place the following sources of evidence in their order of reliability starting with the least reliable.
  - 5.1 evidence obtained directly by the auditor (e.g. conducting test counts at an inventory count)
  - 5.2 oral evidence provided by a director of the client company.
  - 5.3 a confirmation of balance obtained from a reliable independent source. (2)
6. What does the term reasonable assurance mean in the context of audit evidence? (2)
7. Explain why the auditor only needs to gather sufficient appropriate evidence to reduce audit risk to an acceptable level and not to eliminate audit risk altogether. (3)
8. Auditors do not generally conduct tests on 100% (all items) of a population, they tend to gather evidence by sampling. Give two situations where the auditor may decide to conduct procedures on 100% of a population. (2)

#### 4.6

**(30 marks 36 minutes)**

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

The procedures can be described as follows:

1. Inspection
5. Analytical Procedures

- |                  |                          |
|------------------|--------------------------|
| 2. Observation   | 6. Reperformance         |
| 3. Inquiry       | 7. External confirmation |
| 4. Recalculation |                          |

**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)
- d) state whether the above procedures can be used by the auditor when identifying and assessing the risk of material misstatement. Explain. (3)
- e) identify six parties, other than the client's directors and employees, from whom the auditor may obtain audit evidence and give an example of what that evidence may be. (9)

**4.7**

**(30 marks 36 minutes)**

Sufficient audit evidence means that a satisfactory amount (quantity) of audit evidence has been gathered; appropriate audit evidence means that the evidence is reliable and relevant, i.e. it has the necessary quality which the auditor requires.

The following audit procedures have been carried out by the audit team on the audit of Futex (Pty) Ltd, an electronics manufacturer:

- 1. extracted a sample of items from the inventory sheets and performed test counts at the annual inventory count.
- 2. reviewed the report of an electronics expert who was engaged (by the audit firm) to value work-in-progress at year-end.
- 3. reviewed the minutes of the monthly directors meetings and recorded all important decisions in the audit workpapers.
- 4. discussed the allowance for bad debts with the credit controller.
- 5. observed the control procedures taking place in the receiving bay whilst goods were being delivered by a supplier.
- 6. reperformed the aging of a sample of debtors making up the trade accounts receivable by reference to source documentation e.g. invoices/delivery notes.

**YOU ARE REQUIRED TO:**

- a) discuss the factors which the auditor should consider when assessing the quality of audit evidence. (12)

- b) discuss briefly the **reliability** of the evidence gathered from each of the above audit procedures. (12)
- c) state to which assertion if any, each of the above procedures is **most** relevant. (6)

#### 4.8

(16 marks 19 minutes)

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

1. Careful inspection of a vehicle's registration documents provides evidence of the existence of the vehicle.
2. Selecting a sample of inventory items from the perpetual inventory records, and (physically) counting the items on hand for the sample selected provides evidence of the completeness of inventory.
3. Inspecting the repairs and maintenance account (and similar accounts) in the general ledger for items which may actually be purchases of plant and equipment, provides evidence relating to the completeness of plant and equipment.
4. Inspecting the lease agreements for capitalized leased assets to determine whether the risks and rewards of ownership have transferred to the audit client, provides evidence relating to the valuation of the asset.
5. Observing the receiving clerk counting the goods being delivered by a supplier, provides evidence as to the accuracy of purchases.
6. Reperforming the depreciation calculations provided by the client for plant and equipment for the financial year, provides evidence relating to the valuation of the asset.
7. Comparing the names and amounts on the list of creditors at the end of the current financial year to the list of creditors at the end of the previous financial year, provides evidence relating to the completeness of accounts payable.
8. Conducting a positive circularisation primarily provides evidence as to the valuation of accounts receivable.

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

#### 4.9

(19 marks 22 minutes)

A simple explanation of an external audit could be that it is an exercise whereby an independent party (the auditor) gathers evidence about the assertions of the directors to be in a position to express an opinion on those assertions.

**YOU ARE REQUIRED TO:**

- 1) indicate where the assertions are to be found. (1)
- 2) give another word for assertions. (1)
- 3) explain how the auditor conveys the opinion which he or she has arrived at on the assertions of the directors. (1)
- 4) “the auditor obtains audit evidence to draw reasonable conclusions on which to base the audit opinion by performing audit procedures to ...” (3 objectives). Complete this sentence. (3)
- 5) identify the assertions applicable to
  - 5.1 asset balances (2)
  - 5.2 transactions (2)
  - 5.3 presentation and disclosure (2)
- 6) the assertions are restricted to assets and liabilities only. True or false? Justify. (2)
- 7) list the seven types of procedures which the auditor may conduct to obtain the evidence he requires (auditor’s toolbox). (3)
- 8) contrast the terms vouching and verifying in the context of auditing. (2)

**4.10**

**(10 marks 12 minutes)**

The following expense appears in the year end trial balance of Peroxaid (Pty) Ltd.

Wages

R4 932 428

One of the trainee accountants on the audit informs you that the directors are making the following assertions relating to this expense.

Valuation:	the value of wages paid for the year is R4 932 428
Completeness:	all wages actually earned for the year are included in the amount.
Existence:	all employees who earned these wages exist at the financial year end date (reporting date).
Rights:	Peroxaid (Pty) Ltd has the right to pay wages as it sees fit, provided it complies with labour law.

**YOU ARE REQUIRED TO** state, giving reasons, whether you agree with your fellow trainee accountant.



**4.11****(14 marks 16 minutes)**

You are the senior in charge of the audit of Bluesquare (Pty) Ltd, a large manufacturing company. Whilst discussing the audit of non-current assets with a junior trainee, you asked him to explain the assertions pertaining to non-current asset account headings. He responded as follows:

- Materiality: non-current assets in a manufacturing company are always material
- Rights: only non-current assets which the company has actually paid for, are included
- Accuracy: depreciation on non-current assets has been accurately calculated in terms of the accounting policy
- Occurrence: non-current assets are physical assets, intangible assets such as patents and goodwill are excluded as they have not physically occurred
- Impairment: non-current assets are not damaged in any way. If they are, the damage has been disclosed.

**YOU ARE REQUIRED TO** comment on the junior trainee's understanding of the assertions pertaining to non-current assets. Include in your answer a brief explanation of each of the assertions which apply to non-current assets.

**4.12****(10 marks 12 minutes)**

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

1. The audit team conducted test counts on a sample of the piles of logs which had been cut into 6 metre lengths and stacked in a number of locations in the forests.
2. A trainee accountant inspected the vehicle registration documentation for a sample of the company's trucks used for transporting the labour force into the forests.
3. Members of the audit team inspected a sample (selected from the asset register) of the company's heavy duty machinery, noting the condition of the equipment.
4. The audit manager verified the data used by the company to construct the formula used by the company to calculate the cost of the timber on hand at year end.
5. Whilst carrying out procedure 3 above, the audit team also agreed the serial numbers on the items of machinery selected to the numbers taken from the asset register.
6. A trainee obtained the spot rate at the financial year end and recomputed the amount owed to foreign creditors at year end in local currency.

7. A trainee selected a sample of material purchases from the purchase journal for the month following the year end, and by inspection of the relevant GRN, confirmed that the goods were supplied after year end and not before.
8. The senior trainee on the audit carried out of physical verification of all head office employees included on the salary payroll.
9. The audit manager discussed the recoverability of each of the company's long outstanding debtors (over 90 days) with the credit controller and the financial manager.
10. The senior trainee inspected the relevant agreements for all leases of equipment classified as financial leases, to confirm that the classification was correct.

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

**4.13**

**(15 marks 18 minutes)**

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

1. selected a sample of expensive power tools from the factory floor and traced them to the fixed asset register.
2. evaluated the recoverability of bad debts in discussion with the financial accountant.
3. inspected the lease agreements relating to three leases capitalized as finance leases to confirm that the capitalization was appropriate.
4. selected a sample of inventory items from the inventory count sheets, counted the items on hand and compared the quantities to the count sheet.
5. inspected the dates on supplier delivery notes and the corresponding goods received notes to confirm that the purchase was made during the financial year under audit.
6. inspected the documentation relating to the impairment review carried out by the directors in respect of plant and equipment.
7. selected a sample of purchases from the purchase journal and inspected the corresponding documentation to confirm that the supplier invoice was made out to Laurens Ltd and that the goods supplied were of a type used/purchased by Laurens Ltd.
8. read (inspected) the company's accounting policy note in relation to foreign currencies in the financial statements to ensure it was appropriately presented and described and clearly expressed.
9. whilst conducting tests of detail on a sample of sales invoices, confirmed that prices charged and extensions, additions and VAT calculations were correct.

10. selected a sample of Laurens Ltd dispatch notes and matched them to the corresponding sales invoice.
11. positively circularized a sample of debtors.
12. conducted a search for unrecorded disposals of plant and equipment.
13. inspected the title deeds to Laurens Ltd's properties to determine whether there were any encumbrances on the properties.
14. checked the postings from the sales journal to the various accounts in the general ledger, e.g. debtors control, VAT, and to the debtors ledger.
15. confirmed the conversion rate on transaction date used for a currency translation of a machine imported from America.

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

#### **4.14**

**(21 marks 25 minutes)**

1. What is the purpose of designing and implementing internal controls in a business? (1)
2. A business must set its objectives so that risks which threaten those objectives can be identified. One of the objectives for which risks would be identified would be safeguarding the company's assets. List six further general objectives. (3)
3. Identify the components of internal control in terms of ISA 315 (Revised). (2)
4. Explain the meaning of the term "defence in depth" with regard to internal control. (2)
5. Distinguish between division (segregation) of duties and isolation of responsibility. (4)
6. "Collusion and management override are the greatest enemies of good internal control". True or false? Your answer must include an explanation of the terms "management override" and "collusion". (5)
7. Identify the four stages through which a transaction passes where segregation of duties is sound. (2)
8. Give three reasons why it is important to have source documentation numerically sequenced. (2)

#### **4.15**

**(32 marks 38 minutes)**

In terms of ISA 315 (Revised) – Identifying and assessing the risks of material misstatement through understanding the entity and its environment, internal control has five components, one of which is the entity's risk assessment process. The suggestion here is that to adequately

control the business, the directors (management) should assess the risks which the business faces, from minor risks to major risks and respond to the risks by putting internal control procedures/mechanisms/activities in place. In this manner the entire internal control system will be developed.

**YOU ARE REQUIRED TO:**

- a) define business risk. (2)
- b) list the other four components of internal control (other than the entity's risk assessment process). (2)
- c) briefly explain the term control environment. (3)
- d) discuss whether the external auditor is directly interested in all the business risks which are identified by the company's risk process. (3)
- e) describe briefly the elements which make up that part of a company's information system which is relevant to a company's financial reporting system. (6)
- f) state, using four key words in your answer, the objective which management aims to achieve in an accounting (financial reporting) system by implementing application control procedures. (2)
- g) discuss each of the following in relation to internal control:
  - (1) strong control environment
  - (2) sound personnel practices
  - (3) appropriate and comprehensive segregation of duties
  - (4) isolation of responsibilities
  - (5) comprehensive access control
  - (6) good document design
  - (7) regular and frequent comparison and reconciliation. (14)

**4.16**

**(10 marks 12 minutes)**

**YOU ARE REQUIRED TO** select the *most appropriate* answer for each of the following questions:

- 1. Internal controls can be defined as the process designed, implemented and maintained to provide reasonable assurance about the achievement of an entity's objectives with regard to
  - 1.1 maximising profits
  - 1.2 the reliability of the entity's financial reporting
  - 1.3 compliance with corporate governance principles
  - 1.4 the effectiveness and efficiency of the entity's operations, its compliance with the law and the reliability of its financial reporting.
- 2. Internal control is
  - 2.1 an effective method of addressing collusion

- 2.2 a dynamic process
  - 2.3 the sole responsibility of management and the board of directors
  - 2.4 an effective method of addressing the risk of management override.
3. Which of the following is **not**, in terms of ISA 315 (Revised), a component of internal control?
- 3.1 control activities
  - 3.2 control environment
  - 3.3 cost and expenditure control
  - 3.4 monitoring of controls.
4. Which of the following are, in terms of ISA 315 (Revised), components of internal control?
- 4.1 segregation of duties and authorisation
  - 4.2 segregation of duties and the information system relevant to financial reporting
  - 4.3 the risk assessment process and the information system relevant to financial reporting
  - 4.4 the risk assessment process and authorisation.
5. The communication and enforcement of ethical values is part of which of the following components of internal control?
- 5.1 the monitoring of controls
  - 5.2 the control environment
  - 5.3 the disciplinary process
  - 5.4 the control activities.
6. Which of the following is **not** a part of the control environment component of internal control?
- 6.1 risk assessment
  - 6.2 the organisational structure
  - 6.3 commitment to competence
  - 6.4 human resource policies and practices.
7. Which of the following is **not** regarded as a control activity?
- 7.1 segregation of duties
  - 7.2 isolation of responsibilities
  - 7.3 reconciliation of physical assets with recorded assets
  - 7.4 document design.
8. Which of the following **is** regarded as a control activity?
- 8.1 reviewing key performance indicators and ratios
  - 8.2 providing on-going training to all employees
  - 8.3 assessing the likelihood and frequency of risks which have been identified
  - 8.4 assessing whether internal controls are effective over time.
9. Which of the following is most likely to result in good segregation of duties being ineffective?
- 9.1 collusion
  - 9.2 management override
  - 9.3 cost constraints
  - 9.4 carelessness on the part of an employee.

10. Control activities can be categorised
  - 10.1 by type e.g. isolation of responsibilities
  - 10.2 as general or application controls
  - 10.3 as preventive, detective or corrective
  - 10.4 as any of the above.

#### 4.17

**(12 marks 15 minutes)**

UK2010 (Pty) Ltd is a manufacturing company with a large labour force. Each of the procedures or actions listed below (1 to 10) relates to one (or more) of the components of internal control, as identified by ISA 315 (Revised), namely:

1. control environment
  2. risk assessment
  3. information system (relevant to financial reporting)
  4. control activities
  5. monitoring of controls.
- 
1. UK2010 (Pty) Ltd engages an independent labour consultancy to conduct a review of the company's payroll activities on an annual basis. This includes a report to the directors on employee satisfaction, the company's adherence to fair labour practice, legality of employees, etc.
  2. Access to hardcopy employee records is restricted to the human resource manager and her senior administration clerk.
  3. When the factory administration clerk has batched the wage period's clockcards he takes control totals, including the total number of clock cards in the batch. When the data capture clerk in the payroll section receives the clock cards, he counts them before signing a batch control sheet to acknowledge receipt.
  4. The foremen are responsible for checking and authorizing (signing each clock card) overtime hours entered on the clock card and calculated by the wage administration clerk.
  5. Employees are paid by electronic funds transfer. To effect the transfer, two senior employees are required to enter their unique passwords. One password "approves" the transfer and the second password "releases" the payment. Before "approving" and "releasing", the senior employees must check the supporting documentation.
  6. The paymaster (senior manager) carefully reviews the bi-weekly reconciliation of wages paid for the current wage period to the previous wage period.
  7. The company subscribes to Labourwatch, a quarterly journal which contains important information about any current or pending strike action and other labour related threats to the industry.

8. Write access to the employee masterfile is restricted to the human resource manager's senior administration clerk.
9. All individuals who apply to work in the payroll section must pass a test of competency (set by the company's human resource department) on the payroll package used by the company before they can be considered for the position.
10. The company uses a well known payroll package, Payday, for processing the payroll.

**YOU ARE REQUIRED TO** indicate to which component(s) of internal control each action or procedure listed above (1 to 10) applies. Where you select control activity as the component, indicate the type of control activity you consider the action or procedure to be.

#### 4.18

**(21 marks 25 minutes)**

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.

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)
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)
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)
4. Comprehensive enquiries relating to a proposed (new) customer's creditworthiness are carried out by the credit manager. (2)
5. Inventory cycle counts are conducted on different sections of the warehouse at the end of every month. (2)
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)



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)
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)

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

**4.19**

**(12 marks 14 minutes)**

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.
2. Expensive spares and components are kept in a secure area in the warehouse.
3. All employees working on accounting applications on the company's local area network are subject to user identification, password and user profile controls.
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).
5. Management adopt a management philosophy which places emphasis on leadership, sound judgement and ethical behaviour.
6. The production manager approves all overtime hours to be worked before they are worked.
7. The company conducts regular inventory cycle counts. All differences between physical inventory and recorded inventory quantities are carefully followed up.
8. All company cheques must be signed by two authorised signatories.
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.
10. Receiving clerks are required to count goods received and must sign all GRNs they make out.



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):

- (i) segregation of duties
- (ii) isolation of responsibilities
- (iii) access/custody controls (physical controls)
- (iv) authorisation and approval
- (v) comparison and reconciliation

**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).

#### 4.20

**(24 marks 29 minutes)**

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

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

1. Gavin Globe, the financial manager and one of the three employees authorized to effect EFT payments, scrutinizes very carefully all supporting documentation, which is signed and presented to him by Lilly Lite, the creditor's clerk, before authorising the payments file. The file is then transferred to the second senior employee for release. Before the second employee releases the file, he also scrutinizes the supporting documentation, confirming inter alia that it has been signed by Gavin Globe.
2. Whenever a delivery is made to Fusion (Pty) Ltd, Fred Fillement, whose only function is to receive goods, completes and signs a sequenced preprinted multi part goods received note. No other employees are authorized to receive goods. Before signing the GRN, Fred Fillement counts the goods being delivered and matches the quantities and description of the goods received to the corresponding purchase order.
3. Larry Lamp, the human resource manager follows up on all previous work references supplied by prospective employees. All new employees, regardless of what they are employed to do, spend the first two weeks at Fusion (Pty) Ltd, learning about all aspects of the business. Employees are fairly remunerated and treated with respect by management.
4. The Board of Directors who are clearly committed to sound corporate governance, meet each month to discuss in detail the performance of the company in comparison to budgets and forecasts for the month, and will provide constructive suggestions to management.
5. Every three months an inventory count takes place. A team of four employees independent of the "inventory" function, counts the inventory in the warehouse and the shop. Physical quantities counted are then compared to the quantities per the inventory records. All discrepancies are followed up.

**YOU ARE REQUIRED TO:**

- a) identify with an explanation, the **type(s)** of control activity if any, which is (are) evident in each of the statements (1 to 5) above. If you decide that the statement does not describe a control activity, justify your decision. (18)
- b) comment on the control environment at Fusion (Pty) Ltd based on the information given above. (6)

**4.21**

**(23 marks 28 minutes)**

- 1. Distinguish between a transaction file and a masterfile. (2)
- 2. Access to masterfiles should be strictly protected. True or False? Justify. (2)
- 3. What is the purpose of the log of masterfile amendments? Explain. (3)
- 4. What is an access table? (2)
- 5. A terminal authentication control is used to confirm that the terminal is manufactured by an approved manufacturer. True or False? Justify. (2)
- 6. Explain the difference between access at systems level and access at application level. (2)
- 7. Why should “super user privileges” be given to only a limited number of IT personnel? (2)
- 8. Contrast the roles of a system analyst and a programmer. (2)
- 9. John Jerome takes orders for his company over the phone, keying them in “on screen”. To assist him in keying in accurate and complete data, there are a number of programme checks including
  - 9.1 mandatory field
  - 9.2 alpha-numeric checks
  - 9.3 screen dialogueExplain how these three controls may assist John Jerome. (4)
- 10. Give two other screen aids which will assist John Jerome in keying in accurate and complete data. (2)

**4.22**

**(28 marks 33 minutes)**

- 1. Explain the difference between physical access controls and logical access controls in a computer environment. (2)
- 2. A lack of audit trail can be a serious problem in computerised accounting systems. Discuss. (2)

3. What is a user profile? (1)
4. Explain the following principles on which a company should base its computer security policy
  - 4.1 defence in depth
  - 4.2 logging
  - 4.3 least privilege
  - 4.4 fail safe (8)
5. In a batch system, explain the use of
  - 5.1 hash totals (2)
  - 5.2 record counts (2)
6. Explain the following logs and reports (give an example)
  - 6.1 override report (2)
  - 6.2 exception report (2)
  - 6.3 terminal activity log (2)
7. Contrast the following approaches which could be adopted by the external auditors in a computerised environment
  - 7.1 auditing *through* the computer (2)
  - 7.2 auditing *with* the computer (2)
8. Identify which (if either) of 7.1 and 7.2 amounts to a test of controls. (1)

#### 4.23

(10 marks 12 minutes)

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

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

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

1. The company's IT steering committee meets monthly to consider inter alia, the most up to date information on existing and emerging IT risks.
2. The company has a policy in place which facilitates the dismissal of an IT employee (or other employee) guilty of behaviour which demonstrates a lack of integrity or ethics.

3. The company has implemented the principles of least privilege, defence in depth etc, in its computerization.
4. A senior employee in the IT section regularly reviews the log of activity on the system which details all activity which has taken place.
5. The system at TransP (Pty) Ltd regularly sends a screen message to users to change their passwords. Users are permitted to enter their existing password on three further occasions. Thereafter access will no longer be granted until a new password is entered.
6. Pedro Scott, the chief information officer, presents a report on the company's IT activities to the directors at the monthly board meeting. The report is then discussed in detail by the directors and the chief information officer.
7. TransP (Pty) Ltd duplicates its critical processing on a second computer installation which is very secure (mirror site).
8. Several months after introducing a new inventory application, TransP (Pty) Ltd's internal auditors conducted a post implementation review of the system.
9. All personnel in the IT section including the CIO are subject to an annual performance review. This includes an interview with the steering committee which covers career development, how well the individual is performing his function, and disciplinary matters which may have arisen.
10. Management at TransP (Pty) Ltd encourages employees to identify ways in which the applications which they use can be improved. This may result in the need to modify the application software. If so, the request to modify the software must be clearly documented and approved by the user department head, the CIO and the steering committee.

**YOU ARE REQUIRED TO** identify the category of general control and, if applicable, the sub-category into which each of the above (1 to 10) falls.

**4.24**

**(10 marks 12 minutes)**

Select the most appropriate answer for each of the following (1 to 10).

1. A general control is best described as
  - 1.1 the opposite of an application control
  - 1.2 a preventive control
  - 1.3 a control which is part of the overall framework of control for computer activities
  - 1.4 a set of policies and procedures to which employees must adhere in the performance of their duties.
2. Which of the following does **not** form part of the control environment component of the internal control process in a computerized financial reporting system?

- 2.1 commitment to competence
  - 2.2 systems development
  - 2.3 human resource policies and practice
  - 2.4 assignment of authority and responsibility.
3. Which of the following is an important part of the general control category identified as “continuity of operations”?
- 3.1 the segregation of duties within the IT department
  - 3.2 programme change controls
  - 3.3 authentication of users
  - 3.4 risk assessment.
4. The principle of least privilege forms part of a company’s
- 4.1 security policy
  - 4.2 disciplinary procedures for IT personnel
  - 4.3 authentication of users
  - 4.4 data communication controls.
5. Defining the level (or types) of access to be granted to a user is termed
- 5.1 identification of the user
  - 5.2 authorisation of the user
  - 5.3 identification and authentication of the user
  - 5.4 approval of the user.
6. An application control is best described as
- 6.1 a control executed by the system itself
  - 6.2 the opposite of a general control
  - 6.3 a control which contributes to the accurate and complete processing of transactions through a specific application
  - 6.4 a control which contributes to the production of valid, accurate and complete information.
7. Controls in a computerised accounting environment are generally centred around
- 7.1 accuracy and completeness of processing and storage of data
  - 7.2 timeous processing of data
  - 7.3 occurrence and authorisation, accuracy and completeness of processing and storage of data
  - 7.4 existence and accuracy of processing of data.
8. Which of the following is **not** a control activity in a computerised accounting system?
- 8.1 comparison and reconciliation
  - 8.2 access controls at application level
  - 8.3 source document design
  - 8.4 performance reviews.
9. Which of the following is a general control and not an application control?
- 9.1 minimum keying in of information
  - 9.2 batching
  - 9.3 user identification to access the system
  - 9.4 override reports.

10. Which of the following is an application control and not a general control?
- 10.1 the approval of a programme change by the head of the user department
  - 10.2 the approval of an amendment to the inventory masterfile
  - 10.3 the approval of the appointment of the CIO by the board
  - 10.4 the approval of a new back-up strategy for inventory data files.

4.25

(27 marks 32 minutes)

1. What is an application in the context of a computerised accounting system? (1)
2. Use three words to identify the stages through which a transaction flows in a computerised system. (1)
3. Explain the following statement :  
 “The objective of application controls in a computerised accounting environment is generally regarded as being centred around ***occurrence and authorisation*** (validity), ***accuracy*** and ***completeness*** of data processed by and stored on the computer”. (4)
4. Controls designed and implemented for most applications will usually include both manual (user) or programmed (automated) controls. True or false? (1)
5. Logical access controls require that a user is ***identified, authenticated*** and ***authorised*** by the system before access is granted to the system.  
 5.1 explain each of the three items which appear in bold italics (6)  
 5.2 list three ways in which authentication can be achieved (3)  
 5.3 explain the “read and write” level of authorisation which can be given to a user. (1)
6. Is the logging of access violations a control? (1)
7. Most people understand that an employee’s password should be unique and kept confidential and should be changed if confidentiality has been violated or violation is expected, but there are a number of other controls over passwords which are necessary in a business. Identify six additional password controls which should be implemented. (5)
8. Screen aids and related features can be described as all the features, procedures or controls which are built into the application software and reflected on the screen to assist a user to capture information accurately and completely. Describe how the following screen aids and related features can assist a sales clerk to capture the data required to compile an on-screen sales invoice for an existing debtor, accurately and completely
  - minimum keying in of information
  - mandatory fields
  - screen dialogue and prompts. (4)

4.26

(10 marks 12 minutes)

The following controls have been implemented at GoodReads (Pty) Ltd, a large book wholesaling company which has a fully computerised accounting system.

1. When a delivery is made from a supplier to GoodReads (Pty) Ltd, the receiving clerk enters the order number for the goods into the system. If the order number is not valid, the receiving clerk will not accept the delivery.
2. A new employee cannot be successfully added to the employee masterfile without a valid income tax reference number being entered.
3. GoodReads (Pty) Ltd recently appointed a committee to monitor and advise on the specific risks faced by the IT department.
4. When an application programme change request is made by a user department, it must be approved by the IT steering committee and the head of the user department before it is effected.
5. All creditors are paid by electronic funds transfer. To effect a transfer, two senior employees must independently enter their unique passwords.
6. Entry to GoodReads (Pty) Ltd's data centre (which houses important hardware) is restricted. Swipe cards and PIN numbers are used to limit access.
7. The company makes use of firewall and anti-virus software.
8. A purchase order must be supported by a stores requisition signed by the warehouse controller.
9. If a debtor has not paid its account within two working days of exceeding its credit terms, for example 60 days, Barry Potter the credit controller, contacts the debtor to request payment.
10. The chief information officer conducts regular meetings with IT personnel on an individual basis, to enforce the importance of a strong ethical culture and discuss ethical situations which may have arisen.

**YOU ARE REQUIRED TO** indicate whether each of the controls listed under 1 to 10 above, is a general control or an application control. For those controls which you identify as **general** controls, indicate the category of general control to which each relates.

**4.27**

**(16 marks 20 minutes)**

**Part A**

**(8 marks 10 minutes)**

Programme checks are controls which are built into the application software. The sentences below each describe a programme check which occurs during input or processing in various cycles.

1. This check prevents an alphabetic digit being entered in the quantity field for a purchase order.
2. To compile an internal sales order, the sales clerk enters the customer's account number. This programme control checks the debtor's masterfile to confirm that the account number is that of a debtor on the masterfile.



3. An extra character is added to the inventory item codes used by a company in its inventory system. This extra character is generated by manipulating the other characters in the inventory number. When the item code is subsequently input, the computer performs the same manipulation on the inventory characters and must come up with the same extra character for the inputted number to be accepted.
4. When newly approved customers are added to the debtors masterfile, their credit terms (credit limit and days the debtors have to pay) must be entered. The only valid options for the credit limit are R5 000, R20 000 and R100 000. The computer will not accept any other amounts in this field.
5. After processing inventory adjustment forms against the inventory masterfile, the computer checks the document numbers for completeness.
6. When compiling an on-screen purchase order, the order clerk must enter the stores requisition number into the appropriate field. This field must have six digits and the number will be rejected if a lesser number of digits is entered.
7. After processing sales invoices which have been batched, the computer compares the number of invoices processed, to the number of invoices input (entered).
8. One of the company's policies is that no more than 20 hours overtime can be worked within the two week wage period. This check detects attempts to enter overtime hours greater than 20 in the relevant field.

**YOU ARE REQUIRED TO** identify the programme control described in each of the sentences above.

#### **Part B**

**(8 marks 10 minutes)**

Becky Flora the financial manager, has told you that he is concerned about the confidentiality of some of the reports and logs produced by the company's computer system. He tells you that much of the output is available on screen but that there is some confidential output which is in hardcopy. Becky Flora is not asking you for detailed advice but would like you to give him a general explanation about what controls should be in place to reduce the risk that confidential output is kept confidential.

**YOU ARE REQUIRED TO** respond to Becky Flora.

**4.28**

**(34 marks 41 minutes)**

1. Identify four types of information technology risk which could threaten the continuity of operations of a large company which is highly dependent on its IT system. (2)
2. When developing and implementing a new (computerized) system, a company must control the entire project very carefully. Briefly describe six negative consequences which may occur if adequate controls are not put in place. (3)
3. Identify four advantages for a company purchasing packaged software for a new inventory application, over developing the application "in-house". (3)



4. Ribbco (Pty) Ltd houses the equipment, e.g. CPU, servers, routers, which runs the company's IT system in the data centre (a dedicated room). Briefly describe four physical access controls which should be in place to restrict entry to the data centre. (2)
5. Logical access controls are regarded as detective in nature. True or False? Justify. (2)
6. A company should have sound documentation policies in place in respect of IT related documentation. List:
  - 6.1 six different examples of IT related documentation. (3)
  - 6.2 four benefits which flow from sound documentation policies. (2)
7. Once a user has entered his user identification (user ID) he will be required to authenticate himself. Briefly describe three ways in which a user may "authenticate" that he is the "owner" of the user ID which has been entered. (5)
8. Centrum (Pty) Ltd, a large wholesaler in the building materials sector, intends to implement a new inventory control system. The company does not have the necessary skills to develop the system itself and the decision has been taken to acquire suitable packaged software. No decision has been taken on which packages will be acquired. Summarise the controls which should be put in place for the acquisition and implementation of the packaged software for the new inventory application. (12)

**4.29**

**(34 marks 41 minutes)**

You are a trainee accountant in the audit firm of Carlos Rowan and Co. As a result of your interest in computers you have been assigned to the computer audit section and have assisted in the evaluation of computerised accounting and internal control systems at a few clients.

Recently Ben Mensa, a friend of your father, aware of your interest in computers, phoned you at work to ask whether you could assist him with a problem he was facing at his business, Sitomax CC. Sitomax CC is a medium sized wholesaler of sport supplements. Other than having its financial statements compiled annually by an independent accounting professional, Sitomax CC does not have a professional relationship with any audit firm or IT consultancy.

You arrange to meet him after work that same day, and having listened to what he had to say, you decided to assist him, after hours and over weekends. He agreed to pay you on an hourly basis. Your discussion with Ben Mensa went as follows.

"About five months ago, our accountant, Phillip Endoo, requested that he be allowed to introduce a new computerised accounting system. As you may know, all of us in senior management at Sitomax are nutritionists or marketers, not financial or computer people. We leave all that computer stuff to Phillip, who seems to know what is going on. Anyway, his idea was to integrate (I think that was the word he used) our various accounting packages and run them on a network. At that stage we ran our accounting applications on a number of stand alone micros in the various departments, using packaged software.

My only concern with his request was cost, but he assured me that this would be minimal.

He indicated that we could get the software and hardware very cheaply from a friend of his whose computer business was being liquidated as the friend had emigrated to England. Phillip said that he himself would get the new system “up and running” as and when he had time! Well, it has been a complete mess! Phillip tried his best, I suppose, but obviously could not do it on his own.

The result is that the system does not function. For example, the new software does not produce all the information which the departments want, some debtors balances have vanished off the system, others are incorrect, some inventory item codes are incorrect, physical quantities do not agree with the records, and employees don’t know how to use the system. On top of all that, we have lost most of the original data files, and to reconstruct the information from source documents will take months. As you can see, the business is in trouble!”

**YOU ARE REQUIRED TO:**

- a) distinguish between general controls and application controls (3)
- b) discuss the ethical implications arising out of the Code of Professional Conduct, which you should have considered relating to you agreeing to assist Sitomax CC. (7)
- c) evaluate, based on the information given above, the adherence of Sitomax CC to sound *general controls* in respect of control environment, systems development and continuity of operations (24)

**4.30**

**(31 marks 37 minutes)**

You are a senior on the audit of REXXON (Pty) Ltd, a medium sized wholesaler of stationery and office supplies. All of the company’s financial systems are computerised and you have been asked to assist in the evaluation of the company’s general controls. One of the other trainees on the audit has prepared some notes on the company’s general controls and has presented these to you.

***Background***

REXXON (Pty) Ltd runs its accounting applications on a local area network. Terminals on the network are located on users desks in the various departments (e.g. stores, wages), whilst the network servers are located in a room (referred to by staff as the “Techno Room”) in which other office equipment used by the company is housed e.g. printers, the facsimile machine and the office photocopier. Staff wishing to make use of the fax and photocopier or wishing to collect hardcopy output must go to the Techno Room. Staff enjoy this arrangement as it allows them the opportunity to have a cup of coffee or tea from the drinks machine which is also located in the Techno Room and socialize with other staff members. It also contributes to the relaxed and casual atmosphere at the company which Zak Kruger and the other managers try to maintain so that employees enjoy coming to work.

### ***Network administrator***

The company's network is managed and maintained by Dion Reddy, the network administrator, and his four assistants. The IT section reports to Zak Kruger the financial manager. However, Zak Kruger does not get involved (nor does the financial director), leaving all aspects of the company's computer requirements to Dion Reddy and his staff. Dion Reddy has sole responsibility for the purchase of new computer equipment, appointment of computer personnel and, with his staff, also has responsibility for technical problem solving, programme maintenance and password authorization. Dion Reddy and his staff are technically very knowledgeable but do not know much about accounting systems and related internal controls.

### ***Access***

All employees at the company (approximately 80 in total) are given access to the network even though they may not require it to fulfil their functions. For example, warehouse personnel (packers, pickers etc) can get onto the network via three terminals in the warehouse's administration office. These staff only have access to Internet facilities and a selection of computer games resident on the network for all employees to enjoy.

To get onto the network an employee can enter his user identification and personal password at any terminal. At this point a menu will appear which lists all of the applications available on the network e.g. wages, inventory control, games etc, and the employee simply "clicks" on the application he requires.

Once access has been gained to the selected application e.g. the wages application, a menu of the modules within the application is displayed. If an employee wishes to access a module he "clicks" on the desired module and the computer checks the user profile for that employee before granting (or denying) access.

Dion Reddy has implemented the following requirements for personal passwords. They must

- \* be six digits of which the first three digits must be the first three letters of the department in which the employee works and the last three must be numeric e.g. WAG123 would be an employee in the wages department;
- \* be changed on the 2<sup>nd</sup> January each year; and
- \* be authorised by Dion Reddy (or one of his staff) to ensure that the same password is not chosen by more than one employee in the same department.

If an employee leaves the company his password is given to the new employee (it will only be changed on 2<sup>nd</sup> January).

Dion Reddy is also responsible for creating and maintaining user profiles on the system. If an employee wishes to change any details on his profile, e.g. change a "read only" access to a "read and write" access, a written request (on the standard document) signed by the employee must be submitted to Dion Reddy who will then make the change.

At the end of every second month Dion Reddy's four assistants back up the data files and programmes on all terminals in the accounting department by copying the files onto external hard drives. The external hard drives are labeled and given to Dion Reddy who locks them in a drawer in his desk.

**YOU ARE REQUIRED TO:**

- a) distinguish between general controls and application controls. (3)
- b) *identify* the weaknesses in the general controls at REXSON (Pty) Ltd based on the information provided above. For each weakness you have identified *explain* why it is a weakness.  
You are only required to consider the following categories of general control:
  - 1. control environment (8)
  - 2. access controls (11)
  - 3. continuity of operations. (9)



## **CHAPTER 5**

### **PRELIMINARY ENGAGEMENT ACTIVITIES AND PLANNING**



**5.1****(20 marks 24 minutes)**

1. List four sources from which an auditor may gather information about a *prospective* client at the preliminary engagement activities stage of the audit process. (2)
2. Provide five reasons (other than a lack of skills, resources or time) which may result in a firm *not* wishing to enter into a relationship with a prospective client. (3)
3. If a prospective client will not give the proposed auditor access to internal documents or prior financial statements when the proposed auditor is conducting preliminary engagement activities, the audit should not be accepted. Discuss. (3)
4. What is the objective of the planning stage of the audit process? (2)
5. Which three words define the audit strategy? (1)
6. Which three words define the audit plan? (1)
7. Identify five matters which should be dealt with in an agreement on audit engagement terms. (3)
8. The audit strategy and audit plan must be documented. True or false? Explain. (2)
9. Explain how an auditor might respond to high assessed risk at the financial statement level. (3)

**5.2****(20 marks 24 minutes)**

"The objective of the auditor is to plan the audit so that it will be performed in an effective manner." ISA 300 – Planning an audit of financial statements.

1. What stage of the audit process comes before planning? (1)
2. What stages of the audit process come after planning? (2)
3. Define the term “preconditions for an audit”. (2)
4. Indicate the stage of the audit to which the preconditions of an audit are most relevant. Explain. (2)
5. When conducting planning activities, the auditor establishes the overall audit strategy; broadly describe the matters to which the auditor will give attention in establishing the audit strategy. (3)
6. What is an audit programme and when is it compiled? (1)
7. What is the relationship between audit planning and audit risk? (2)
8. What is a significant risk, and when are significant risks, if any, identified? (2)



9. When conducting planning activities the auditor must determine the nature, timing and extent of ..... (3)
10. When conducting risk assessment procedures, the auditor's objective is primarily aimed at identifying the risks of material misstatement at financial statement level. True or false? Justify. (2)

### 5.3

(22 marks 26 minutes)

When conducting an audit, the entire **audit process** can be broken down into distinct but interlinked stages which are described as follows:

1. Preliminary engagement activities (4)
2. Planning (10)
3. Responding to assessed risks (5)
4. Concluding (3)

**YOU ARE REQUIRED TO** give an explanation of each stage.

### 5.4

(15 marks 18 minutes)

Your firm has recently completed the audit of Parka (Pty) Ltd for the financial year end 31 March 2016. This was the first financial year for which your firm was appointed as auditors for this large manufacturing company.

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

1. Audit team members conducted a physical inspection of the company's plant and equipment to identify any impairment of the asset.
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.
3. The engagement partner evaluated the suitability, for the 31 March 2016 audit of Parka (Pty) Ltd, of your firm's newly adopted materiality guidelines.
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.
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.
6. A trainee on the audit team obtained certificates of balances at 31 March 2016 from all long term creditors.
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.

8. The engagement partner took a decision to work closely with the company's internal audit division on a number of audit related matters.
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.
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.
11. The audit senior set the performance materiality limits for the audit of the major account headings.
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.
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.
14. The audit manager scrutinized all the minutes of directors meetings for the year ended 31 March 2016 and noted all information and resolutions of audit importance.
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.

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.

**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.

## 5.5

**(10 marks 12 minutes)**

Select the most appropriate answer for each of the following (1 to 10).

1. Which of the following is **not** regarded as a preliminary engagement activity?
  - 1.1 establishing whether the prospective client can be appropriately serviced.
  - 1.2 determining the audit strategy.
  - 1.3 agreeing the terms of the engagement with the prospective client.
  - 1.4 evaluating whether the firm is able to comply with the ethical requirements relating to the engagement.
2. In terms of the ISAs, an audit engagement can only be accepted if:
  - 2.1 the auditor has established with the client that the preconditions for an audit are present.

- 2.2 the prospective client has signed an agreement limiting the auditor's liability for negligent performance.
  - 2.3 the designated auditor and audit team have been approved by those charged with governance at the client.
  - 2.4 the company's board of directors confirms the auditor's appointment by directors resolution.
3. Which of the following is **not** a precondition for an audit?
    - 3.1 the acknowledgement by management that it understands its responsibilities to provide unrestricted access to persons within the company from whom the auditor determines it is necessary to obtain audit evidence.
    - 3.2 the financial statements are prepared in terms of an acceptable financial reporting framework.
    - 3.3 an acknowledgement by management that it is responsible for such internal control as it (management) determines is necessary to enable the preparation of financial statements which are free from material misstatements.
    - 3.4 compliance with the requirements of the King III report on corporate governance.
4. If management attempts to impose a material limitation on the scope of the auditor's work prior to the acceptance of an audit engagement, the auditor:
    - 4.1 should decline the engagement.
    - 4.2 accept the engagement but include details of the scope limitation in the engagement letter.
    - 4.3 accept the engagement but inform the client in writing that the audit report will be qualified or a disclaimer of opinion will be issued.
    - 4.4 report the matter to the Independent Regulatory Board for auditors and decline the audit.
5. The engagement letter must contain reference to:
    - 5.1 the auditors evaluation of the integrity of the client's management.
    - 5.2 the audit strategy to be adopted.
    - 5.3 the audit firm's quality control procedures.
    - 5.4 the financial reporting framework to be adopted for the preparation of the annual financial statements.
6. The engagement letter must explain that:
    - 6.1 the auditor is responsible for the detection of fraud in the financial statements but not the prevention of fraud.
    - 6.2 the auditor will detect all material misstatement due to fraud but cannot be expected to detect immaterial misstatement due to fraud.
    - 6.3 the auditors are not concerned with fraud resulting from the misappropriation of assets but will be interested in all fraud arising from fraudulent financial reporting.
    - 6.4 none of the above.
7. The audit plan is best described as:
    - 7.1 the scope, timing and direction of the audit.
    - 7.2 the scope, timing and direction of risk assessment procedures.
    - 7.3 the nature, timing and extent of planned risk assessment procedures, "further" and "other" procedures.
    - 7.4 the nature, timing and extent of the evaluation of the company's internal controls.

8. Which of the following will **not** be part of the audit strategy?
  - 8.1 deciding to engage the services of an expert to assist in the valuation of work-in-progress.
  - 8.2 deciding to make use of statistical sampling techniques.
  - 8.3 determining relevant sample sizes.
  - 8.4 deciding to conduct an interim audit two months prior to year-end.
9. Planning materiality for an audit:
  - 9.1 is a judgement made by the auditor about the size of misstatements in the financial statements that will be considered material.
  - 9.2 is set once the risk assessment procedures have been conducted.
  - 9.3 is not changed once it has been initially set.
  - 9.4 is part of performance materiality.
10. Which of the following is **not** part of the auditor's responsibility when carrying out the concluding stage of the audit process?
  - 10.1 evaluating whether the financial statements adequately disclose the significant accounting policies selected and applied.
  - 10.2 authorising journal entries to correct factual misstatements.
  - 10.3 evaluating whether the terminology used in the financial statements is appropriate.
  - 10.4 evaluating whether sufficient, appropriate evidence has been obtained to reduce audit risk to an acceptable level.

## 5.6

(10 marks 12 minutes)

Listed below under "A" are the first parts of ten sentences. Listed under "B" are the second parts of each of these sentences. When the parts (A and B) are combined a complete and correct statement is made.

### *List A*

- A1 The objective of the auditor is to plan the audit ...
- A2 The overall audit strategy sets the ...
- A3 Special audit consideration should be given to ...
- A4 The fact that an audit client is listed on the JSE will influence ...
- A5 The audit plan lays out, inter alia, the ...
- A6 The compilation and signing of the engagement letter is the final step in ...
- A7 The extent of testing will depend largely on assessed risk and ...
- A8 Involving the key members of the engagement team in the planning process enhances the ...
- A9 The appropriateness of audit evidence relates to its ...
- A10 Increasing the supervision of the audit team will be an overall response to address ...

### *List B*

- B1 ... significant risks.
- B2 ... relevance and reliability.
- B3 ... effectiveness and efficiency of the planning process.
- B4 ... so that it will be performed in an effective manner.
- B5 ... materiality limits.

- B6 ... the overall audit strategy.
- B7 ... nature, timing and extent of planned risk assessment procedures.
- B8 ... assessed risk at the financial statement level.
- B9 ... the preliminary engagement activities.
- B10 ... scope, timing and direction of the audit.

**YOU ARE REQUIRED TO** match the parts of each sentence under “A” with the parts of each sentence under “B” to form a complete and correct statement.

## 5.7

**(18 marks 22 minutes)**

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.

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 client’s manufacturing facility to familiarise yourself with the manufacturing process.
2. Drafting an engagement letter for the audit.
3. Conducting a debtors circularisation.
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.
5. Flowcharting (drawing a diagram of) the internal control system for sales.
6. Considering the potential effect on the audit, of the King III report on corporate governance.
7. Evaluating the schedule of uncorrected misstatements for the current audit.
8. Deciding on the balance between tests of controls and substantive tests.
9. Considering the appropriateness of the prior year’s planning materiality level for the current year’s audit.
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.
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.

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.

**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.

## 5.8

**(33 marks 40 minutes)**

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 III Report on Corporate Governance. His stance is that business is tough and that all the transparency, disclosure and fairness 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, an interior decorating business which is owned by the wife of Art Andersunn and Co's partner in charge of the Taxation department. The company's public interest score requires that the company be externally audited.
8. Interworld Ltd, a prestigious, international corporation with operations world wide 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)
- b) comment of how information about a prospective client can be obtained. (4)
- c) comment on the matters to which your committee should give consideration in deciding on whether to accept the above audit appointments. (25)

**5.9**

**(30 marks 36 minutes)**

Your firm recently took over the audit of Cupid (Pty) Ltd. The company's Memorandum of Incorporation stipulates that the company must have its annual financial statements externally audited. You, as manager of the audit team, drafted an engagement letter to the directors of Cupid (Pty) Ltd laying down the terms of engagement for the annual audit as required by ISA 210. Shortly thereafter you received a letter from Harry Hart, the financial director which read as follows:

Dear...

re: 2016 annual audit - Cupid (Pty) Ltd

Thank you for your letter dated 15 February. I have a number of queries on which I would like some clarification

1. ***Fees***

The audit fee is not stipulated in the engagement letter. Our previous auditors, who incidentally did not send us an engagement letter, stipulated the audit fee before undertaking the audit. This was far more convenient for us. You have stated that "the fees will be agreed with us prior to billing" so I cannot really see why we should not simply negotiate the fee prior to the commencement of the audit.

2. ***Fraud***

It appears that you are accepting no obligation in respect of fraudulent activity at the company. If you conduct your audit properly surely any fraud will be identified. Identifying fraud would at least make the audit useful.

3. ***Access to records and information***

In principle, we agree that your team will be given access but must point out that certain decisions taken by the directors are regarded as confidential and will not be disclosed.

4. ***Involvement of experts***

Although we did discuss the issue of you engaging an expert to assist in the valuation of work-in-progress, we cannot allow this for the following reasons:

- 4.1 the previous auditors saw no need to engage an expert, and were quite prepared to rely on the representations of the plant manager.



- 4.2 any expert which you engage will need to be given access to confidential information relating to our manufacturing process.
- 4.3 we feel that if you can't "do the job" you shouldn't accept the audit.

5. **General**

The general feeling amongst the directors is that you are attempting to shed all responsibility but at the same time charge a substantial audit fee (see also point 6). Besides the matter raised under "fraud" above:

- 5.1 you are very quick to remind us of our duties in respect of all internal controls yet you reserve the right to decide what is material and which controls you will rely on, and you state that you won't be giving an opinion on the internal controls! You seem to think you can just pick and choose to do whatever suits you.
- 5.2 furthermore, you require us to give you **written** confirmation of representations we make, it is as if you anticipate that we will not tell the truth.
- 5.3 you intend to provide only reasonable assurance about fair presentation; what good is that?

6. **Audit Requirement**

I should perhaps remind you that as a private company which has its financial statements externally compiled and has a public interest score of 300 points, we don't have to be audited. This is not a compulsory audit so the aggressive stance you have taken in your engagement letter is misplaced. The directors are accepting this audit voluntarily and are not expecting the intensity of a compulsory audit.

I would be pleased if you would respond to the matters raised in this letter as soon as possible.

Yours faithfully

*H Hart*

Financial Director

**YOU ARE REQUIRED TO** draft a letter to Mr Hart in response to the matters he has raised in his letter.

**5.10**

**(25 marks 30 minutes)**

You are a member of your audit firm's quality assurance team. The firm has recently been appointed as the auditors of Vortex (Pty) Ltd, a company which manufactures a large range of diving and hang-gliding equipment. The company has been in operation for twenty years. The audit is not complicated as the systems are well established and the staff generally competent. One complication is that before any of the company's diving equipment can be sold, it must be rigorously quality control tested for safety purposes. In prior years, all year-end inventory has been tested by an independent expert to ensure that it is saleable. The company has an internal audit department. No other services will be rendered to Vortex (Pty) Ltd.

Having satisfactorily concluded the preliminary engagement activities in terms of ISA 220 and ISQC 1, Kirsten Wild, the manager in charge of the audit requested a trainee to draft an engagement letter. The trainee provided the following letter:



### **Firm's letterhead**

The Shareholders  
Vortex (Pty) Ltd  
14 Wave Road  
Springfield 0312

To the Chairman

Having carried out the preliminary investigation into your company, we are pleased to record our acceptance of the appointment as auditors and hereby confirm the terms of the engagement as follows :

1. We will conduct the 31 July year-end audit for which we have been appointed
2. The engagement will be completed by 31 August
3. Our role is to certify the fair presentation of the financial statements
4. Your role as management will be to provide our staff with all the information we require to gather sufficient, appropriate evidence of fair presentation
5. We do not guarantee an unqualified audit report as auditing does have its limitations
6. Fees will be a matter of negotiation, but will be based on prior years

Please would you sign this letter, retain a copy, and return the original to us.

I look forward to working on your audit.

Signed: .....

Audit manager

**YOU ARE REQUIRED TO** identify any weaknesses in this letter. You are not required to re-draft the letter.

### **5.11**

**(35 marks 42 minutes)**

ISA 315 (Revised) – Identifying and assessing the risks of material misstatement through understanding the entity and its environment, states that the auditor should obtain an understanding of the entity and its environment. It is an important statement in the planning of the audit.

1. What is the auditor's overall objective of gaining an understanding of the entity and its environment? (2)
2. List six broad areas or aspects of conducting an audit for which having a thorough knowledge of the entity, will greatly assist the auditor. (3)
3. Audit procedures to obtain an understanding of the entity are referred to as "risk assessment procedures." Identify three categories of risk assessment procedures and give two examples of each category. (6)
4. ISA 315 (Revised) requires that "the members of the engagement team should discuss the susceptibility of the entity's financial statements to material misstatement." Explain

the reasoning behind getting the members of the audit team collectively involved in this discussion. (3)

5. The auditor's understanding of the entity and its environment consists of an understanding of five aspects. The first is "the industry, the regulatory framework and other external factors." What are the other four? (2)
6. In terms of ISA 315 (Revised), a company's internal control process consists of five components. Describe each component in not more than 20 words. (5)
7. Identify five potential benefits of information technology for a company's internal control system. (5)
8. Identify five specific risks to a company's internal control, where the financial information systems are computerized. (5)
9. What is a significant risk? Give three examples. (3)
10. Does the auditor assess the risk of material misstatement at the:
  - 10.1 financial statement level
  - 10.2 assertion level
  - 10.3 financial statement level and at the assertion level? (1)

## 5.12

(30 marks 36 minutes)

You are the manager in charge of the audit of CovePoint (Pty) Ltd, a large wholesale company operating out of 10 warehouses located in the major centres country wide. This will be the second year in which you have conducted the audit. The company has a public interest score of 300 and prepares its financial statements *internally* in terms of IFRS.

During March your senior commenced planning the audit for the current year (financial year-end 30 June) by updating the audit file workpaper on understanding the entity and its environment and has made the following notes:

1. My discussions with Andrew Deans, the newly appointed financial manager were very worrying. He has recently returned from extended travels around the world and he seemed very nervous. He is definitely not up to date with the International Financial Reporting Standards. He is unlikely to receive much help from the financial director because, as noted in last year's file he is also not up to date, choosing rather to delegate accounting matters to the financial manager!
2. Avid Investors (Pty) Ltd has purchased a 25% share in CovePoint (Pty) Ltd (it is the company which has recently been in the news for alleged foreign exchange transgressions), and has managed to get two directors onto the Board of CovePoint (Pty) Ltd as a condition of the company purchasing the 25% shareholding. Avid Investors (Pty) Ltd will be the largest shareholder.
3. CovePoint (Pty) Ltd's liquidity position has worsened since the prior year financial year-end, and the intention seems to be, according to Andrew Deans, that Avid Investors (Pty) Ltd will provide loan capital as required.

4. My discussions with Josh Blaykee, the internal audit manger, revealed that
  - 4.1 his department uncovered an extensive fraud in the purchasing department which has cost the company a great deal of money. Fortunately for us the fraud wasn't underway when we conducted last year's audit!
  - 4.2 Avid Investors (Pty) Ltd have used their influence on the Board to do away with the audit committee as a "cost cutting exercise" and Josh Blaykee is concerned that his department may be next. The department is at present strong and competent.
  - 4.3 a new computerised salary and wage system has been implemented.
5. Despite some poor trading results in some regions, CovePoint (Pty) Ltd has kept its warehouses in all of the ten major centres in operation. Inventory levels remain very high.
6. The credit control function has been decentralized and is carried out by the regional offices. Credit terms are still set by the sales director and financial director and have recently been extended in an attempt to boost sales.
7. The audit deadline will be 21 working days after year-end.

**YOU ARE REQUIRED TO** discuss the effect that the information given above will have on the overall audit strategy.

### 5.13

**(50 marks 60 minutes)**

You have recently been appointed as senior-in-charge of the audit of SignPosts (Pty) Ltd, a subsidiary of Billboard Ltd. The company's subsidiary status and public interest score require that SignPosts (Pty) Ltd has its annual financial statements externally audited. The company produces a wide selection of signs and signboards, ranging from small signs used on doors etc to large freestanding road signs. Traffic and road signs form the major portion of the company's sales. SignPosts (Pty) Ltd only supplies signs; it does not attach or erect them.

Your firm, which is located in Durban, has held the appointment of auditor for some years but you have not worked on the audit before. Early in April your audit manager forwarded a letter to you from the external auditors of Billboard Ltd which indicated that they (the external auditors) require the "audit pack", consisting of the audited financial statements, various schedules and questionnaires for the 30 June 2016 financial year end audit of SignPosts (Pty) Ltd, to be in their offices by 15 July 2016. This development has taken your firm by surprise as in prior years no such instruction had been given. No work on the 2016 audit has taken place.

Your audit manager also attached a note to the letter suggesting that you get started on the engagement immediately by attending the monthly meeting between Gregg Rock and Reg Panday, the financial controller and internal audit manager respectively, of SignPosts (Pty) Ltd, which was scheduled for the next day. You arranged to attend, and despite your lack of knowledge of SignPosts (Pty) Ltd, you were able to take note of the following:

1. The company's year-end inventory count has been scheduled for 30 June 2016. Inventory consists of
  - 1.1 raw materials for manufacture

- 1.2 work-in-progress (the manufacturing process is quite complex as various weather coatings on outside signs must be applied and heat treated)
  - 1.3 finished goods in the form of standard signs manufactured by SignPosts (Pty) Ltd; as well as
  - 1.4 custom-made signs for specific customers awaiting invoicing and delivery.
- Inventory is held at all of the company's four manufacturing facilities located in Bloemfontein, Johannesburg, Cape Town and Durban.
2. The company has numerous debtors, and accounts receivable has always been a material amount. The financial controller mentioned that the company was experiencing difficulty in recovering a number of material amounts owed by certain provincial and national road authorities. This has arisen out of disputes over road signs which SignPosts (Pty) Ltd has manufactured and invoiced, but which bear the names of towns and streets which have had their names changed during, or subsequent to, the manufacture of the signs. The authorities concerned have refused to accept these signs, claiming that SignPosts (Pty) Ltd should have been aware of the name changes as they are published in the Government Gazette. SignPosts (Pty) Ltd have countered that they manufactured the signs "per the order". Gregg Rock indicated that the failure to recover the amounts owed has placed serious strain on cash flow, and could affect future dealings with these customers. SignPosts (Pty) Ltd's lawyers are very undecided about what the outcome of a court case would be, other than it would be long and drawn out.
  3. As a matter of course, SignPosts (Pty) Ltd's internal auditors perform ongoing reviews and tests of controls on the company's accounting systems. They also evaluate the company's risk assessment procedures and its responses thereto.

Having attended the meeting between Reg Panday and Gregg Rock you decided to commence with planning your audit right away as suggested by your audit manager.

**YOU ARE REQUIRED TO:**

- a) explain why it is so important for the auditor to obtain a thorough "understanding the entity and its environment". (5)
- b) discuss the procedures you will conduct to identify and assess the risk of material misstatement through understanding SignPosts (Pty) Ltd and its environment. (30)
- c) discuss, giving reasons, your assessment of the risk of material misstatement in respect of the 30 June 2016 audit of SignPosts (Pty) Ltd ***based on the information given in the question.*** (15)

**5.14**

**(40 marks 48 minutes)**

As a result of resignations from your audit firm you were recently (late March) appointed as senior-in-charge of the audit of Gametime (Pty) Ltd a wholesaler of a large range of sports equipment. The company is 60% owned by AllAction Ltd with the balance of the shares being held by private individuals. The financial year-end of the company is 31 July.

A preliminary discussion with your audit manager early in April revealed that:

1. The audit deadline is three weeks after the financial year-end. In addition to the normal audit pack, subsidiaries in the AllAction Ltd group must submit a report compiled by the external auditors on their adherence to sound corporate governance including sustainability disclosures in the financial statements.
2. AllAction Ltd has a large internal audit division which regularly conducts assignments at its subsidiary companies. Subsidiaries do not have internal audit departments, but do appoint audit committees.
3. Regardless of any procedures which our audit firm decides to carry out, Gametime (Pty) Ltd requires that our firm performs
  - 3.1 a comprehensive positive debtors circularisation
  - 3.2 detailed tests of controls on the company's electronic funds transfer payment system for the payment of creditors.
4. Gametime (Pty) Ltd conducts a comprehensive year-end inventory count. The inventory count for 31 July 2016 year-end will take place on Saturday 12 and Sunday 13 July. No normal business is conducted on these days. Inventory is substantial.
5. The company holds monthly management meetings at which sales, financial/ accounting and other data is discussed. Accounting records are kept right up to date which ensures that these meetings can take place within the first week of each month.
6. Many of the inventory items Gametime (Pty) Ltd sells are purchased from companies within the AllAction group, a practice which is encouraged by the holding company. The company's inventory is housed in a large warehouse from where it is shipped to its numerous customers. Sales are only made on credit .
7. All of the company's accounting systems are computerised and are resident on a local area network.
8. By early April no audit work has been carried out in respect of the 31 July 2016 year-end audit.

Your firm's technical division maintains a file for each audit client which contains articles, journals, press releases relevant to that client's business sector. Technical support is provided by the firms computer audit division where necessary in respect of the use of the firm's audit software, and evaluation of client systems.

As you are unfamiliar with this client your manager has asked you to document how you intend to proceed with the audit. He has suggested that your audit consist of 3 "stages" namely a planning stage, an interim audit and the final audit. He requires a schedule which reflects the **timing** of each stage of the audit, the **reason** you have chosen the timing and an **outline of the work** you intend to carry out at each stage.

**YOU ARE REQUIRED TO** draft the schedule as requested by your audit manager.

Note 1: You are not required to provide detailed audit procedures.

Note 2: Do not concern yourself with administrative planning.

**5.15****(32 marks 38 minutes)**

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 re-organisation 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 :**

- (a) describe the procedures you will conduct to assist you in your assessment. Give examples of the information you would be seeking for each procedure. (20)
- (b) evaluate the risk of material misstatement at financial statement level. (8)
- (c) comment on your overall response to the risk of misstatement at financial statement level. (4)

**5.16****(30 marks 36 minutes)**

In planning an audit, the use of analytical procedures may be used to assist in identifying and assessing the risks of material misstatement. The following information pertains to Dough Ball (Pty) Ltd one of your audit clients.



1. Dough Ball (Pty) Ltd bakes bread products which it supplies to numerous supermarkets, petrol station shops, etc, throughout Gauteng.
2. The company operates from one central bakery and uses a fleet of vans to deliver to its customers.
3. Minimal inventory is held at any time.
4. The company employs a small number of administration staff and a reasonably large labour force. Temporary staff are employed around public holiday periods when bakery product sales increase.
5. The accounts department maintains detailed production and delivery records. Reasonably detailed monthly accounts are prepared.
6. There is a detailed annual budget which is broken down into months.

All of the above documentation for the current and prior year is available to your firm as well as the draft financial statements for the financial year-end 30 June 2016.

**YOU ARE REQUIRED TO:**

- a) justify the performance of analytical procedures as a risk assessment procedure. (4)
- b) briefly discuss the characteristics which must be present in data if the auditor is to use the data to perform analytical procedures (at any stage of the audit). (4)
- c) discuss the factors you would consider in deciding whether analytical procedures will be appropriate substantive tests for a particular account heading when conducting further audit procedures on those account headings. (8)
- d) detail the analytical review procedures you might conduct at the planning stage for your audit of Dough Ball (Pty) Ltd based on the information provided. (14)

**5.17**

**(32 marks 39 minutes)**

You have recently joined the audit firm of Bath and Cutter, and have been appointed as senior-in-charge of the audit of Foodfare (Pty) Ltd, a medium sized company in the domestic foods sector. The company has a 31 July year-end and this year will be the first year that your firm has held the appointment as auditor. The company has a public interest score in excess of 350, due mainly to the size of its labour force.

Foodfare (Pty) Ltd has a number of food production facilities spread around KwaZulu Natal with its head office in Pinetown. The company has fully integrated computerised financial accounting and management reporting systems which were developed some years ago in-house. The systems were developed in-house to accommodate a number of unique (and complex) features pertaining to the company's business model and financial reporting system. Most data processing takes place at the IT centre at head office. The production facilities are

all linked to head office and each other which allows for real time processing of certain applications.

The audit firm to which you belong has five partners and about twenty additional audit staff members. The Foodfare (Pty) Ltd audit will be the firm's largest and most computerised client. The fact that you have been appointed as senior-in-charge has presented you with an important opportunity to use your experience gained at your previous firm in auditing in complex computerised environments.

Unfortunately things did not get off to a good start. Willy de Ville, the manager in charge of the audit has (like most of the other staff members) little experience in “more complex” computerised audit environments and believes that adopting a strategy of auditing around the computer is perfectly adequate. The "planning meeting" for the 31 July audit, in fact turned out to be Willy de Ville simply issuing instructions to the audit team, mainly about the verification of year-end balances, with hardly any discussion of Foodfare (Pty) Ltd's computerisation being held.

On challenging Willy de Ville he responded as follows:

"I don't know what you did at your previous firm but this firm adheres to the planning statement ISA 300 in developing the overall audit strategy plan. This statement does not even mention the word computers which suggests to me that auditing around the computer is a perfectly adequate strategy for the audit."

**YOU ARE REQUIRED TO:**

- a) comment on whether Bath and Cutter should have accepted the audit engagement of Foodfare (Pty) Ltd, based on the information given in the question. (5)
- b) discuss whether Willy de Ville's decision to audit “around the computer” is appropriate and whether his justification is valid. (11)
- c) explain why a combination of “auditing through the computer” and “with the computer” is often the most appropriate audit strategy and plan on an audit such as Foodfare (Pty) Ltd. (6)
- d) identify the components of Foodfare (Pty) Ltd's internal control pertaining to its computerisation, about which the audit team should gain an understanding, to be in a position to perform an effective audit. Provide a brief comment on each component.(10)





## **CHAPTER 6**

# **MATERIALITY, RISK AND FRAUD**



**6.1****(18 marks 22 minutes)**

1. Define audit risk. (1)
2. Define significant risk. (1)
3. Define control risk. (1)
4. Define detection risk. (1)
5. Into which constituent element of audit risk does management override fall? (1)
6. Explain the assertions relating to "presentation and disclosure". (3)
7. The auditor does not have control over all constituent elements of audit risk. Explain. (2)
8. Under what circumstances may an auditor ignore risk which may result in material misstatement? (1)
9. Explain the following assertions:-
  - 9.1 Occurrence (1)
  - 9.2 Accuracy (1)
  - 9.3 cut-off (1)
  - 9.4 classification (1)
10. In general terms how is detection risk kept to an acceptable level? (3)

**6.2****(10 marks 12 minutes)**

For each of the questions listed below (1 to 10) select the most appropriate answer.

1. Audit risk is made up of the following components:
  - 1.1 inherent risk and materiality.
  - 1.2 inherent risk and significant risk.
  - 1.3 control risk, detection risk and inherent risk.
  - 1.4 control risk and materiality.
2. Audit risk is best described as:
  - 2.1 the risk that the auditor will be sued for negligent performance.
  - 2.2 the risk that the auditor will fail to recover the costs of the audit due to the client refusing to pay the audit fee charged.
  - 2.3 the risk that the auditor will not adequately respond to any significant risk which has been identified.
  - 2.4 the risk that the auditor will express an inappropriate opinion when the financial statements are materially misstated.
3. Which of the following risks can be controlled by the auditor:
  - 3.1 significant risks.

- 3.2 detection risk.
  - 3.3 control risk.
  - 3.4 inherent risk.
4. Which of the following is regarded as an inherent limitation of the audit function:
- 4.1 the complexity of the international financial reporting standards.
  - 4.2 the Companies Act 2008 requirements relating to the timing of the annual general meeting at which the audited financial statements must be presented.
  - 4.3 the fact that the auditor is dependent on the client for his fees.
  - 4.4 the subjectivity of information included in the financial statements.
5. Risk assessment procedures will usually consist of:
- 5.1 a combination of further and other procedures.
  - 5.2 substantive procedures only.
  - 5.3 substantive procedures and tests of controls.
  - 5.4 inquiry, observation and inspection as well as analytical procedures.
6. Risk assessment procedures are carried out to:
- 6.1 specifically identify fraud and other significant risks.
  - 6.2 to identify and assess the risk of material misstatement at the financial statement level and assertion level.
  - 6.3 provide a basis for establishing the audit strategy.
  - 6.4 provide a basis for determining the scope of the audit.
7. The assertions are best described as:
- 7.1 the representations by management which are embedded in the financial statements.
  - 7.2 the accounting policies used in the financial statements.
  - 7.3 the principles embodied in the reporting framework adopted by the company.
  - 7.4 the disclosures made by the directors responsible for the preparation of the financial statements.
8. A significant risk is defined as:
- 8.1 the risk that there will be material misstatement in an account heading which is material to fair presentation.
  - 8.2 a risk that, in the auditor's judgement, requires special audit consideration.
  - 8.3 a risk which is a combination of control risk and inherent risk.
  - 8.4 none of the above.
9. Risks at financial statement level are best described as:
- 9.1 the risks of material misstatement in the financial statement disclosures.
  - 9.2 the risks that the relevant accounting framework adopted in the presentation of the financial statements is inappropriate.
  - 9.3 risks that relate pervasively to the financial statements as a whole.
  - 9.4 risks that are not related in any way to the assertions.
10. All other factors being equal, an increase in the assessed risk of material misstatement will:
- 10.1 increase audit risk.
  - 10.2 decrease audit risk.

10.3 have no effect on audit risk.

10.4 increase significant risk.

### 6.3

(15 marks 18 minutes)

A friend of yours is presently undertaking a vacation job at your audit firm. This is his first exposure to auditing as he has neither studied auditing at university nor worked in an audit firm previously. On glancing through an audit file he came across the following note, and has asked you what it means,

"Having completed our risk assessment procedures we are confident that the risk of material misstatement for the assertions relating to trade accounts payable is similar to that of last year. Therefore our audit plan will be to carry out a mix of tests of controls and substantive testing."

**YOU ARE REQUIRED TO** explain to your friend the meaning of the following terms in the context of an audit. You must link all the terms together in your explanation.

1. Risk assessment procedures
2. Material misstatement
3. Assertions
4. Audit plan
5. Substantive testing
6. Tests of controls.

### 6.4

(27 marks 32 minutes)

1. What is the link between audit risk and the assertions? (2)
2. Distinguish between the risk of material misstatement at financial statement level and at assertion level. Illustrate with an example. (3)
3. How does the auditor respond to a high level of risk at financial statement level? (3)
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)
5. An immaterial account balance cannot attract audit risk. True or false? Justify. (2)
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)
7. Property, plant and equipment is often mistakenly regarded as being "low risk" from an auditing perspective. The truth is that there are numerous situations/factors which could result in the risk of material misstatement related to property, plant and equipment account headings being assessed as high.

List at least three situations/factors which could result in the risk of misstatement attached to each of the assertions relating to property, plant and equipment being high. Do not use the same situation/factor for more than one assertion. (Note, you are not required to consider the assertions applicable to Presentation and Disclosure). (12)

**6.5**

**(20 marks 24 minutes)**

**PART A**

**(8 marks 10 minutes)**

During the year-end audit (31 March 2016) of Matchbox (Pty) Ltd, the following errors were identified whilst conducting the audit of property, plant and equipment.

1. An expensive piece of equipment used for manufacturing timber boxes was purchased in February 2016 and brought into production in April 2016. However, the machine has been depreciated for a full twelve months at 31 March 2016.
2. A jointing machine leased on an operating lease had been capitalized at 31 March 2016.
3. No adjustment has been made for a new crosscut machine which had been stolen during the year. The machine was not insured.
4. Whilst conducting a physical verification of assets, a trainee accountant identified a number of items of equipment which had not been recorded in the fixed asset register.
5. The company extended its warehouse during the year under audit. Most of the work was carried out by Matchbox (Pty) Ltd's own employees. Wages of the construction team were capitalized to the cost of the extension.
6. A significant number of the company's tree felling machines were out on contract in forests located around the country.

**YOU ARE REQUIRED TO** state, with reasons, which assertions relating to property, plant and equipment will be affected by each of the above (1 to 6).

**PART B**

**(12 marks 14 minutes)**

Whilst conducting procedures on various cycles on the audit of Hallmark (Pty) Ltd a wholesaler of stationery and paper products, the following situations arose.

1. A number of supplier invoices were found which were not made out to Hallmark (Pty) Ltd.
2. Whilst reperforming the calculation of overtime hours on a sample of clockcards, a number of errors, all of which favoured the wage earner, were identified. The trainee also noticed that some overtime hours recorded on the clockcards had not been authorised as required.
3. A number of Hallmark (Pty) Ltd dispatch (delivery) notes had been matched to the customer's order but not to a sales invoice.

4. VAT on all the sales for the month of January (financial year-end 31 March) had been charged at 10% (instead of 14%) due to an error in processing.
5. A sample of test counts of different inventory items on the warehouse floor revealed that some of the items were not included on the inventory sheets at the year end inventory count.
6. A batch of goods received notes for goods received in the last week of the financial year had not been matched to supplier invoices at year-end, and hence the corresponding purchase had not been raised.
7. A number of credit sales made in the first two weeks of the new financial year were included in the March sales due to a mix up with dates on the dispatch notes.
8. Numerous errors were found in the depreciation calculations for plant and equipment.

**YOU ARE REQUIRED TO** identify the assertions which would be affected by each of the above.

## 6.6

**(20 marks 24 minutes)**

During the “understanding the entity and its environment” stage of planning for the audit of Novex (Pty) Ltd you obtain the following information, inter alia, about the company.

1. The company imports large quantities of inventory.
2. Some of the products which Novex (Pty) Ltd sells have expiry dates, after which they are not usable/saleable.
3. The company sells, inter alia, chemicals.
4. Inventory is stored in several warehouses around South Africa.
5. 30% of the company’s sales are cash sales made to the informal health care sector.
6. During the year under audit, credit terms and policies were made less stringent to boost sales.
7. The company’s manufacturing division leases some of its assets.
8. Obtaining spares for some of the manufacturing assets which the company owns, is extremely difficult which has resulted in a number of machines standing idle.
9. The work force at Novex (Pty) Ltd fluctuates quite significantly from month to month. Casual labour is brought in frequently for short periods.

**YOU ARE REQUIRED TO** identify the financial statement assertions which will be affected by the above information. Provide reasons.



**6.7****(16 marks 20 minutes)**

You are currently carrying out risk assessment procedures at your client Swinn (Pty) Ltd, a manufacturing company and subsidiary within an industrial conglomerate. The following information pertains to this assessment:

1. The financial director has been very evasive in answering questions, generally displaying a very dismissive attitude to the audit.
2. Some of the products manufactured by Swinn (Pty) Ltd have not kept up with market requirements.
3. In prior years directors annual bonuses were based upon earnings reflected in the audited annual financial statements. This policy has been abandoned and directors monthly salaries have been increased.
4. The company decided to retrench its internal auditors in a cost cutting exercise; the holding company internal auditors will be available if required.
5. Close to the end of the year a number of complex entries relating to asset revaluations were put through.
6. For the six weeks prior to the year end, the credit controller was absent from work due to ill health. During this period a number of employees in the section took over his duties, e.g. authorizing credit terms, passing credit notes, etc.
7. Management is regarded by the staff as being very dictatorial as certain members of management will frequently override controls. Some staff members have expressed the view that the holding company puts too much pressure on management to perform.
8. Numerous transactions take place with other companies within the group.

**YOU ARE REQUIRED TO** explain whether each of the above will increase or decrease your assessment of the risk of material misstatement. Your explanations should indicate whether the risk of misstatement at financial statement level or at assertion level will be affected. You are not required to consider the information collectively.

**6.8****(33 marks 39 minutes)**

You are a trainee accountant at a small audit firm. Your firm was recently appointed as auditors of Under18 (Pty) Ltd, a company which sells upmarket fashionwear to the female teenage market. The previous auditors had resigned after a dispute with the company's directors about the audit fee. The company has been operating for the last five years and has a number of outlets in each of the five major cities in South Africa.

A unique feature of the company is that they sell only for cash or on account, no cheques or credit cards are accepted. Accounts must be opened in the name of a person over the age of 21 years e.g. a parent. On average thirty five percent of annual sales are made for cash.

Most of the company's inventory is imported. There is a large central warehouse in Johannesburg from which inventory is dispatched to the company's outlets where it is either displayed on the shop floor or kept in a small storeroom.

Although sales have generally been good in previous years, sales for the financial year-end 31 March 2016 have shown a decline. The directors of the company attribute this to two things, negative fluctuations in foreign exchange rates which have resulted in increased costs for the company's imports, and increased competition in the market place. In an attempt to increase sales the directors decided during the year to relax the granting of credit by extending the credit limits and terms for all existing and new account holders. The company has a small overdraft on its bank account but which is within the facility granted by the bank.

When the company was formed five years ago, it was financed by 10 private investors who provided long-term loans. (The company has a very small share capital). None of these 10 long-term loans is secured, but in terms of the loan agreement the investors are entitled to call up their loans immediately if the company does not achieve a pre-determined net profit before tax. The loan agreement requires that an annual audit of the company be carried out. The directors are very anxious that the stipulated (pre-determined) net profit before tax is achieved.

**YOU ARE REQUIRED TO:**

- a) discuss the factors which your firm would have considered prior to accepting the appointment of auditor of Under 18 (Pty) Ltd, based on the information given above. (8)
- b) define audit risk. (2)
- c) evaluate the risk of material misstatement relating to the following account balances or classes of transaction at 31 March 2016 based on the information given above
  - \* inventory (12)
  - \* sales (5)
  - \* accounts receivable (6)

You are advised to consider the risk relating to each assertion applicable to each of the above account balances or classes of transaction.

**6.9**

**(18 marks 22 minutes)**

You have just completed the "identifying and assessing the risks of material misstatement" stage of planning of a new client, Apex Ltd. You have established the following :

1. The financial accountant and financial director are not at all co-operative with the auditors.
2. 60% of the company's operating equipment is in remote, isolated areas of South Africa and its neighbouring countries.
3. the company is involved in long-term construction contracts which can last up to five years.

4. some of the operating equipment used on the contracts is leased from foreign companies.
5. Numerous complex journal entries were put through prior to the year end. Supporting documentation is minimal, but the entries were all authorized by the financial director.

**YOU ARE REQUIRED TO :**

- (a) assess the risk of material misstatement at financial statement level. Give reasons. (8)
- (b) assess the risk of material misstatement at assertion level. Indicate which assertions are affected. (10)

**6.10**

**(30 marks 36 minutes)**

You are on the audit team of Chemtrade (Pty) Ltd, a company which manufactures and distributes a range of industrial chemical products to other manufacturers. Whilst conducting risk assessment procedures on the 31 March 2016 audit, you gathered the following information inter alia, about the company:

1. During the course of the year Edgar Hoover the newly appointed chairman of the company, requested the resignation of the financial director John Dillinger, a conservative, independently minded and well respected chartered accountant who had been at Chemtrade (Pty) Ltd for some years. John Dillinger had angered the chairman by refusing to implement certain accounting policies which would improve the performance of the company as reflected in the financial statements. As their working relationship had become untenable, John Dillinger resigned.
2. John Dillinger had been replaced by Floyd Nelson, a young and inexperienced but aggressive chartered accountant whom the chairman had recruited from another company. Floyd Nelson was also appointed as chairman of the audit committee by Edgar Hoover. John Dillinger has sued the company for R5 million in respect of monies due to him when he left the company some months prior to year-end.
3. Under the direction of Edgar Hoover, the company has recently set up a number of joint ventures and other business alliances and a fair number of transactions have taken place between them and Chemtrade (Pty) Ltd. Documentation relating to these entities and transactions appears to be minimal.
4. The valuation of inventory at year-end had in prior years been conducted in conjunction with the external auditors, by an independent specialist chemical engineer on the insistence of John Dillinger to satisfy audit requirements. For the current year Floyd Nelson decided against this practice as he deemed it unnecessary, stating that the auditors don't make the rules here, they must accept the valuation arrived at by myself and the production manager."
5. During the financial year, the company had ceased production of a particular range of chemicals which it only exported to Europe. However, due to the economic downturn in Europe, the orders for this range of chemicals have virtually ceased. Because the company had, and still has, a very large stockpile of this range of chemicals, the plant

and equipment used in the manufacture of these products has been lying idle for the seven months prior to the year-end. According to the production manager, there are no plans to commence with production of this range or to adapt the plant and equipment to manufacture another type of chemical.

6. During the financial year, a government environmental agency filed a lawsuit against the company for the material sum of nearly R10m for what it describes as “extensive environmental damage to certain wetland areas”. The matter is being handled by the company’s lawyers, but at the financial year end the matter was unresolved. Should the decision go against the company, there could be serious consequences other than financial for the company, e.g. loss of certain manufacturing licences.
7. An analysis of the accounts receivable balance at year-end revealed that the percentage of debt owed by foreign debtors (in Europe) had increased substantially compared to the prior year due mainly to the fact that the company’s trading partners in Europe are taking considerably longer to pay than they had in prior years. Management attributes this to the economic downturn in the European markets. Sales to this market in prior years have been material.

**YOU ARE REQUIRED TO** evaluate, based on the information given above, the risk of material misstatement at financial statement level and at assertion level for the year-end audit of Chemtrade (Pty) Ltd. Where you believe that there is risk of material misstatement at assertion level, you must identify the assertion(s) to which the misstatement relates.

## 6.11

**(30 marks 36 minutes)**

You are a manager in the audit firm of Perrow and Evans. The partnership has a total of six partners and has been in existence for many years. The partnership has a good reputation which has ensured its survival.

One of the partnership’s long-standing clients is Proby Industries (Pty) Ltd, a successful industrial company operating in KwaZulu Natal. In July 2015 80% of Proby Industries (Pty) Ltd shares were sold by the existing shareholders to Raider Industries (Pty) Ltd (The Raider Group). The shareholders of Raider Industries (Pty) Ltd are a group of young executives generally regarded as being competent but very ambitious "highflyers". The change in ownership of Proby Industries (Pty) Ltd resulted in a number of changes at the company. The entire board of directors, all of whom filled executive roles, e.g. financial director, production director, was dismissed without compensation and the company's bankers and attorneys were replaced. All of these former directors are suing the company. Raider Industries (Pty) Ltd installed their own management team, and appointed the bankers and attorneys who act for all of the companies in the Raider Industries (Pty) Ltd group.

Shortly after the take over, all accounting systems at Proby Industries (Pty) Ltd were integrated into the Raider Industries (Pty) Ltd group’s system. Your firm was not consulted about this but the Raider Group internal auditors had overseen the conversion and had continued to monitor the system throughout the year. The accounting policies previously adopted at Proby Industries (Pty) Ltd were standardised to conform with group accounting policies.

The nature and volume of trading of Proby Industries (Pty) Ltd has not changed to any great extent except that the company has for the first time in its history commenced import and export activities. In addition many of the traditional suppliers to Proby Industries (Pty) Ltd were replaced by companies in the Raider Industries (Pty) Ltd group. In certain cases contracts with traditional suppliers had been broken resulting in court cases involving significant amounts of money being brought against the company. Various sale and leaseback contracts had been entered into between Proby Industries (Pty) Ltd and other Raider Industries (Pty) Ltd group companies.

At a meeting with the newly appointed financial director (Proby Industries (Pty) Ltd's audit committee was disbanded by the newly elected board) to discuss the pending audit, he informed you that Perrow and Evans were to follow the instructions of the Raider Group auditors. He also informed you that the shareholders and the directors considered the external audit an unnecessary cost. He made it clear that he wanted the audit completed promptly without any timewasting procedures.

**YOU ARE REQUIRED TO** draft a memorandum to Peter Perrow the partner in charge of the audit of Proby Industries (Pty) Ltd detailing your assessment of the risk of material misstatement in the financial statements for the March 2016 year-end audit of Proby Industries (Pty) Ltd.

## 6.12

**(32 marks 38 minutes)**

Superior Knowledge (Pty) Ltd is a company in the information technology sector. It has a 30 June year-end. The company was formed some years ago by Harvey Hughes, and enjoyed a number of years of rapid growth brought about by the boom in the information technology industry. Your firm has held the position of auditor since the company's inception. The company offers a number of services e.g. installing networks and developing software, as well as wholesaling software packages and hardware. Harvey Hughes has surrounded himself with a team of ambitious, and in some cases demanding, directors, all of whom have shares in the company.

The success of the company can be largely attributed to two factors. First, Marvin Maharaj the product development director, whose innovative thinking and technical knowledge led the company into new markets. (Marvin Maharaj has recently resigned from the company and emigrated to America). Second, over the years, the directors, including Harvey Hughes, have invested much of their personal wealth in the company, and have worked hard to protect it.

You have been put in charge of a special audit of Superior Knowledge (Pty) Ltd for the 9 months ended 31 March 2016, (you have been on the audit team for two years) and in preparation for the audit you have obtained the following information.

1. These audited financial statements are required for a meeting to be held with the company's bankers. The directors intend to raise additional finance and obtain extension of the repayment date of the company's loans (see pt 3 below).
2. As with most companies in the information technology sector, trading conditions over the last year have proved extremely difficult to the extent that the draft income

statement at 31 March reflects a small profit, but one which is significantly reduced compared to the previous financial year-end.

3. During its growth years the company borrowed extensively to finance expansion. Loans, mostly secured by the assets of the company and the directors' personal guarantees, were taken from various banks and investment companies, and a number of these loans must be repaid within the next 12 months. The company's rapidly slowing cashflow suggests that repayment of these loans will prove difficult.
4. During October 2015 an action was brought against Superior Knowledge (Pty) Ltd by Massgoods Ltd, a consumer goods retailer and one of its larger clients. Massgoods Ltd is claiming damages in excess of ten million rand from Superior Knowledge (Pty) Ltd. The basis of their claim is that application software developed by Superior Knowledge (Pty) Ltd for their acquisitions and payments cycle, was defective and had facilitated a major fraud at Massgoods Ltd. The directors of Superior Knowledge (Pty) Ltd are considering an out of court settlement, as Harvey Hughes put it "to avoid legal costs and to keep it quiet."
5. Due to declining consumer expenditure and slow business growth many of the retailers and wholesalers which Superior Knowledge (Pty) Ltd supply are having to reduce prices and give extended credit to make sales. A number have not been able to continue trading and have been placed in liquidation. In addition two of the four large system implementations in which Superior Knowledge (Pty) Ltd is currently involved have been suspended by the respective clients until such time as there is an "upturn in business activity".
6. The slowdown in trading has also resulted in a fairly large increase in Superior Knowledge (Pty) Ltd's inventory holding, including hardware and software specifically purchased for the four system implementations referred to in paragraph (5) above.

**YOU ARE REQUIRED TO:**

- a) indicate whether it is necessary for you to plan this special audit of the financial statements at 31 March in the same manner as you would plan the annual financial year-end audit. Justify your answer. (5)
- b) explain the difference between inherent risk and control risk. (4)
- c) assess the risk of material misstatement in the 31 March 2016 financial statements of Superior Knowledge (Pty) Ltd. Fully justify your answer by discussing all the factors indicated above which could impact on your assessment. (23)

**6.13**

**(10 marks 12 minutes)**

Listed below under "A" are the first parts of ten sentences. Listed under "B" are the second parts of each sentence. When the parts (A and B) are combined, a complete and correct sentence is made.



**List A**

- A1 A misstatement in the financial statements which exceeds the amount the auditor considers to be material, is referred to as being .....
- A2 Materiality can be broken down into planning materiality, final materiality and .....
- A3 The auditor's judgements about materiality are made in the light of surrounding circumstances and are affected by the .....
- A4 The omission from the financial statements of a note dealing with a contingent liability will be material if .....
- A5 A misstatement in the financial statements which is material when judged against a factor other than amount, is referred to as being .....
- A6 Performance materiality must be determined for the purpose of determining .....
- A7 To state that planning materiality cannot be changed as the audit progresses, is .....
- A8 To state that performance materiality will be stricter (lower) than planning materiality, is .....
- A9 The materiality guideline used to evaluate the effect of uncorrected misstatements on the financial statements, is referred to as .....
- A10 The auditor's best estimate of misstatement in a population based on misstatement identified in a sample from that population, is referred to as .....

**List B**

- B1 ..... false
- B2 ..... size and nature of a misstatement
- B3 ..... it could reasonably be expected to influence the economic decisions of users taken on the basis of the financial statements
- B4 ..... projected misstatement
- B5 ..... quantitatively material
- B6 ..... true
- B7 ..... performance materiality
- B8 ..... final materiality
- B9 ..... nature, timing and extent of further audit procedures
- B10 ..... qualitatively material

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

**6.14****(26 marks 31 minutes)**

1. Discuss materiality in the context of the preparation and presentation of financial statements. (4)
2. The auditor's determination of materiality is a matter of professional judgement and is affected by the auditor's perception of the needs of users. In determining materiality, it is generally accepted that it is reasonable for the auditor to make assumptions about users. Briefly describe these assumptions. (4)
3. 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)
4. Identify five factors to be considered when quantifying "planning" materiality. (3)

5. Distinguish between planning materiality and performance materiality. (2)
6. What effect is a significant risk, identified during the “identifying and assessing the risk of material misstatement” stage of planning, likely to have on the performance materiality limit? (2)
7. Explain the term “qualitatively material”. Give an example. (2)
8. When the auditor identifies misstatements, he should discuss all the misstatements with the client in an attempt to have them rectified. However, management may decide not to correct the misstatements. Provide four reasons why the client may chose not to correct the misstatements. (4)
9. Identify four factors to be considered in evaluating the materiality of uncorrected misstatements. (3)

**6.15**

**(35 marks 42 minutes)**

You are the senior on the audit of Akha (Pty) Ltd for the financial year-end 29 February 2016. The company sells building materials. Although Akha (Pty) Ltd’s public interest score is slightly less than 100, the company’s annual financial statements are externally audited every year. The reason is that none of the shareholders is active in the company and as a result they have included a clause in the Memorandum of Incorporation which requires that the company be externally audited. You have reached the evaluating and concluding stage of the audit and are considering the following audit differences (uncorrected misstatements) which have been recorded in the audit workpapers.

1. During the inventory count your audit team identified a number of tins of waterproofing sealant which had passed the expiry date stamped on the tins. This had been reported to the operations director who responded that "although the product doesn't work very well after expiry very few customers look at the expiry date, so not to worry". However, you requested your audit team to check, in detail, all the categories of product which made use of expiry dates, to establish the extent of the problem. At the conclusion of this procedure it was revealed that inventory which had passed its expiry date but had been included on the inventory sheets at year-end amounted to R197 233. Akha (Pty) Ltd does not operate a perpetual inventory system. A simple quantity only Kardex system is maintained by each section of the business and a comprehensive inventory count is undertaken at year-end to establish closing inventory.
2. Also included on the year-end inventory sheets were items costed at R83 491 which represented goods delivered to Akha (Pty) Ltd on the day before the inventory count which had taken place on the last day of the financial year. However, due to preparations for the inventory count, goods received notes for these goods were not made out until the following week and were recorded in the March 2016 purchase journal.
3. The three directors of the company are paid a bonus based upon the gross profit for the year. Once the gross profit has been calculated by the financial controller, 10 percent



thereof is accrued in the year-end financial statements and paid out once the audit is completed. This bonus has not been disclosed in the note on directors emoluments as the directors feel that it causes dissatisfaction amongst the company's employees.

4. During testing of purchases several misallocations of expenses were revealed. Fortunately the audit team was able to isolate the errors to a week just before year-end during which the accountant had been ill and a junior member of the accounting staff had carried out the allocation. Your detailed analysis revealed that purchases had been incorrectly debited with
  - 4.1 R8 721 repairs to an Akha (Pty) Ltd delivery vehicle,
  - 4.2 R80 000 for a new shelving system used to display power tools and
  - 4.3 R4 648 of general administration expenses such as stationery, refreshments etc.
5. The audit of debtors had revealed that an amount of R56 209 owing from 24 November 2014 by Wallblox (Pty) Ltd was still outstanding at 29 February 2016. During heavy rain in January 2016 Wallblox (Pty) Ltd's premises had been flooded, causing extensive damage and the company's creditors are pressing to have Wallblox (Pty) Ltd placed in liquidation. The directors of Akha (Pty) Ltd have neither provided for, nor written off this debt, and are reluctant to do so until they have heard the outcome of the creditors' action.

Extracts from the draft financial statements:

Gross Profit	R3 317 913
Net profit before taxation	R1 327 165
Non-current assets	R1 550 000
Current Assets	R1 778 683
Current liabilities	R486 321

Your firm's approach is to evaluate the materiality of audit differences both qualitatively and quantitatively and to assist in this exercise the following final materiality guidelines have been set for this audit

: net profit before tax	R99 500
: net current assets	R100 000
: non-current assets	R120 000

#### **YOU ARE REQUIRED TO:**

- a) comment on whether the fact that Akha (Pty) Ltd is audited because the shareholders require an audit would have affected your planning materiality for the 2016 audit. (3)
- b) comment on what external professional intervention a company with a public interest score of less than 100 is required to have in terms of The Companies Regulations 2011 with regard to its annual financial statements. (2)
- c) distinguish between "factual misstatements" and "judgemental misstatements" and to explain why the auditor makes this distinction. (4)

- d) discuss the above audit differences, both singularly and collectively, with regard to the fair presentation of the financial statements of Akha (Pty) Ltd at 29 February 2016.(26)

6.16

(48 marks 58 minutes)

You are currently engaged (early May) on the finalisation of the 29 February 2016 year-end audit of EyeSpye (Pty) Ltd, a wholesaler and installer of security products ranging from electric fencing to surveillance cameras.

The following unresolved audit matters (identified misstatements) have been referred to you by members of the audit team for evaluation. Your firm's review procedures require that you document your evaluation on a workpaper to be discussed with your manager at the audit review meeting.

**Matter 1.** EyeSpye (Pty) Ltd holds twenty five percent of the ordinary shares in Funnymunny (Pty) Ltd a manufacturer of counterfeit money detectors. This investment in Funnymunny (Pty) Ltd is a long-term investment and, as EyeSpye (Pty) Ltd has significant influence in the affairs of Funnymunny (Pty) Ltd, by virtue of its representation on the Board, it accounts for the investment using the equity method. As EyeSpye (Pty) Ltd has no other investments in associates or subsidiaries it does not prepare consolidated financial statements. The two companies do not trade with each other and, at the date EyeSpye (Pty) Ltd acquired its interest, the assets and liabilities of Funnymunny (Pty) Ltd were fairly valued. The initial investment cost was R250 000 and no goodwill arose on acquisition.

For its financial year-end (also 29 February 2016) Funnymunny (Pty) Ltd reported a loss of R800 000 after tax. This was the first loss which the company had ever incurred and arose from the collapse of one of its customers who was unable to pay for a large purchase of detectors the customer had installed in a foreign country.

The misstatement has arisen because Craig Bond, the newly appointed financial director, refuses to account for EyeSpye (Pty) Ltd's share of Funnymunny (Pty) Ltd's loss at 29 February 2016. His reason is that "this was a one-off loss, Funnymunny (Pty) Ltd traded successfully for years and is financially very strong. For us to account for this loss simply suggests that our investment has been impaired which just isn't the case"

Evidence obtained by the audit team confirmed that Funnymunny (Pty) Ltd is financially sound and that its business prospects are good. (9)

**Matter 2.** Between 2 August 2015 and the financial year-end 29 February 2016 EyeSpye (Pty) Ltd installed surveillance systems in ten office complexes. In March 2016 one of the office complexes was broken into and it was established that the security system had failed due to an error in its installation. All surveillance systems are warranted for 1 year. EyeSpye (Pty) Ltd's contracts manager quickly realised that the same error would have been made in the other nine systems. Modifications were promptly carried out on all systems (ten) at a total cost of R144 000. In addition, EyeSpye (Pty) Ltd paid the owners of the office complex which was broken into, an amount of R50 000 at the end of April 2016 to compensate for the loss they had suffered as a result of the break in. Craig Bond and the Board regard this voluntary payment of R50 000 to be "good business sense for a good customer", and the full amount of R194 000 has been treated as a 2017 period cost. (8)

**Matter 3.** Included in accounts receivable at 29 February 2016 is an amount of R132 000. This relates to a contract signed with a large supermarket to supply and install a laser beam security system in its warehouse. The contract price of R132 000 was made up of R82 000 for parts and R50 000 for installation cost. Craig Bond is of the opinion that the sale can be raised at 29 February 2016 because EyeSpye (Pty) Ltd has installed the laser beam system in thirteen other warehouses for this company without a single problem. The parts for this installation (cost R40 000) were excluded from the year-end inventory count, and had in fact been delivered by 29 February 2016 to the supermarket warehouse to await installation. (7)

**Matter 4.** The summarised workpaper for allowances prepared by a senior trainee indicated the following.

<b>Allowance</b>	<b>Average last 3 yrs</b>	<b>Current year (client)</b>	<b>Our opinion</b>
Bad Debts	9%	142 913 (8%)	Clients allowance is fair
Obsolete Inventory	12%	297 493 (13%)	Clients allowance is fair
Warranties	3%	171 590 (1%)	see comment below

In my opinion the allowance for warranty claims is understated and should not be less than R343 180 (2% of turnover); Craig Bond has reduced the provision to 1% as he believes that with the improved quality procedures which the company has put in place, claims will be reduced. Whilst there is some evidence to support this, the reduction is excessive. (5)

**Matter 5.** The trainee who tested the costing of inventory at 29 February 2016 identified that incorrect cost prices had been used for a number of inventory items. With the help of the client, the trainee established that inventory on hand at 29 February 2016 was undervalued by R179 250. Craig Bond has decided to “adopt the prudent approach and ignore this on the grounds that the auditors are only interested in overstatement of assets and that in relation to turnover, it is not worth worrying about.” (6)

**Matter 6.** During the course of the year EyeSpye (Pty) Ltd entered into a contract to supply electric fencing to Shok CC, a close corporation owned by two of the directors of EyeSpye (Pty) Ltd. The company’s Memorandum of Incorporation contains a clause which permits the company to enter into contracts in which its directors are interested. On raising the issue of disclosure of the details of this contract in the annual financial statements with Craig Bond, his response was “the directors complied with the Companies Act and disclosed their interest in the contract to their fellow directors at the appropriate time. No further disclosures are required.”

The minutes of directors meetings reveal that the Companies Act has been complied with. (5)

To assist you in evaluating unresolved audit matters you are required to make use of the firm’s final materiality guidelines which for this audit, are as follows:

<b>Account Heading/Grouping</b>	<b>%</b>
Net profit before taxation	5%
Non-current Assets	8%
Current Assets	5%
Current Liabilities	5%

**Extracts from the Draft Financial Statements at 29 February 2016.**

	2016 R	2015 R
<b>Non current assets</b>	3 621 845	3 647 840
Property, Plant etc	2 787 645	2 813 640
Investment in Associate	834 200	834 200
<b>Net current assets</b>	2 634 258	2 098 232
<b>Current Assets</b>	4 774 061	4 208 740
Inventory	2 288 412	1 905 542
Accounts Receivable	1 786 415	1 557 286
Bank	699 234	745 912
<b>Current Liabilities</b>	2 139 803	2 110 508
Trade Creditors	1 968 213	1 636 920
Allowance-warrantees	171 590	473 588
<b>Turnover</b>	17 158 986	15 786 267
<b>Net profit before taxation</b>	2 921 934	2 369 740

Your firm's evaluation procedures require that you prepare a workpaper to be discussed with your manager at the upcoming review meeting in which you

- a) \* classify each matter as either a ***factual misstatement***, a ***judgmental/projected misstatement*** or ***no misstatement***
- \* consider each matter in relation to relevant materiality guidelines
- \* raise any other points considered in the evaluation and
- \* make a recommendation as to how each matter should be treated in respect of modifying the audit report
- b) \* provide a conclusion to the workpaper based on a collective evaluation of all matters.

**YOU ARE REQUIRED TO** prepare the workpaper to be discussed with your audit manager at your upcoming meeting.

Your workpaper ***must*** be set out on a ***double page*** as follows:

**a) Workpaper (40 marks)**

Matter	factual or (judgmental/projected) or no misstatement	Materiality guideline considerations	Other points considered	Recommendation
1.	1 .....	.....	.....	.....

**b) Overall conclusion ..... (8 marks)**

**6.17****(17 marks 20 minutes)**

You are a member of the team on the audit of Consumex Ltd a listed company which sells a wide range of consumer goods. You and other members of the team are currently discussing the materiality limits for the planning of the current audit. As a starting point you used the prior year materiality limits set for the various account balances and classes of transactions with a clear understanding that these limits could be revised as more information was gathered during the audit.

Before the discussion amongst team members got underway, Beckie Zulu a junior trainee posed the following question “When deciding on our planning materiality, is there a “cost/benefit” issue we should be considering?”

During the identification and assessing risk of material misstatement stage, the following information was obtained.

1. Early in the year, Consumex Ltd had increased the number of staff in the internal audit department and appointed a very experienced individual as the chief audit executive. (2)
2. The company negotiated two large long-term loans during the year. Both loans included loan covenants which require strict adherence to specified liquidity ratios. The company has not had to contend with this in prior years. (3)
3. The number of major transactions with related parties increased considerably during the year. (2)
4. The directors have notified you that the financial statements will be submitted to the Department of Trade and Industry in an attempt to raise capital for a rural expansion programme which the company wishes to commence. Before they will advance loans, the DTI requires that the financial statements reflect certain profit, turnover and asset levels. (3)
5. Halfway through the year the company relaxed its credit terms in an attempt to boost sales. The amount of credit made available to customers was increased dramatically and repayment terms extended. (3)

**YOU ARE REQUIRED TO:**

- a) respond to the question from Beckie Zulu. (4)
- b) discuss whether the information above (1 to 5) would have any effect on the planning and performance materiality limits and your assessment of risk for the upcoming audit. (13)

**6.18****(23 marks 27 minutes)**

1. Misstatements in the financial statements can arise from either fraud or error. What is the distinguishing factor between fraud and error? (1)

2. Why is the auditor interested in fraud at an audit client? (2)
3. Is it the auditor's duty to report fraud to the police? Explain. (2)
4. Distinguish between "management fraud" and "employee fraud" and explain why the distinction is made. (2)
5. In terms of ISA 240 – The auditor's responsibilities relating to fraud in an audit of financial statements, two types of intentional misstatement are relevant to the auditor. They are, misstatements resulting from fraudulent financial reporting and misstatements resulting from misappropriation of assets. Give 3 examples of how each of the two types of intentional misstatements can be accomplished. (6)
6. What are the responsibilities of management and those charged with governance, with regard to fraud? (2)
7. What is the general responsibility of the auditor for detecting material misstatement due to fraud? (2)
8. Should the auditor adopt the attitude that there is no fraud unless he finds it, or should he adopt the attitude that there is fraud and he should specifically look for it? Explain. (2)
9. What is management override and why is it important in relation to fraud? (2)
10. Why is it important that the auditor test journal entries at an audit client (for authority in particular)? (2)

**6.19**

**(10 marks 12 minutes)**

Listed below under "A", are the first parts of ten sentences. Listed under "B" are the second parts of each sentence. When the parts (A and B) are combined, a complete and correct sentence is made.

**List A**

- A1 Events or conditions that indicate an incentive or pressure to commit fraud are referred to as.....
- A2 The element or characteristic which distinguishes fraud from error, is.....
- A3 Intentionally using an inappropriate policy for revenue recognition to inflate profits is an example of.....
- A4 The auditor does not simply accept everything he is told by the client; this attitude is referred to as.....
- A5 The auditor should consider the risk of fraudulent financial reporting in terms of management's attitude, opportunity and.....
- A6 Embezzlement of cash sales by a cashier would be classified as.....
- A7 To state that the auditor has a responsibility to prevent fraud is.....
- A8 Where the auditor considers that there is a risk of fraudulent financial reporting, the risk would be considered to be a.....

- A9 To state that an increased risk of fraudulent financial reporting would generally result in stricter performance materiality, is.....
- A10 Authorising a journal entry designed to manipulate an account balance is a form of.....

**List B**

- B1 .....professional scepticism
- B2 .....incentive/pressure
- B3 .....misappropriation of assets and employee fraud
- B4 .....fraud risk factors
- B5 .....significant risk
- B6 .....fraudulent financial reporting and management fraud
- B7 .....true
- B8 .....management override
- B9 .....intention (of the perpetrator)
- B10 .....false

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

**6.20**

**(20 marks 24 minutes)**

The following conditions or events exist at various of your firm's audit clients.

1. The company adheres to the principles of sound corporate governance.
2. The company has converted itself from a complex corporate structure to a more simple structure by unbundling itself.
3. The directors' remuneration is largely dependent on the company's financial results.
4. Management decisions are strongly influenced by the managing director, a clever but forceful autocratic man.
5. The company's motto is "no question - we will be number one" and employees are encouraged to be aggressive and competitive as progress and promotion depends upon results.
6. The financial director has little regard for the auditors, describing the annual audit as an irritation.
7. Recommendations made by the auditors to the company at the conclusion of the audit are implemented timeously.
8. The IT department of a large company is generally inexperienced and has a number of vacancies.
9. The company has two major customers, which are both experiencing a serious decline in the demand for their products.



10. The financial director is proposing changes in accounting policies which will improve the financial position of the company in appearance, but not necessarily in fact.
11. A number of complex year-end adjustments have been made.
12. A large number of consultants have been engaged during the year to render advice or services, but no tangible benefits or services seem to have accrued to the company.
13. Independent reviews of financial reconciliations e.g. cash book, creditors, inventory, are carried out by internal audit on a surprise basis.
14. Systems development controls are sound but subsequent program changes are not always documented, approved and tested properly.
15. There are numerous transactions with related parties but authority is obtained from the Board for such transactions.
16. The company has a well defined formal risk assessment process in place.

**YOU ARE REQUIRED TO** indicate whether each of the above conditions or events will increase, decrease or have no noticeable effect on the risk of fraud/theft occurring at these companies. Provide brief reasons for your answer. Consider each one separately.

**6.21**

**(16 marks 19 minutes)**

According to ISA 240 - The auditor's responsibilities relating to fraud in an audit of financial statements, the auditor is required to recognise situations which may result in misstatement in the financial statements arising out of the misappropriation of assets.

Consider the following

1. A client company which holds large quantities of inventory does not keep perpetual inventory records. Relations between the warehouse manager and the warehouse personnel are very poor as the warehouse manager does not treat his staff with respect.
2. A company which has a centralized accounting department makes all its payments (e.g. wages, salaries, creditors) by electronic funds transfer. 10 employees are provided with the facilities on their computers to authorize and effect electronic transfers for their various sections.
3. The company reconciles its creditors ledger with creditors statements only at year-end.
4. The company pays salaries well below the industry norm and adopts the attitude that "if staff don't like it they can leave".
5. Employees caught stealing from the company or making unauthorised use of company assets are dismissed immediately and prosecuted.
6. The company makes a significant number of cash sales.



7. Management and other employees constantly complain about the company (many of the complaints being unfounded). Company morale is low.
8. There is inadequate authorisation of expenditure incurred by management and employees on behalf of the company e.g. salesmen's expense claims, management travel claims.

ISA 240 classifies the factors which could lead to the risk of misstatement arising from misappropriation as follows:

- Classification a - incentives/pressures to misappropriate assets
- Classification b - opportunities to misappropriate assets
- Classification c - attitudes/or rationalization which suggest that misappropriation may take place.

**YOU ARE REQUIRED TO** indicate into which classification each of the above risk factors (1 to 8) falls, and to give a brief explanation as to why each of the factors increases the risk of misappropriation.

## 6.22

**(37 marks 44 minutes)**

Your audit firm was recently appointed as auditors of The House of Persia (Pty) Ltd (following the unexpected resignation of the previous auditor), a medium sized company which sells expensive carpets. The company has a public interest score of around 300 and its annual financial statements are compiled internally. The following information pertains to the company:

1. The company was started twenty years ago and has grown into a large family business with ten outlets situated in upmarket shopping malls in three major cities in South Africa. Individual outlets are not particularly large, but collectively the inventory of carpets is considerable.
2. The shares in the company are held by the Irani family, and all senior positions are held by members of the family. Other positions, for example in the accounting department are also held by family members. The accounting system is computerised.
3. All carpets are imported. Suppliers are mainly situated in Turkey, Iran and Morocco. Ronnie Irani, the managing director and major shareholder of The House of Persia (Pty) Ltd, and his oldest son are responsible for purchasing the carpets. They visit suppliers three or four times a year.
4. A major issue in the imported carpet trade is the sale of fake carpets, and many of the dealers in South Africa have dubious reputations. Fake carpets, which can be obtained very cheaply, are sold to the public as genuine handknotted imported carpets. It is very difficult for anyone who does not have the necessary expertise and experience to determine whether a carpet is genuine or fake. The House of Persia (Pty) Ltd claims that it deals only in genuine carpets, but is currently in dispute with a wealthy customer who is challenging the authenticity of a number of carpets she purchased.

5. Every carpet is unique (no two carpets are the same) in terms of colour, pattern, material used and density of the knots, and cost can vary considerably. Whilst each carpet is supported by some form of purchase documentation, this documentation is not always comprehensive and is frequently in a foreign language. e.g. Turkish. Purchases are made in various foreign currencies. Carpets do not carry any form of identification tag or number, but each carpet can be identified by an expert, by its style, colour, pattern, region etc. When carpets are sent to The House of Persia (Pty) Ltd's outlets a label, giving a brief description of the carpet and its selling price is attached to the carpet. All selling prices are set by Ronnie Irani. Because of the uniqueness of each carpet, there is no standard mark up, and prices can vary considerably. As the carpets sell consistently and do not deteriorate over time, only a small allowance for "obsolete stock" is made each year.
6. There is no tight audit deadline for the upcoming financial year-end audit. However, as the bank relies on the audited financial statements when reviewing its continued support of the company's overdraft banking facilities, a copy must be sent to the bank once the audit is complete.
7. Although the Irani family is concerned about political tensions in the Middle East, they are satisfied that their supply of carpets will be unaffected.

**YOU ARE REQUIRED TO:**

- a) evaluate the risk that the annual financial statements, on which your firm will report, contain material misstatement as a result of *fraudulent financial reporting*. (10)
- b) discuss your *strategy* for the upcoming audit of The House of Persia (Pty) Ltd. (12)
- c) assess the risk of material misstatement of The House of Persia (Pty) Ltd's inventory for the upcoming financial year-end audit. Structure your answer in terms of the assertions. You are not required to consider "presentation and disclosure". (15)

**6.23**

**(40 marks 48 minutes)**

You are a member of the team on the year-end audit of Grandslam (Pty) Ltd for the financial year-end 31 May 2016. You have been assigned to the audit of the acquisitions and payments cycle and early in June you are reviewing the working papers for audit work conducted on the cycle prior to year-end. You have established the following:

1. Grandslam (Pty) Ltd is a medium sized wholesaler in the very competitive sports equipment sector. Sixty percent of the company's shares are owned by Worldsport Ltd, a listed company, with the balance being held by the four executive directors of Grandslam (Pty) Ltd. Grandslam (Pty) Ltd derives many benefits from being part of the Worldsport Ltd group, but the holding company places significant demands on its subsidiaries in respect of trading performance e.g. profit targets. Subsidiaries which do not come up to expectations are sold or closed down. Grandslam (Pty) Ltd has had a difficult trading year and profit has declined. All subsidiaries of Worldsport Ltd must be audited annually.

2. The company's long-term liabilities and current liabilities are reflected in the draft financial statements at 31 May 2016 as follows:

<b><i>Long-term Liabilities</i></b>	2016	2015
	R	R
Worldsport Ltd	1 500 000	1 500 000
Finbank	1 750 000	1 750 000
 <b><i>Current Liabilities</i></b>		
Trade Creditors	4 781 913	4 367 824
Accruals	93 820	90 417

Interest on the long-term loans is set at market rates. The loan from Finbank is secured by personal guarantees from the four directors. In addition, in terms of the Finbank loan agreement, the loan becomes repayable immediately if specified liquidity and solvency ratios are not reflected in the audited annual financial statements.

3. During an interim audit conducted earlier in the year (February) the audit team identified a number of instances where the company had purchased goods for the personal use of the four directors. When confronted with the evidence, the directors claimed that this had simply been an "accounting oversight". The directors paid the company the amounts required to settle the matter including the repayment of the VAT which had been claimed by the company on the purchases.
4. All accounting systems are computerized and are well designed. The four directors form the management team and are involved in the day to day running of the business. There is no audit committee or internal audit department.
5. Grandslam (Pty) Ltd purchases sports equipment from both local and foreign suppliers. Conventional documentation is used in the acquisitions and payments cycle e.g. purchase orders, goods received notes, suppliers delivery notes, etc. Internal documents are sequenced and each department retains a copy of the document(s) it produces e.g. a copy of every GRN is filed in the receiving department.
6. Segregation of duties in the acquisitions and payments cycle is generally sound. For example, all orders are dealt with by the order department (which is headed by Ivan Bassow, the section supervisor) and there is a separate secure receiving area.
7. Audit work on purchases was carried out at the February interim audit and hence no year-end "cut off" procedures have been conducted. The numbers of the last documents used in the cycle for the financial year were recorded by a trainee who attended the year-end inventory count. The trainee also recorded the document numbers of all goods received notes at 31 May 2016 for which the suppliers invoice had not been received.
8. Vinnie Koorhoff, the creditors supervisor, has two creditors clerks reporting to him. His section is responsible for reconciling creditors in the creditors ledger with creditors' monthly statements, resolving (and documenting) queries with creditors, and preparing the monthly creditors payment schedule; creditors are paid by EFT. Vinnie Koorhoff reconciles the creditors ledger and creditors control account in the general ledger on a monthly basis. He has provided you with a list of trade creditors at

31 May 2016. The prior year working papers contain a list of trade creditors at 31 May 2015.

You anticipate that verification work on year-end trade creditors will commence early in July. Your firm does not conduct creditors circularisations.

**YOU ARE REQUIRED TO:**

- a) quantify the risk that the 31 May 2016 financial statements of Grandslam (Pty) Ltd will contain misstatement resulting from *fraudulent financial reporting* as low, medium or high. Justify your answer. (12)
- b) describe the procedures you would conduct to determine whether the company had continued to purchase goods for the personal use of the directors between the interim audit (February) and the 31 May 2016. (8)
- c) describe the audit procedures you will conduct to verify the trade creditors balance reflected in the annual financial statements at 31 May 2016. (20)  
Notes 1: Deal only with the *valuation* and *completeness* assertions.  
2: Do not concern yourself with accruals.

**6.24**

**(25 marks 30 minutes)**

Your firm has recently been appointed auditors of Armtronics Ltd, a large company which markets sophisticated electronic equipment for heavy industry as well as the arms industry. The previous audit firm lost the audit as a direct result of a conflict with Bart Stone the managing director of Armtronics Ltd, over the adoption of various accounting policies by Armtronics Ltd. The conflict had become very heated, due mainly to Bart Stone's aggressive nature, and had led to a qualified audit opinion.

Whilst familiarising yourself with the company and its environment you discover that:

- 1. Bart Stone had risen up through the ranks of Armtronics Ltd with ruthlessness and determination. On the way, he had built his personal wealth on a foundation of shares in Armtronics Ltd.
- 2. he has surrounded himself with an aggressive team of loyal managers. You consider that this loyalty is partially due to the fact that management are not paid a salary but are given a monthly retainer, superior fringe benefits and a percentage of reported profits.
- 3. much of the sophisticated electronic equipment is imported from the United States, Japan and Taiwan whilst exports, particularly arms, are made to the governments of Middle Eastern and African countries.
- 4. you also discover that one of the divisions of the company namely the "Foreign Development Division" sells arms exclusively to companies who in turn sell to mercenary and guerrilla organisations. Bart Stone commented that "the world arms

market is cut throat and secretive, provided that our government customers don't find out who we supply - no problem! We cover our tracks pretty well!"

5. Bart Stone places little emphasis on "historical accounting figures" despite the reasonably sophisticated computer facilities available. The vast majority of computer time is used for forecasting and analysis of worldwide economic trends within the electronics industry. As Bart Stone says "accountants and bankers deal with history - you've got to be a prophet to make a profit!"
6. Armtronics Ltd has an audit committee which consists of three non-executive directors, all of whom are experts in armament manufacture, and Ben du Rand, Bart Stone's brother-in-law, who is the chairman.
7. over the years Armtronics Ltd has reported figures better than its competitors but for the last two years profits have receded. Although there appears to be no real threat of going concern difficulties, liquidity has tightened significantly. The company is heavily committed to long-term borrowings and the company's bankers have indicated that their continued financial support will be reviewed in the light of the audited financial statements for the year under audit.
8. Bart Stone appears unconcerned about the drop off in profits. He has responded to your enquiries by saying "the company is in good shape; the Heavy Industry Division is solid. The Arms Division is thriving with the wars in the Middle East. Last year Armtronics Ltd concluded the first of many contracts with Stone Arms Inc, which is based in Vienna, for the supply of arms to various worldwide governments. The Foreign Development Division - we won't talk too much about that!"

**YOU ARE REQUIRED TO** evaluate the risk the annual financial statements on which you will report, contain material misstatement as a result of ***fraudulent financial reporting***. Your answer should consider:

- a) the incentives/pressures on the company to engage in fraudulent financial reporting.
- b) situations or conditions which provide the opportunity to engage in fraudulent financial reporting and
- c) the attitudes of management which may suggest fraudulent financial reporting.

# **CHAPTER 7**

## **AUDIT SAMPLING**



## 7.1

(20 marks 24 minutes)

The auditor obtains evidence sufficient to be able to draw conclusions which in turn support the audit opinion. Audit evidence is obtained by applying auditing procedures, and these may be applied to an entire set of data, usually referred to as the population, or to part of the population by selecting a sample from that population.

**YOU ARE REQUIRED TO** answer the following questions regarding audit sampling.

1. What is audit sampling? (2)
2. Where an auditor applies procedures to less than 100% of a population, what are the items to which the auditing procedures are applied *collectively* known as? (1)
3. Why is it important that the sample be representative of the population? (2)
4. What is sampling risk? (2)
5. Reduce all steps in an audit sampling exercise to 4 broad stages. (2)
6. What are the 5 factors to consider when planning an audit sample? (2)
7. At the outset of a sampling exercise, what should the auditor determine regarding the population? (2)
8. What are sampling units? Give 3 examples of sampling units in relation to accounts receivable. (2)
9. List four parameters which must be determined when setting the sample size for a statistical sample? (2)
10. What is stratification? Give 2 examples of how accounts payable may be stratified. (3)

## 7.2

(12 marks 14 minutes)

Whilst conducting the audit of Interphase (Pty) Ltd, a large computer software wholesaler, you got into conversation with Joe David, the company's marketing director. In the course of the conversation you commented on the heading used in their latest national advertising campaign:

"Research shows that Interphase software is the most commonly used software on home computers in the country."

You asked Joe David what research was done. He replied:

"We sent out a short questionnaire to a sample of the customers listed on our debtors masterfile. To get a good response we only sent the questionnaire to customers we thought would take the time to respond. Two of the questions we asked were as follows:



**First** whether they “agreed” or “disagreed” that Interphase software meets the needs of home computer users and **second** whether or not they sold more Interphase software to their customers than other brands of software. Most of our customers who returned the questionnaire “agreed” that Interphase software did meet the needs of home computer users, and 72% of those who replied indicated that they did sell more Interphase software to their customers than they did other brands. So that is statistically pretty conclusive.”

**YOU ARE REQUIRED TO**, based on your knowledge of the requirements of meaningful sampling, comment on Joe David’s response.

**7.3**

**(8 marks 10 minutes)**

**YOU ARE REQUIRED TO** select the most appropriate answer to the following questions.

1. The auditor’s objective when using audit sampling is to:
  - 1.1 keep the cost of the audit within a reasonable but acceptable cost budget.
  - 1.2 provide a reasonable basis on which to draw conclusions about the population from which the sample is drawn.
  - 1.3 address one of the limitations of an audit.
  - 1.4 identify only those misstatements or deviations which are material.
2. The risk that the auditor’s conclusion based on a sample may be different from the conclusion if the entire population were subjected to the same procedure is termed:
  - 2.1 statistical risk.
  - 2.2 inherent risk.
  - 2.3 sampling risk.
  - 2.4 non-sampling risk.
3. An approach to sampling which is based on the random selection of the sample items and the use of probability theory to evaluate sample results is termed:
  - 3.1 monetary unit sampling.
  - 3.2 risk based sampling.
  - 3.3 audit sampling.
  - 3.4 statistical sampling.
4. For audit sampling purposes the individual items making up the population which is being sampled are referred to:
  - 4.1 sampling units.
  - 4.2 sampling blocks.
  - 4.3 sampling stratifications.
  - 4.4 sampling transactions.
5. A tolerable misstatement relates to:
  - 5.1 the rate of deviation from prescribed control procedures which is acceptable to the auditor.
  - 5.2 the materiality level set by the auditor when planning the audit.
  - 5.3 the monetary amount of misstatement in a population which is acceptable to the auditor.

- 5.4 the extent of misstatement in disclosure which the auditor regards as acceptable.
- 6. A misstatement or deviation in a population which is clearly not representative of the population is termed:
  - 6.1 a sampling error.
  - 6.2 a constituent of sampling risk.
  - 6.3 a tolerable misstatement.
  - 6.4 an anomaly.
- 7. A lower level of sampling risk which the auditor is willing to accept will:
  - 7.1 result in a smaller sample size.
  - 7.2 result in a greater sample size.
  - 7.3 have no effect on the sample size.
  - 7.4 have no effect on the sample size but will increase audit risk (i.e. the risk of expressing an inappropriate opinion).
- 8. Selecting samples for testing from a population without following a structured technique is termed:
  - 8.1 random selection.
  - 8.2 systematic selection.
  - 8.3 haphazard selection.
  - 8.4 stratification selection.

#### 7.4

(18 marks 22 minutes)

You are the technical partner of Barnard and Burger, an audit firm which has just merged with the firm of Meyer and Mendes to form a new firm, Barnard and Meyer.

In trying to standardise policies for the combined firm, a major disagreement arose regarding the use of *statistical* sampling on audits. Barnard and Burger used statistical sampling extensively for many years, while Meyer and Mendes dispensed with the use of statistical sampling some years ago, relying on judgemental sampling techniques and other forms of testing.

At a meeting of all the partners of the new firm, Harry Sandberg (who was the technical partner of Meyer and Mendes) presents the following arguments against the use of statistical sampling:-

- 1. We found that statistical sampling reduces the degree to which the auditor uses his knowledge of each client and his professional judgement in determining sample sizes and evaluating results. (4)
- 2. Linked to the above: we always feared that a court-of-law would regard us as being negligent for using mathematical trickery instead of professional judgement should we have to defend our use of statistical sampling. (4)

3. It is more cost effective (and less tedious) to obtain more assurance from analytical procedures and less from tests of controls. Our experience was that our sample sizes, using statistics, were becoming too large. (4)
4. We found that each new intake of trainee accountants had to be trained in the use of statistical sampling - in fact many of us never fully understood what we were doing. (3)
5. Finally, there are a large number of practical problems involved with statistical sampling, for example: how can you select a random numbered sample from an unnumbered population (e.g. entries in a purchases journal) not to mention how you generate truly random numbers. (3)

**YOU ARE REQUIRED TO** respond to each of Harry Sandberg's arguments.

## 7.5

**(15 marks 18 minutes)**

The following four situations have arisen at different audit clients:

1. A trainee accountant was conducting audit procedures on cheques (selected by cheque number) using statistical sampling. A cheque that had been selected by random sample was missing. The trainee failed to realise it was missing and simply chose the next cheque in the sequence for his sample. An investigation into the missing cheque would have revealed a material fraud. (2)
2. When designing audit procedures to be implemented in the revenue cycle, the trainee omitted a procedure which required the tracing of invoices to the sales journal. As a result a substantial number of unrecorded sales remained undetected by the auditor. (2)
3. Using a statistical sampling method, a trainee selected a sample from the inventory masterfile of a large wholesaler of consumer goods. The sample was used for testing of inventory for existence by physical count. The trainee carried out the sampling exercise correctly and efficiently enabling him to satisfy himself that the inventory balance did not contain material misstatement arising from the inclusion of non-existent inventory. However a few days later the company's internal audit department unexpectedly picked up a major fraud in the warehousing section which led to the discovery of non-existent inventory in the inventory masterfile. (2)
4. The audit senior planned to obtain his assurance in respect of the client's allowance for doubtful debts in part from tests of controls over credit control and in part from analytical review procedures on doubtful debts applied at year end. The auditor failed to detect that the allowance was materially understated. An enquiry into the procedures employed by the trainee revealed that the trainee had set his tolerable rate of deviation too high when conducting his tests of controls. Breakdowns (deviations) in key controls over the granting of credit were not detected. (3)

**YOU ARE REQUIRED TO:**

- (a) explain sampling risk and non-sampling risk (do not simply give definitions). (6)

- (b) indicate, with reasons, whether the situations described above (1 to 4) should be categorised as sampling risk or non-sampling risk. (9)

**7.6**

**(15 marks 18 minutes)**

Consider the following separately:

1. You have assessed the risk of material misstatement of the accounts receivable balance due to the inclusion of fictitious debtors to be higher than the previous year. What effect is this likely to have on the sample size for a positive debtors circularisation? Justify.
2. This year you will be able to conduct subsequent receipt testing due to a change in the audit deadline. If you decide to conduct a positive debtors circularisation in addition to subsequent receipt testing what is the effect on the sample size for the debtors circularisation compared to the prior year likely to be? Justify.
3. An instruction from the audit manager that the level of assurance required on the audit of all major account headings is to be increased for the current audit compared to the prior year was issued. What effect is this likely to have on the sample sizes used to test the existence of debtors? Justify.
4. A directive from the audit manager that the tolerable misstatement in the accounts receivable balance can be increased compared to the prior year has been issued. What effect is this likely to have on the size of the sample you select for subsequent receipts testing. Justify.
5. A lack of experienced employees in the revenue and receipts cycle at an audit client has led you to expect an increase in the rate of deviation for the tests of controls you are about to conduct on the cycle. What effect is this likely to have on the size of the sample you are about to extract? Justify.
6. You have decided to stratify the accounts receivable population (by amount) before extracting samples. You did not do this the previous year. What effect is this likely to have on the aggregate (total) number of items selected for testing? Justify.
7. The number of debtors in the accounts receivable (debtors) masterfile has increased by 10% to three thousand six hundred and twelve debtors since the prior year end. What effect is this likely to have on sample sizes extracted from the total population of debtors for audit purposes? Justify.

**7.7**

**(15 marks 18 minutes)**

1. You received a memorandum from your audit manager stating that your tolerable rate of deviation for certain tests of controls to be conducted in the acquisitions cycle on the audit of Buy-It Ltd, should be increased from the prior year's tolerable rate of deviation.

2. Your evaluation of the extent to which management has failed to monitor internal controls in the payroll cycle of Messi Ltd, has led you to believe that an increase in the expected rate of deviation over the authorization of overtime payments on time records is necessary.
3. As a result of information obtained when conducting risk assessment procedures on the audit of Castles (Pty) Ltd, you have concluded that the risk of non-existent inventory being included in the inventory balance at year end is substantially higher than for the prior year's audit. You are about to select a sample of inventory items for existence testing.
4. Due to more efficient and timeous record keeping at Spartan (Pty) Ltd, your audit plan for the year end audit will include meaningful subsequent receipts testing for the existence of debtors at year end. This is likely to have an effect on the sample size for the planned positive debtors circularization.
5. The audit manager on the audit of Bolton (Pty) Ltd has instructed the team that he would like to be in a position to gain more assurance from the operating effectiveness of controls so that less substantive work can be conducted.
6. On the audit of Folsom Ltd, the number of inventory items on the spare parts inventory masterfile has increased by three thousand. This is as a result of the company introducing a number of new products. For budgeting purposes the audit senior wants to know what effect the increased number of inventory items is likely to have on the sample size for items to be counted at the year end inventory count. The sample will be statistically based.
7. Citizin Ltd, a large manufacturing company has a substantial amount of money invested in plant and equipment. The fixed asset register reveals thousands of items which vary greatly in value. The audit senior wishes to stratify the plant and equipment population by monetary value in an attempt to make the audit of this section more effective and efficient. However, he is unsure as to whether stratification will, in general terms, reduce sample sizes, all other factors being equal e.g. there is no increase in the risk of material misstatement.

**YOU ARE REQUIRED TO** indicate what the effect on the relevant sample sizes would be for each of the situations described (in 1 – 7) above. Consider each *situation separately* and justify your answer for each.

## 7.8

**(22 marks 26 minutes)**

You are an audit manager at Fergusson and Co. You are reviewing the plan of the audit of a manufacturing company, Rowz (Pty) Ltd. The planning has been done by Steven Denham, the senior on the audit. This is his first large audit as senior.

Fergusson and Co, as part of their standard planning procedures, requires the completion of a pre-printed document titled "Sampling Methods", which details the sampling methods to be used on all major areas of an audit.

Steven Denham's completed "Sampling Methods" form for the upcoming Rowz (Pty) Ltd audit, part of which, is reproduced below:

<i><b>Area</b></i>	<i><b>Method</b></i>	<i><b>Reasoning</b></i>
1. Inventory count	I will choose large value items from the inventory. I will continue doing this until 50% of the inventory value has been counted.	As the auditor's concern is generally over- statement of assets, inventory items must be selected with the emphasis on large items. (4)
2. Purchases	A haphazard selection of 200 purchases of R5 000 or more made by the junior trainee working on the purchases section.	By making a totally random selection, we can, at a later stage, evaluate the results on a statistical basis should we want to. (6)
3. Completeness of Creditors	The completeness of creditors' balances at year end will be tested using monetary unit sampling.	I can use our firm's step by step instructions to implement this statistically based sampling plan as completeness is an important assertion for creditors. (5)
4. Directors Minutes	I suggest a statistical sample here but need advice on which one would be appropriate.	There is a directors meeting held every two weeks other than when the company is shut down for holiday periods. This year there were 24 meetings. I know that we usually review all directors minutes but this seems excessive. A statistical sample would give us a better result quicker. (3)
5. Cost of Plant and Equipment	To verify the cost of plant and equipment, all we need to do is full verification procedures on <i><b>all</b></i> additions for the year. No sampling required.	If we agree the opening balance on the cost of plant and equipment accounts to our prior year work papers and verify all additions, the year end balance will be correct. (4)

**YOU ARE REQUIRED** in your capacity as audit manager, to evaluate, with full explanation, Steven Denham's planned sampling methods and reasoning.

## 7.9

**(26 marks 31 minutes)**

You are a trainee accountant at an international auditing firm. Both statistical and non-statistical sampling is used on audit and from time to time problems arise with the various important elements of sampling, e.g. sample selection, evaluating results, etc. The following problems have arisen on various audits:

### ***Audit 1***

A trainee accountant was using a statistical sampling plan to determine whether the internal controls over the authorisation of journal entries were operating throughout the year. The client is a large national retailer of consumables and there are thousands of journal entries passed during the year. A hardcopy, numerically sequenced journal entry authority (JEA) is compiled which details the journal entry and which must be authorised by one of three accountants in the accounting department before being processed on the system.

As journal entries come from a number of sources there are numerous number sequences. The trainee used the audit software to temporarily resequence the JEAs into one sequence so that a random sample could be drawn. Having done this, he performed the sampling exercise and concluded that the number of unauthorised journal entries was well within the tolerable rate of deviation. Subsequently, another trainee working on bad debt write-offs found a number of unauthorised journal entries. On further investigation it was established that the trainee who had conducted the statistical sample had not confirmed that all the sequences of JEAs had been included in the temporary resequencing of JEAs.

#### **YOU ARE REQUIRED TO:**

- a) explain sampling risk and non-sampling risk. (3)
- b) explain whether the situation above is an example of sampling risk or of non-sampling risk. (3)
- c) discuss whether the trainees conclusion can still be accepted on the basis that his sample results were “well within” the tolerable deviation rate. (4)

### ***Audit 2***

At another client the audit team had decided to perform the following:

- 1.1 subsequent receipts testing as a part of testing existence of debtors at year end, and
- 1.2 testing of completeness of debtors at year end by selecting a sample of post year end receipts from the cash receipts journal and tying them back to the debtors list at year end.

The existence testing was carried out on a statistical basis and the audit team was careful to make sure all aspects of the exercise were carried out properly. The conclusion of the test was “we can state with 95% confidence that the rand value of sales made after year end but included at year end, lies between R80 000 and R90 000”. Other cut-off tests performed subsequent to this revealed that R125 000 of sales made after year end had been included in the year end debtors balance.

For the completeness testing, a small sample of 15 receipts was selected from the several hundred receipts from debtors in the post year end period. Of the 15 selected (haphazard selection) 2 instances were found where the receipt was in respect of a sale made *prior* to the year end but which was not included in the debtors balance at year end. The trainee concluded as follows: “Only two misstatements were identified by the sample; as this represents only a tiny percentage of the total number of receipts in the post year end period, it falls within the limits of tolerable misstatement”.



**YOU ARE REQUIRED TO:**

- a) describe how subsequent receipts testing (1.1 above) is carried out. (4)
- b) explain whether the fact that the result of the existence sampling exercise did not agree with subsequent evidence is an example of sampling risk or non-sampling risk. (3)
- c) discuss whether there would have been any benefit in stratifying the list of debtors by value before the selection of the samples from the various strata took place. (3)
- d) explain how the trainee would have carried out the completeness testing once he had selected the sample of 15 payments from debtors received in the post balance sheet period. (3)
- e) comment on whether you agree with the trainees conclusion in respect of the testing for completeness. (3)

**7.10**

**(30 marks 36 minutes)**

UltraImage Ltd, a large manufacturing company in the printing and stationery sector, has a fully computerised accounting system. The applications are menu driven and are access controlled. One of the modules on the network is “journal entries” and the controls for passing a journal entry are as follows:

1. write access to the module is restricted to a single clerical assistant and the financial controller.
2. all journal entries regardless of which cycle/account headings are involved, are captured through this module.
3. when an employee requires that a journal entry be passed, e.g. a discount adjustment to a debtor’s account, a “Journal Entry Request” (JER) showing the accounts to be debited/credited must be made out and submitted with supporting documentation to one of three senior accounting personnel for authorization. JERs are numerically sequenced.
4. The senior member of staff authorizes the JER (by signing), having scrutinized the supporting documentation, and returns the JER and the supporting documentation to the requester of the journal entry.
5. The supporting documentation is filed and the JER given to the clerical assistant for entry. She captures the journal entries she is given and files the JER in the accounting department’s filing room.
6. A transaction file of all journal entries is kept on the computer by numerical sequence as well as a log of the journal entries.

Your senior is somewhat concerned about the controls over journal entries and has assessed the risk that unauthorized journal entries could be passed as high. He has decided to conduct



a statistically based sample on the journal entries and has asked you to prepare a document (for discussion with the audit team) listing the ten steps in the sampling exercise, and relating each step to testing the authorization of the journal entries.

**YOU ARE REQUIRED TO:**

- a) based on the information given above, state whether you agree with your senior's assessment that the risk of unauthorized journal entries is high. Justify your answer.(9)
- b) prepare the document requested by your senior. (18)
- c) indicate, assuming that we carried out the statistical sampling exercise, and that our projected deviation rate exceeded our tolerable deviation rate, whether we can justifiably assume that fraudulent journal entries have been passed. Explain. (3)

**7.11**

**(30 marks 36 minutes)**

You are working on the audit of Playboy (Pty) Ltd, a company which wholesales computer play stations such as Nintendo and Sony. The company's business model is simple and effective. It imports four different types of play station; these are stacked in their sealed boxes in four designated areas of the warehouse. As orders come in from retailers, the play stations are promptly shipped out in their sealed boxes. At year-end there were roughly fifteen thousand units on hand. Of the fifteen thousand units held, approximately ten thousand were the expensive Sony and Nintendo play stations, (about five thousand of each make) with the balance being made up of the cheaper Creativ and Blaster play stations also in approximately equal quantities.

One of the procedures which your firm has carried out each year at the annual inventory count has been to carefully open a small sample of sealed boxes to confirm that each box contains a play station. The box is then resealed. In prior years no instances of empty boxes had been found; internal controls in the receiving and issuing of inventory and physical controls over inventory are sound. The company has a strong control environment.

However, at the year-end inventory count which is currently underway the same procedure identified a box stacked with the other boxes which was empty but had been carefully resealed. This was the only empty box from a non-statistical sample of thirty boxes randomly selected from the fifteen thousand units.

The members of the audit team are divided on what should be done about this and the following conversation takes place:

Peter Dean: We can ignore it – one empty box in fifteen thousand hardly makes a difference – it's not material.

Roy Sidhu: No, I think we should open another thirty boxes and if we find no empty boxes in that sample, we can ignore it.

Bob Boon: I agree with Peter, one out of thirty is a tolerable error rate.

Creedence Ndlovu: How can you have a tolerable error rate for a test like this? Obviously there has been theft here which is serious. If we think there is theft we have to do something about it. If it comes out later that there has been major theft, the company can sue us for not picking it up. If necessary every box will have to be checked.

Peter Dean: You know the warehouse manager is very fussy about us being careful when opening the boxes so lets just record our finding and move on.

**YOU ARE REQUIRED TO:**

- a) state the assertion to which the procedure of checking the contents of the boxes relates.(1)
- b) comment on the size of the sample selected for this procedure. (7)
- c) comment on the opinions of the audit team based on the conversation recorded above.(12)
- d) comment on whether the warehouse manager should be notified of the empty box. (3)
- e) describe, giving reasons, how you would go about increasing your tests on the contents of boxes. (7)



## **CHAPTER 8**

### **THE REVENUE AND RECEIPTS**

**CYCLE : SALES, DEBTORS,**

**CASH, AND CASH AT BANK**



**8.1****(22 marks 26 minutes)**

The following documents are used in the revenue and receipts cycle of Backwoods (Pty) Ltd a wholesaler of camping equipment.

- |                   |                                |
|-------------------|--------------------------------|
| 1. delivery note  | 6. sales invoice               |
| 2. receipt        | 7. internal sales order        |
| 3. picking slip   | 8. deposit slip                |
| 4. customer order | 9. statement                   |
| 5. credit note    | 10. customer remittance advice |

**YOU ARE REQUIRED TO:**

- a) place the documents in the order in which they are most likely to occur. (5)
- b) explain the purpose of each of the documents listed. (12)
- c) give three reasons why Backwoods (Pty) Ltd numerically sequence their documents.(3)
- d) comment on whether the document numbers on the customer's documents used in the system are useful to Backwoods (Pty) Ltd. (2)

**8.2****(15 marks 18 minutes)**

Greenbox (Pty) Ltd is a large wholesaler of garden equipment. The company's revenue and receipts cycle is well staffed and is divided into clearly defined functions, namely receiving of orders, warehousing (picking), dispatch, invoicing, recording of sales, mailroom and receipting/cashier. It also has a "goods returned" function which handles the return of goods by customers and a credit management section. The following control procedures take place in the day to day running of the company.

- 1. Jonny Greenfingers follows up on trade references supplied by prospective customers seeking credit.
- 2. Carl Camelion, checks the detail on all internal sales orders prepared by the six order clerks.
- 3. Walter Weed, one of the warehouse clerks, makes out a back order note for an item which is ordered but is not "in stock".
- 4. The gate controller counts the number of boxes on the company's delivery truck and agrees it to the delivery notes held by the driver.
- 5. Themba Treetops compares the goods to be delivered, to the picking slip and delivery note as they are packed into boxes for delivery.
- 6. Harriet Hedge phones all debtors who have exceeded their credit terms every 48 hours to establish when Greenbox (Pty) Ltd can expect payment.

7. When customers collect goods they have ordered, they sign a delivery note and retain a copy.
8. Benji Berry checks the sequence of the invoices entered in the sales journal to identify missing invoices.
9. Gustav Glass compares prices on the invoice to the official pricelist and reperforms the VAT calculation.
10. Petrus Prunus regularly reviews bank deposits and investigates any gaps in daily banking.
11. Lolly Lupin makes out credit notes for defective goods which are sold and returned by customers. Before doing so she obtains the authority of Petrus Prunus to issue the credit note.
12. Daisy Dumisa goes through the “back orders” file on a weekly basis to ascertain the status of the backorder.
13. Petrus Prunus reviews the general journal frequently and follows up on any journal entries pertaining to debtors, such as bad debts written off.
14. Internal sales orders sent to the accounting department are filed in numerical sequence.
15. Themba Treetops goes through the days picking slips at the end of each day to confirm that they have all been acted upon.

**YOU ARE REQUIRED TO** indicate the function under which each of the control procedures (1 – 15) is most likely to occur at Greenbox (Pty) Ltd.

### 8.3

**(16 marks 19 minutes)**

Tufftool (Pty) Ltd is a manufacturer of a range of garden and agricultural implements. It is a large company with sound internal controls based on the components of internal control namely:

- \* control environment
- \* risk assessment process
- \* the information system and related business processes relevant to financial reporting
- \* control activities
- \* monitoring of controls.

Each of the following pieces of information relates to the revenue and receipts cycle.

1. When launching a new product (implement/tool), Tufftool (Pty) Ltd’s safety committee considers carefully whether user safety requirements for the product have been complied with.

2. Employees in the revenue and receipts cycle have their responsibilities clearly defined and are rewarded for excellent service.
3. Tufftool (Pty) Ltd's agricultural sales representatives visit farmers in their region. Sales orders from farmers are entered by the salesmen on a laptop computer and sent online to the credit control section in the sales department.
4. The clerk in the credit control section who receives the sales order (see 3 above) will confirm that the farmer is a valid customer and that he is not behind on his payment terms. If all is in order, the clerk will effect the transfer of the sales order to the "sales order file".
5. When pickers in the finished goods warehouse have selected items to be transferred to despatch, they are required to sign the relevant picking slip.
6. Mary Muggins an employee in the credit management section, works exclusively on "debtors relations". She is in regular contact with debtors, making sure that they pay on time and that they pay the correct amount. Where a debtor is experiencing financial difficulty, Mary Muggins will work out a payment plan to minimize any losses the company may suffer.
7. When an amendment to the debtors (accounts receivable) masterfile is required, e.g. addition of a new customer, a masterfile amendment form must be completed. The masterfile amendment forms are pre-printed and pre-numbered and must be referenced to supporting documentation e.g. credit application.
8. The board of Tufftool (Pty) Ltd meets every two months. In addition to other matters on the agenda, the financial controller and sales director make a ratio and trend analysis presentation on all major aspects of the revenue and receipts cycle including new accounts opened, bad debts written off, any debtors who have been handed over, achievements of sales targets by sector, region, product, etc.

**YOU ARE REQUIRED TO** identify the component to which each of the above (1 to 8) relates. Provide a brief explanation for each of your answers.

#### 8.4

**(10 marks 12 minutes)**

You are on the audit team of Spaceman (Pty) Ltd, a company which manufactures cupboards, storage boxes, metal baskets etc. The company's accounting systems are all computerised and located on a local area network. The following policies, procedures and practices are in place at the company:

1. Once Chester Kolbe, the credit controller, has investigated a potential client's creditworthiness, he signs the relevant credit application before taking it to the financial accountant for final authorisation.
2. Employees who work in the revenue and receipts cycle are sent regularly on training courses relating to their functions within the cycle, e.g. when software is updated.



3. When a debtor exceeds his/its payments terms the system automatically puts a “hold” on the debtors account which prevents the debtor from making any further purchases.
4. Online access to the company’s bank account is limited to only five individuals in the company.
5. The ability to download a daily listing of electronic transfers from debtors (receipts) is restricted to two of those five individuals.
6. Orders from customers who have a hold on their accounts are written to a “pending sales order” file.
7. Any programme enhancements made to the revenue and receipts software are subject to a full range of programme change controls.
8. All employees including those in the revenue and receipts cycle are required to sign a confidentiality agreement to the effect that they will not disclose any information pertaining to the company’s clients, customers, suppliers etc.
9. Warehouse pickers have neither read nor write access to the sales order file.
10. Suitable physical protection is provided to inventory held in the warehouse and in the dispatch area.

**YOU ARE REQUIRED TO** indicate whether each of the above is a general control or an application control. Where you have chosen “general control”, indicate the category of general control into which it falls.

## 8.5

**(25 marks 30 minutes)**

A friend of yours, Reg Park, recently purchased all the shares in Crazytimes (Pty) Ltd, a wholesaling company which sells all kinds of goods for outdoor pursuits, e.g. skateboarding, BMX, kayaking etc. The company sells only on credit. Debtors pay only by cheque or EFT. The previous owners who were also the directors, spent more time engaged in outdoor pursuits than in looking after the business, choosing to leave the running of the business in the hands of various “managers” and other employees. The goods which the company sells are popular so the business has survived this ownership neglect, and your friend (an entrepreneur) sees potential in the company. He asked you to have a look at the accounting system and internal controls which you did, only to find that, despite the design, and the documentation of the system being basically sound, the control awareness and proper operation of control activities by employees was poor. The cycle has been broken down into the usual functions for a revenue and receipts cycle and all functions are adequately staffed. On reporting to Reg Park, his response was “OK, as I am the sole director and will not be involved much in the business I want you to explain two things to me. Firstly, if we assume that the staff are honest but careless or as you say, not very control aware, what could go wrong in the revenue and receipts cycle, and secondly, if some of the staff are dishonest, including the managers, how could they be stealing from or defrauding the company?”

**YOU ARE REQUIRED TO** respond to Reg Park by explaining

- a) what could go wrong in the revenue and receipts cycle, assuming that the staff are honest but careless and not very control aware. (15)
- b) how dishonest employees (including managers) could be stealing from/defrauding the company in this cycle. (10)

## 8.6

**(35 marks 42 minutes)**

About 18 months ago, Clinton Clean formed a private company called Scrubbadub (Pty) Ltd. The business of the company is to operate laundromats. Initially Clinton Clean opened only two locations near to his home. However, these proved so successful that he decided to expand the operations to an additional 48 sites, locating the laundromats close to high density apartment areas and institutional residences.

All laundry equipment, e.g. washers and dryers, are cash operated only, charges are based on time, and customers must select the length of time they wish to use the equipment. Once the time has been selected the machine displays the exact amount to be inserted.

Each machine records in its computer memory, a breakdown of each washing time, the total time the machine has been used and the amount charged. This information can easily be downloaded onto a laptop. The machines take coins and notes but do not provide change, i.e. the correct amount of cash must be inserted for the time selected. Each machine has the capacity to store cash equivalent to (equal to) 7 days of continuous use. Once capacity has been reached, the internal strongbox containing the cash must be emptied; until this is done the machine will not function.

Clinton Clean has quickly realized that with 50 locations, he cannot collect cash, bank it and run the business efficiently. He and his wife have kept things going and have reached the point where they need to employ staff whose major function will be to collect and bank cash whilst Clinton Clean and his wife concentrate on other aspects of the business. The laundromats are open for 16 hours a day, 7 days a week, and each laundromat has 2 caretakers (employed by Scrubbadub (Pty) Ltd), each of whom works an 8 hour shift.

Clinton Clean has advised you that he will require 2 assistants (to collect and bank cash) and that they will work 5 days a week as it is only possible for them to visit 5 locations a day to carry out their responsibilities. The machines do not have a removable strongbox; cash can be removed and the machines memory accessed for downloading whilst the machine is in operation i.e. it is not necessary to stop a machine whilst a customer is using it.

As he is concerned about not being directly involved in collecting and banking cash, he has asked you to advise him on an accounting system and related internal controls for cash sales at Scrubbadub (Pty) Ltd.

**YOU ARE REQUIRED TO** advise Clinton Clean accordingly.

You have been on the audit team of Brandwear (Pty) Ltd, a clothing manufacturer for the last two years. You are currently (July) working on the 30 June 2016 year-end audit, and have been assigned to the audit of “cash and bank”.

As part of risk assessment procedures carried out at the planning stage you have been requested by Otis Redding, the financial manager of Brandwear (Pty) Ltd to evaluate the internal controls at “Cashwear”. “Cashwear” is the sales outlet (factory shop) attached to the factory from which clothing manufactured by the company can be bought at reduced prices for cash. Your enquiries into “Cashwear” revealed the following.

1. The outlet was opened in September 2015 for employees of Brandwear (Pty) Ltd only, but had proved so popular that the decision was taken to open the outlet to the general public. Although this increased sales significantly, internal controls at the outlet were not adequately adapted to deal with the increase.
2. Sales are only made for cash; i.e. no cheques, credit cards etc are accepted. The directors will not consider running the shop on anything other than a “cash only” basis, as this significantly reduces administration costs and no losses can be suffered from bad debts.
3. The outlet is located at the back of Brandwear (Pty) Ltd’s finished goods warehouse. Clothing for the outlet can be conveniently transferred onto the shelves and racks in the outlet through an interleading door and employees can come and go as they wish. Customers also have easy access to the outlet, entering (and leaving) directly from the street.
4. The outlet is open during factory hours only i.e. from 7:30a.m. to 4:30p.m.
5. The outlet is run by Greta Garbo. If the outlet gets too busy for her to handle she calls one (or two) of the finished goods stores clerks to assist.
6. As sales are made only for cash, customers are given a receipt. To prepare a receipt Greta Garbo writes out details of the goods purchased on a blank piece of paper, (using a sheet of carbon paper to make a duplicate), enters the sale details and stamps both copies with a Brandwear (Pty) Ltd stamp. The customer is then required to sign both copies of the receipt. The carbon copy is kept in a file by Greta Garbo, and the customer retains the “top copy”. Receipts are only prepared by Greta Garbo, i.e. if she is being assisted by a stores clerk, the stores clerk is not authorised to make out a receipt.
7. Cash from customers is placed in a large metal cash box, which is kept under the counter. Only Greta Garbo and Vish Naidoo, one of the clerks in the accounting department have keys to the cash box. At 4:30 p.m. each day Greta Garbo, or one of the stores clerks, drops off the locked cash box containing the day’s takings with Vish Naidoo. At some stage prior to the commencement of business the following day, Vish Naidoo empties the cashbox, placing the cash in the company safe. At 7:30 a.m. each morning Greta Garbo collects the empty cashbox from Vish Naidoo. (Note. All items sold in the “Cashwear” outlet are priced in multiples of R5, e.g. R25, R30, R55. This works very effectively to reduce the need for Greta Garbo to keep a change float of more than R200).

8. The daily cash from sales in the “Cashwear” outlet is kept in the company safe as described above. On Friday morning Joe Ryder, the senior wages supervisor, takes the money from the safe to make up the week’s wages packets for factory workers. Additional cash to make up the pay packets is always required and to get the amount needed Joe Ryder cashes a cheque at the bank.
9. At the end of each month, Greta Garbo and Joe Ryder notify Otis Redding of the total amount of cash sales made (taken from the filed receipts) and the total amount of cash used for wages (taken from the wage records) respectively.

Otis Redding passes the following journal entry e.g.

Dr Wages	100
Cr Cash Sales	100

Narration: Raising of wage expense and cash sales.

**YOU ARE REQUIRED TO** identify and explain the weaknesses in internal control at Brandwear (Pty) Ltd evident from the information provided in points 1 to 9 above. (Ignore any VAT implications).

**8.8** **(43 marks 52 minutes)**

**PART A** **(25 marks 30 minutes)**

You are a member of the internal audit department at Big Boy Manufacturing Ltd. As part of the department’s regular internal control reviews you have been assigned to arranging and supervising counts of the company’s cash floats. The head of internal audit believes that carrying out these counts enhances the control environment.

The main petty cash float is maintained by the chief cashier. There are, however, three other floats in operation. One is held by the secretary in the buying department, and is used to make small cash purchases. The second is kept by the raw materials storeman and is used for giving change when selling scrap materials, e.g. off cuts. Scrap is only sold to employees and only cash is accepted, no cheques, credit cards or EFTs are accepted for scrap sales. The third float is under the control of the sales director's secretary, and is used to refund occasional entertainment and travelling expenses incurred by the company's sales representatives from time to time. The approximate total amount of cash on hand at any one time is eight thousand rand, and the largest amount of cash (float and sales) is held by the raw material storeman.

All of the cash floats are maintained on an imprest basis.

**YOU ARE REQUIRED TO** outline the steps to be taken/procedures to be followed by members of the internal audit staff when conducting cash counts at Big Boy Manufacturing Ltd.

- a) state whether you agree or disagree with the opinion of the head of internal audit that the cash counts enhance the control environment. Justify your answer. (3)
- b) explain the imprest method of maintaining cash floats. (4)

- c) comment on whether the counts should be conducted on a surprise basis. (2)
- d) describe two precautionary measures which should be taken by an internal auditor when conducting cash counts at Big Boy Manufacturing Ltd. (3)
- e) describe the controls which should be in place to ensure that all the cash sales of scrap raw materials is accounted for. (13)

## PART B

(18 marks 22 minutes)

You are in charge of the audit of “cash and bank” at Beachbreak (Pty) Ltd for the financial year-end February 2016. During the interim audit conducted during late December 2015, you had audited the bank reconciliation at 31 November and found it to be correct. All payments to trade creditors and all other payments over R20 000 made by Beachbreak (Pty) Ltd are carried out by electronic funds transfer. Amounts of R20 000 or less are paid by cheque. During March, as part of your normal year-end procedures, you are preparing to audit the bank reconciliation prepared by Otis Redding and presented below.

### *Bank reconciliation at 29 February 2016 – Beachbreak (Pty) Ltd*

Balance as per cashbook			R127 261.30
Add: outstanding cheques			
49378	3 October 2015	4 446.35	
52133	10 December 2015	15 210.65	
52876	18 February 2016	9 316.00	
53192	22 February 2016	943.89	
53193	22 February 2016	47 209.11	<u>77 126.00</u>
			204 387.30
Add: direct EFT deposit: Note 1			<u>18 649.30</u>
			223 036.60
Less: bank charges and fees for February 2016			<u>163.00</u>
Balance as per Bank Statement 29 February 2016			<u>222 873.60</u>

Note 1: This represents an electronic funds transfer credited in error by the bank, to Beachbreak (Pty) Ltd’s account on the 17 February 2016.

**YOU ARE REQUIRED TO** describe the audit procedures you would conduct on the bank reconciliation of Beachbreak (Pty) Ltd at 29 February 2016.

## 8.9

(28 marks 34 minutes)

You are a member of the audit team on the 30 April 2016 year-end audit of Gone Fishing (Pty) Ltd, a wholesaler of fishing equipment, e.g. rods, reels, fishing boots etc. You have been assigned to the audit of the revenue and receipts cycle. The company sells only on credit to account holders.

At the end of February, the audit team visited the company to carry out the completion of an internal control questionnaire relating to the revenue and receipts cycle.

Towards the end of March, you returned to the company to review the questionnaire extracts of which are attached.

**YOU ARE REQUIRED TO:**

- a) based on the extracts from the internal control questionnaire provided, identify weaknesses in the revenue and receipts cycle of Gone Fishing (Pty) Ltd. For each weakness you identify, explain why you believe it is a weakness. (22)
- b) describe two *tests of controls* you could carry out on each of the 3 controls listed under Function: Order Department *assuming* that the answer to all of the questions was “yes”. Ignore the comments on Schedule 1 when answering this part of the question. (6)

See schedules on the next page.

*Schedule 1 - Extracts from the Revenue and Receipts Internal Control Questionnaire*

	<b>Function: Order Department</b>	<b>Yes/No</b>	<b>Comments</b>
1	Are <i>all</i> orders received from customers, recorded on sequenced internal sales orders (ISOs)?	No	ISOs are only made out for orders received over the telephone. When an order is faxed or sent through the post, an ISO is not necessary as we have a document to work with. ISOs are preprinted but are not sequenced as there is no need for this.
3	Does the order clerk confirm that all orders received are from authorised customers (account holders)?	Yes	The order clerk has a list of all debtors names against which she confirms this. If an order is accepted from a non-account holder, the accounting department will pick it up later on when the customer signed delivery note is sent to the department.
6	Does the order clerk confirm that the order will not result in the customer exceeding its credit limits <i>prior</i> to accepting the order?	No	This is not applicable. Before opening an account for a customer, we request two trade references from the customer which we follow up. Only if these are satisfactory, will we open an account for the customer. There is no need to set credit terms or limits.
	<b>Function: Warehouse/Dispatch</b>		
1	Are goods picked from the stores using sequenced picking slips (ISO)?	No	As indicated above, ISOs are not made out for all orders received. Where an ISO is made out (phone orders) it is sent to the warehouse and used for picking the goods. Where the order is received through the post or by fax, the customer's order/fax is sent by the order department to the warehouse for picking the goods.
4	Does a senior staff member check that all goods picked are supported by a picking slip (either an ISO or a customer order/fax)?	No	This is not necessary. Goods picked are laid out in the picking area for dispatch. Pickers are instructed to pick carefully according to the document they are using to pick goods.



You are a member of the newly established internal audit section of Cold Front (Pty) Ltd, a company which supplies parts and accessories to refrigeration and airconditioning maintenance businesses in the Gauteng region. Cold Front (Pty) Ltd was started by Frans Frost an engineer, some years ago and has never had particularly sound internal controls. The company has grown steadily over the years and the weaknesses in the internal controls has started to have an adverse effect on the business, e.g. lost sales, theft of inventory etc. Hence the establishment of the internal audit section. You have been assigned to evaluate controls in the revenue and receipts cycle, and as your first step, you have compiled the following narrative description of the cycle:

1. The daily incoming mail is opened by the company receptionist and all orders received from customers are placed in a box marked "Incoming Orders". The box is then sent to the senior warehouse clerk who initiates the picking of the items ordered.
2. Some customers fax their orders direct to the senior warehouse clerk prior to sending their orders through the post. The company does not accept telephonic orders; if customers phone to place an order they are requested to submit or fax a hardcopy order.
3. Sales are only made on credit (no cash sales). There is no demand for "over the counter" sales.
4. On receipt of the customer orders/faxes the senior warehouse clerk makes a photocopy of each one. He files the originals alphabetically (by customer name) in a lever arch file. He splits the photocopy orders roughly into two piles and hands a pile to each of the two junior warehouse clerks who, amongst other duties, are responsible for picking the items ordered from the shelves.
5. As the junior warehouse clerks pick the goods from the shelves, they tick off each item picked on the photocopy order. If an item ordered is out of stock, the warehouse clerk puts a cross against the item on the photocopy order. If the order for a particular item can only be partially filled (say 3 out of 5), the clerk crosses out the 5 on the photocopy order and enters a 3. He then ticks the item off. The clerks place the items picked for each order in a plastic basket (called a picking basket) which, once the order has been picked is placed by the junior warehouse clerk on a rack in the dispatch section. The relevant photocopy order is placed in the picking basket with the items picked.
6. In the dispatch section, the senior dispatch clerk makes out a three part, pre-printed, numerically sequenced delivery note, taking the details required to complete the delivery note from the photocopy order. Where an item has a cross against it (out of stock) on the photocopy order, it is **not** included on the delivery note.
7. Once the delivery note has been made out, the items are taken from the picking basket and packed in a box for delivery. The box is labeled by a junior dispatch clerk and the delivery note number written on the side of the box.
8. The company delivers all orders to its customers using a fleet of small delivery vehicles. Boxes to be delivered are loaded onto the vehicles under the supervision of



the driver. The driver is given the list of deliveries to make as well as two copies of the delivery note for each delivery. As the goods are loaded, the driver checks the delivery number written on each box against his list and copies of the delivery notes to ensure that all the correct boxes have been loaded.

9. When a delivery vehicle leaves (or arrives at) the company's premises, a guard at the security gate records the time of departure (or arrival).
10. On receipt of the goods, the customer is required to sign and date both copies of the Cold Front (Pty) Ltd delivery note. The customer retains one copy and the driver keeps the other. On returning to Cold Front (Pty) Ltd, the driver gives the signed delivery notes to Carmen Chetty, the company bookkeeper, who is responsible for writing up invoices, receipting payments from customers, passing credit notes etc. Carmen Chetty and the driver reconcile the signed delivery notes to the driver's list of deliveries and both sign the list.
11. On Friday mornings, Carmen Chetty makes out an invoice for each delivery note received during the week. She obtains the customer details as well as the description and quantity of items delivered from the delivery note and the prices of the items from the official price list. To complete the invoice she does the extensions, casts and VAT calculations. Invoices are pre-printed, sequenced and in duplicate. The top copy is sent promptly to the customer and the second copy remains in the invoice book.
12. Once she has made out all of the invoices, Carmen Chetty writes up the "weekly sales journal" and posts (enters) the sale to the individual debtors account in the debtors ledger. If the entity to whom the sale has been made, does not have an account, Carmen Chetty opens a ledger account for the new debtor.

**YOU ARE REQUIRED TO *identify* and *explain*** the weaknesses in the revenue and receipts cycle at Cold Front (Pty) Ltd, based on the information given above.

You are ***not*** required to make recommendations to resolve the weaknesses.

## **8.11**

**(27 marks 32 minutes)**

You have recently been appointed to the accounting department of Seedbed (Pty) Ltd. Initially, you will be involved with the improvement of the company's financial systems. Reg Rose, the financial controller, has asked you to deal first with aspects of the revenue and receipts cycle.

Seedbed (Pty) Ltd is a wholesaler of a substantial range of seedlings (young plants). The company does not sell to the general public and does not sell for cash. Sales are made only to account holders on credit.

The company does not make deliveries. Sales are made exclusively to retail nurseries, and customers must visit Seedbed (Pty) Ltd's premises (which covers several hectares) to select and collect the seedlings they require.

### ***Selection of seedlings***

When customers arrive at Seedbed (Pty) Ltd's premises, they are met by a seed salesman on a "seedmobile". There are ten seed salesmen each with a seedmobile. The seedmobile is a small motorised cart which is used to drive the customers around the seedbeds, (the premises are too large for customers to walk), so that the customer can select the trays of seedlings he requires. These are placed in the seedmobile and driven to the customer car park area where they are off-loaded into the customer's vehicle. Each seed tray contains 24 seedlings.

### ***Recording the sale***

When a customer arrives, the seed salesman requests the customer's name and account number. Each seed salesman has a hard cover book which contains three-part, preprinted, sequenced invoices. As a customer selects the seedlings, the seed salesman enters the quantity of seed trays taken as well as the code and price per tray for that type of seedling, which are marked on the seed tray. When the customer has completed his or her selection, the salesman completes the invoice by doing the extensions (quantity x price) additions and VAT calculation. Once the seed trays have been loaded into the customer's vehicle, the customer and the salesman both sign the invoice. The customer retains the top copy, the salesman removes the second copy, placing it in a wire basket in the sales office, before moving on to deal with the next customer. The third copy remains in the invoice book. Each seed salesman makes about twenty sales a day.

From the time the invoices are placed in the sales office, the revenue and receipts cycle is computerised. The primary source document for raising sales and the corresponding debtor is the invoice. Each morning Eddie Key, the data entry clerk, takes the previous day's invoices from the wire basket and enters the required information from the invoice onto the system. Reg Rose has informed you that he is not satisfied with input controls over sales. He has specifically requested that a batch system be introduced and that sound control techniques over the entering of source data via the keyboard be in place. He has indicated that Petunia Park, an administration clerk, should be employed fulltime in the sales department and that reasonable expenditure can be incurred in making application programme changes if necessary.

### **YOU ARE REQUIRED TO:**

- a) identify and explain the weaknesses in the revenue and receipts cycle of Seedbed (Pty) Ltd up to the point at which the salesman places the invoice in the wire basket. (12)
- b) describe how a batch system for sales invoices could be introduced at Seedbed (Pty) Ltd. Your description must include the batch controls which should be implemented, and the procedures Petunia Park will carry out. (15)

**8.12**

**(30 marks 36 minutes)**

A friend of yours, Matthew Miller, recently came to see you for some advice. His business, Screen Aids (Pty) Ltd, sells a range of television and computer related products such as computer games, spares etc. The business has grown quickly and Matthew Miller feels that

certain systems require improvement if efficiency and customer service is to be maintained. His initial concerns relate to the revenue and receipts cycle.

Currently customers (account holders only) phone orders through to Screen Aids (Pty) Ltd, using the product catalogue which they are given by Screen Aids (Pty) Ltd. Order clerks take down the details of the order by writing out a multipart internal sales order/picking slip which is then processed through picking and dispatch. As the business has grown, this manual system has proved inefficient and more and more mistakes in deliveries etc, have occurred. Matthew Miller sought the advice of a computer expert who suggests that Screen Aids (Pty) Ltd put a telesales system into operation. This would involve the existing sales order clerks being trained in the use of computers. Each clerk would be allocated to a terminal and would create the necessary documentation on the computer. Customers will still be given up to date catalogues as in the past. The order could then be printed out in the warehouse for picking and dispatch purposes. Matthew Miller likes the idea but wants to clear up some matters with you. He tells you that the computer expert's explanations were too technical and that he didn't want to look stupid by asking the expert too many questions!

However, he has asked you the following questions:

1. If we give each of the three buying clerks their own terminals, surely it increases the risk of unauthorised orders being placed and our other system applications on the network being accessed by unauthorized people. How do we control this? (10)
2. If the order is being taken over the phone how are we going to check on inventory availability and the credit worthiness of the customer, before we dispatch the goods?(4)
3. The computer expert used a number of terms I did not understand in particular, "least privilege", "minimum entry" and "mandatory fields". What do these mean? (6)
4. As far as I can understand, errors could still occur whilst taking orders, for example:
  - 4.1 orders could be taken from customers who aren't approved.
  - 4.2 the sales order clerks may type in incorrect quantities, or product codes, or could even type in the wrong description, and leave out the quantities. Am I correct? (10)

**YOU ARE REQUIRED TO** respond to Matthew Miller's questions.

**8.13**

**(36 marks 42 minutes)**

You are a member of the team on the audit of Tapp Tapp (Pty) Ltd, a company which supplies plumbing requisites (baths, basins, pipes, joints, etc) to plumbing contractors. You have been assigned to the audit of the revenue and receipts cycle and are in the process of evaluating the accounting system and related internal controls in the cycle. Information pertaining to certain aspects of the cycle appears below.

1. The company sells only on credit. This reduces the risks arising from having cash on the premises.
2. All sales are made from Tapp Tapp (Pty) Ltd's premises which consist of a showroom, warehouse and administrative offices under one roof.

3. Plumbing contractors must visit the company's premises to make purchases as Tapp Tapp (Pty) Ltd does not deliver. This suits the contractors as it means they can make their purchases early in the day (the company's business hours are 7am to 5pm) and collect the goods at the same time.
4. Customers (contractors) are served by any one of six technically trained salesmen who sit behind a long counter in the sales area. Each salesman has his own computer terminal.
  - 4.1 when a contractor arrives at the counter, one of the salesmen will enquire as to the contractor's name and, having accessed the "create sales invoice" module, will enter the given name, e.g. Watertite Plumbers CC into the computer. This brings up the customer details on screen which is formatted as a sales invoice. The salesman will then confirm the details e.g. account number, address etc, with the customer by reading the details off the screen to the customer.
5. The contractor's order is then taken as follows:
  - 5.1 to determine inventory availability and price, the salesman accesses the inventory masterfile.
  - 5.2 if the item is available (which is usual) and the customer is satisfied with the price, the salesman proceeds with taking the order.
  - 5.3 to complete the invoice, the salesman enters the inventory item code and quantity of each item required in the relevant fields. This automatically completes the other fields on the invoice e.g. description of goods, selling price, VAT, total selling price. The invoice is automatically sequenced by the computer software.
  - 5.4 the computer then prints out a four-part invoice. The top copy remains in the sales department and is filed. The second copy is sent to the accounting department where it is filed. The remaining two copies are handed to the customer who takes them to the "despatch department" which is a secure area attached to the warehouse. Both copies of the invoice are handed to any one of five despatch clerks who picks the items required from the warehouse. Once the items have been picked, the despatch clerk, using an ink stamp, stamps both copies of the invoice "FILLED" and hands one copy of the invoice to the customer with the goods. The customer then loads the goods onto his vehicle and leaves Tapp Tapp (Pty) Ltd's premises. The remaining copy of the invoice is filed in the despatch department.
6. If a contractor does not have an account, the salesman will select the "open new account" module of the accounts receivable software and, following the screen prompts, will enter the contractor's name, trading name, registration number (if applicable), address and bankers. The salesman will request the contractor's identity document and enter the identity number into the computer. Once this has been completed, the contractor is automatically allocated an account number and added to the debtor's masterfile. He can then make whatever purchases he requires.

**YOU ARE REQUIRED TO:**

- a) explain the internal control objectives of validity, accuracy and completeness in the context of sales in the revenue and receipts cycle. (3)

- b) explain the following assertions pertaining to the accounts receivable balance in the year-end financial statements of Tapp Tapp (Pty) Ltd: existence, valuation, completeness and rights. (5)
- c) identify the two assertions pertaining to the audit of accounts receivable which, under normal circumstances, will attract the most risk of material misstatement. Give brief reasons. (4)
- d) identify and explain the weaknesses in internal control in the aspects of Tapp Tapp (Pty) Ltd's revenue and receipts cycle which are described in points 1 – 6 above. Do not concern yourself with backorders. (24)

#### 8.14

(24 marks 29 minutes)

Jobfixers (Pty) Ltd, a company which supplies a range of tools, has a fully integrated computerised accounting system resident on its local area network. The following activities/procedures take place at some point in the revenue and receipts cycle :

Sales orders (email, phone or fax) are entered into the system. Ben Bolt the sales order clerk, accesses the sales order module and completes an on-screen sales order. This process is subject to a range of application controls which ultimately result in the order which has been taken, being written to a *pending sales order file* or a *sales order file*. All pending sales orders must be approved by Clarence de Wet the credit controller, before the order can be accepted. Clarence de Wet performs this function on the system (i.e. not manually). Processing of sales orders is in real time.

At various times of the day Foster Grove the warehouse administration clerk, accesses the sales order file from his terminal in the warehouse. He selects the sales order he wants to have picked and prints out a copy of the sales order in the form of a picking slip. When Foster Grove selects a sales order for "picking", the system allocates (attaches) a status code to the sales order (on the system) which indicates that it has been selected for picking and is now at the picking slip stage. (The sales order selected is not transferred to a separate picking slip file). Once the tools have been picked, they are moved to the picking control area of the warehouse with the picking slip. At this point, one of the two picking control clerks, checks the tools picked against the picking slip to identify incorrect tools or incorrect quantities picked. The control clerk is then responsible for correcting and approving the picking slip on the system.

Once the picking control clerk has completed his duties, the tools and the hardcopy picking slip are transferred to the despatch area where Joe Hart the despatch controller, performs a final check of the goods before creating the invoice on the system. (Jobfixers (Pty) Ltd sends a copy of the invoice with the goods). Loyiso Gwala is in charge of the warehouse.

#### YOU ARE REQUIRED TO :

- a) give two reasons why a sales order might be placed on the pending sales order file. (2)
- b) explain how approval on the system by Clarence de Wet of pending sales orders, would be successfully carried out. (8)

- c) indicate what access privilege to the sales order file should be given to each of the individuals listed below. Explain your reason for selecting the access privilege you believe should be given:
- (i) Foster Grove, the warehouse administration clerk (2)
  - (ii) The picking control clerks (4)
  - (iii) The pickers (2)
  - (iv) Joe Hart, the despatch controller (3)
  - (v) Loyiso Gwala, the warehouse manager. (3)

**8.15**

**(35 marks 42 minutes)**

Catwalk (Pty) Ltd is a retailer of fashionwear. The company has a very large retail outlet in a shopping mall in Gauteng. One of the company's business strategies has been to concentrate on maximizing turnover.

The selling prices of Catwalk (Pty) Ltd clothing are generally higher than those of similar fashion retailers but credit is given freely. This has resulted in large bad debt write offs but management believes that the policy has provided greater profits in the long run.

However, with the appointment of a new financial director, Vikram Kader, the company has decided to discontinue the policy of maximizing turnover "at all costs" and to concentrate on developing a good customer base and managing debtors efficiently.

The existing system works as follows:

1. The accounting systems are all computerised. When a new customer wants to purchase clothing he or she is offered credit. If the customer wants to open an account, the customer is taken by any one of the sales personnel to a private office at the back of the retail outlet. The salesperson accesses the "masterfile amendment" module of the revenue application, selects the "add new customer" option, and completes the "on screen" application form which appears, by keying in the customer's details, name, phone numbers, address, identity number.

The customer is then asked what credit limit they require. Once all the information has been keyed in, the debtors masterfile is updated.

2. The software allocates a "customer account number" to the new customer and a small plastic card bearing the customer's name and account number is printed out. This is handed to the customer, who returns with the salesperson to the sales counter where the customer's purchases are entered onto the system from the terminal at the counter.
3. When a customer who already has an account wishes to make a purchase, he or she simply provides the salesperson with his or her "customer account number". The salesperson enters the account number provided and if it is accepted, charges the goods to the customer's account.

Vikram Pather has, inter alia, requested that new application software be written for the revenue and receipts. You, a member of the debtors section in the accounting department at Catwalk (Pty) Ltd, will be part of the data control group responsible for the preparation and entry of data onto the new system.



### YOU ARE REQUIRED TO:

- a) identify, with a brief discussion, the weaknesses in those aspects of the existing revenue and receipts system described in points 1 to 3 above. (15)
- b) describe the controls which should be put in place to ensure that all additions of new customers to the debtors masterfile are **valid**. You are **not** required to consider accuracy and completeness. (10)
- c) outline briefly the controls other than those carried out by the data control group, which should be put in place to ensure that the debtor information put onto the new revenue and receipts system is valid, accurate and complete. (6)
- d) describe four control procedures which should be conducted by the data control group in respect of the preparation and entry of data onto the new system. (4)

8.16

(45 marks 54 minutes)

Supplyline (Pty) Ltd is a company which supplies a wide range of household goods to other companies, CCs and traders in the Eastern Cape region.

The company sells only on credit to approved account holders. The company generally has a satisfactory internal control system but changes in the method by which debtors pay their accounts, means that some changes are required. The major change is that far more debtors are paying by electronic funds transfer directly into the company's bank account. There are still some debtors who pay by cheque (this is expected to continue) and some of the traders in the more rural areas still deposit cash directly in Supplyline (Pty) Ltd's bank account. Moses Mabida, the financial accountant has told you that there are quite often problems with identifying exactly which debtor has made the EFT payment into the company's bank account. He also tells you that he wants to link the company to its bank so that a daily bank statement can be downloaded and printed out. EFTs can then be posted (entered into) the debtors' accounts daily. (Note: He does **not** want to use the facility which allows the bank statement to be downloaded into the company's system. The company already posts its sales to the debtors accounts daily so entering payments from debtors daily will result in "up to date records". The company's accounting applications are computerized. Moses Mabida has asked you to recommend a system for the receiving and recording of payments from debtors, EFTs, direct (cash) deposits, and cheques. He informs you that you should ignore the system that is currently in operation and make the recommendations you deem appropriate based on what should be done. However, he has identified the employees in the company to whom you can allocate duties as follows:

- \* Clarissa Chetty – the receptionist
- \* Loverboy Zumah – debtors clerk Note 1
- \* Samuel Kramer – messenger and general administration clerk
- \* Millicent Scott – credit controller Note 1
- \* himself (Moses Mabida) – financial accountant Note 1

Note 1: If they do not already have it, these three employees will be given access to the local area network to the level necessary to perform their functions.

**YOU ARE REQUIRED TO** recommend an internal control system for the receipting and recording of payments received from debtors. Do not concern yourself with the control environment, risk assessment or monitoring components of the system.

**8.17**

**(20 marks 24 minutes)**

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

Accounts receivable	R2 631 981
Sales	R9 246 124

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

***Accounts receivable***

Accuracy:	All credit sales have been accurately recorded.
Existence:	The possibility does exist that debtors included in the R2 631 981 will not pay the amount they owe.
Obligation:	All debtors included on the list have agreed to pay and therefore have an obligation to do so.
Validity:	Only genuine debtors have been included in the balance of R2 631 981 i.e. there are no fictitious debtors.

***Sales***

Recognition:	All revenue in the form of sales has been recognized.
Collectability:	The proceeds from all sales recorded have been or will be collected.
Valuation:	The amount of R9 246 124 represents the total value of sales made.
Rights:	Safe-T (Pty) Ltd has the right to include all sales even though some debtors may not pay.

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

**8.18**

**(12 marks 14 minutes)**

The following procedures were carried out on the audit of Biscuitboys (Pty) Ltd, a company which manufactures and sells biscuits to numerous food retailers.



1. Inspected the authorizing signatures on a sample of masterfile amendment forms and supporting documentation e.g. credit application form for new customers added to the debtors masterfile during the year.
2. Enquired of the credit controller as to whether Biscuitboys (Pty) Ltd is required to comply with any regulations contained in the Consumer Protection Act. The company does not sell to the general public.
3. Conducted subsequent receipt testing on a sample of the debtors balances at the financial year end.
4. Inspected a sample of credit notes and supporting documentation for the signature of the credit controller.
5. Discussed the plans to expand the business by supplying food retailers in neighbouring countries with the marketing director.
6. Observed the picking control clerk checking the goods selected by the warehouse pickers against the picking slip.
7. Read the monthly management reports pertaining to accounts receivable and credit sales to identify any problems which had arisen in the revenue and receipts cycle.
8. Enquired of the warehouse manager as to whether he had write access to the sales order file.
9. Obtained a confirmation of the balance owed at the financial year end to Biscuitboys (Pty) Ltd by each of the three major food retailers the company supplies.
10. Reperformed the aging of a sample of debtors accounts.

**YOU ARE REQUIRED TO** state whether each of the above is a risk assessment procedure, a test of controls or a substantive procedure. If you consider that a procedure could be a dual purpose test, justify your answer.

## 8.19

**(37 marks 44 minutes)**

You are currently (June) engaged on the audit of Mutterworths (Pty) Ltd, a wholesaler of books, and have been placed in charge of the audit of accounts receivable. The company has a 30 June financial year-end and an audit deadline of 15 July 2016. As a result of the audit deadline you decided to circularize debtors at 30 April 2016 and to perform roll forward tests for the months of May and June. The debtors masterfile reflects that the company has approximately 375 debtors ranging from very large retail outlets to small specialist bookshops. Your firm makes use of generalized audit software which has a very effective circularisation application.

Your initial analysis of the debtors masterfile at 30 April had revealed the following.

Total amount owed to Mutterworths (Pty) Ltd	R1 738 294
Number of new accounts opened during the current financial year	47

Number of accounts with balances over R75 000	9
Number of accounts under R5 000	235
Number of duplicated accounts, credit balances, missing fields, etc	nil

Ageing of total amount:	30 days – R850 938
	60 days – R656 254
	90 days – R60 744
	120 days – R170 358

Your firm's policy is to perform only positive debtors circularisations and with the co-operation of Ukay Zedden, the debtors controller, you were able to successfully incorporate your circularisation letters into the company's debtors statement run on 25 April 2016.

By the end of May all debtors, other than the three below had confirmed that the balances reflected on their confirmations were correct and you are about to follow up on the following responses:

Debtor	Balance	Response
Boekwurms CC	R43 076	As our previous correspondence with Mutterworths (Pty) Ltd has indicated, we are not going to pay one cent of this amount. It represents a charge for incorrect textbooks which were delivered to us. We ordered the 3 <sup>rd</sup> edition of the book and the 2 <sup>nd</sup> edition (which is out of date) was delivered. The books have been stored in our warehouse for 6 months waiting collection by Mutterworths (Pty) Ltd. We simply will not pay. (5)
Printables (Pty) Ltd	R116 250	This balance is overstated by R45 511. A payment by EFT which we made to Mutterworths (Pty) Ltd in February 2016 (and which went through our bank on 7 February) does not appear to have been credited to our account. (6)
Bookreview (Pty) Ltd	R62 500	This balance is overstated by R22 000. In error we placed the same order for a textbook twice and received both orders. The debtors controller at Mutterworths (Pty) Ltd agreed that we could return the duplicated consignment for credit which we did on the 18 <sup>th</sup> April. See your goods returned note RN2471. (4)

#### **YOU ARE REQUIRED TO:**

- a) explain whether a positive debtors circularisation provides evidence in respect of all of the assertions relating to accounts receivable. Do not concern yourself with the assertions relating to presentation and disclosure of accounts receivable. (8)

- b) explain why some auditing firms may choose not to perform negative debtors circularisations. (2)
- c) indicate, giving reasons, the basis on which you would have decided which debtors accounts you would have included in your sample of debtors to be circularized. (6)
- d) describe briefly the “roll forward procedures” you will conduct to supplement your debtors circularisation. (6)
- e) describe the procedures you would carry out in respect of the responses received from debtors included in the table above. (Marks for each as indicated in the table.) (15)

## 8.20

(25 marks 30 minutes)

You are on the audit team of Mello Music (Pty) Ltd, a distributor of musical instruments. As the company has a tight reporting deadline, your firm carried out an interim audit to 30 April 2015. The financial year-end is 30 June 2015. You are responsible for the audit of the revenue and receipts cycle and as part of your interim audit, you carried out reasonably extensive work on accounts receivable at 30 April, including a positive debtors circularisation. As part of your verification of accounts receivable at 30 June, your senior has requested that you conduct procedures on the debtors control account for the months of May and June as part of your roll forward procedures. The debtors control account for May and June as it appears in the general ledger of Mello Music (Pty) Ltd, is as follows:

01/05	Balance	b/d	1 723 080	31/05	Cash	CRJ 101	821 016
31/05	Sales	SJ 127	797 333	31/05	Discount allowed	DJ 52	62 104
31/05	Discount reversal (Note 1)	J64	18 250	30/06	Goods returned June	GRJ 14	42 102
				30/06	Bad debts (Note 4)	J 69	15 200
24/06	Sales	SJ 132	921 888	24/06	Cash	CRJ 107	694 831
30/06	Sales (Note 2)	J68	98 017	30/06	Discount allowed	J 66	37 896
30/06	Sales (Note 3)	J68	<u>72 400</u>	30/06	Balance	c/d	<u>1 957 819</u>
			<u>3 630 968</u>				<u>3 630 968</u>
01/07	Balance	b/d	1 957 819				

Note 1. Reversal of discount previously given to Violet Violins CC. 30 day settlement discount erroneously granted. Debtor paid at 60 days; therefore no discount due.

Note 2. Raising of sales for period 25 June to 30 June. (Sales journal closed off at 24 June.)

Note 3. Raising of sale to Wonder Pianos (Pty) Ltd. This amount relates to an imported piano in which Wonder Pianos have expressed an interest and for which a formal order is expected in August.

Note 4. Amount owed by Chellos (Pty) Ltd, written off as company placed in liquidation.

**YOU ARE REQUIRED TO** describe the procedures you will conduct relating to the debtors control account given above.

**8.21**

**(45 marks 54 minutes)**

Your firm has recently been appointed as auditors of Wallandall (Pty) Ltd, a distributor of paint. Prior to becoming a private company, Wallandall had been a close corporation, but had decided to convert from a close corporation to a company. The conversion took place on 1 April 2015. Despite having a public interest score of less than 100, the company in terms of its Memorandum of Incorporation, is required to have an annual external audit. When it was a CC, Wallandall underwent neither an audit nor a review.

The following information, inter alia, was obtained when conducting procedures to identify and assess the risk of material misstatement through understanding the company and its environment:

1. Accounting systems at Wallandall CC (although computerised) were not well maintained and internal controls were generally poor.
2. Although the directors realised that attention needed to be given to the systems, little was done to resolve the problems until the latter part of the year.
3. On 1 March 2016 (a month before year end) Cherry Checkitt joined the company as internal auditor. This was a new position. Her first responsibility was to evaluate and improve systems at Wallandall (Pty) Ltd and to this end she, inter alia, obtained approval for the appointment of a credit controller from 1 April 2016.
4. Shortly after it was announced (in early February 2016) that Cherry Checkitt would be joining the company as internal auditor, the company's debtors manager, Adam Brown resigned suddenly requesting that he be allowed to leave within a week as he intended emigrating. He had been with Wallandall for five years during which time he had been solely responsible for all aspects of sales and debtors, e.g. receiving payments, passing adjusting entries, credit control, maintaining ledgers etc. His responsibilities had been taken over by Gunston Smith the senior debtors clerk who had quickly discovered that Adam Brown had "done things his way". There were numerous long outstanding debts, unexplained adjusting entries to debtors, a lack of audit trail (documentary evidence) as well as little evidence of regular reconciliations and problem resolution. Other than obtaining approval for the appointment of a credit controller (see pt 3) Cherry Checkitt had not been able to spend much time on the revenue and receipts cycle prior to year end. For the purposes of the year end balance, Gunston Smith has produced a reconciliation of the debtors ledger and the debtors control account and produced an aged list of debtors.
5. The debtors balance has increased steadily over the years and there are, at year end, some two thousand four hundred debtors in the debtors masterfile ranging from nil balances to thousands of rands. The debtors balance at year end is material.
6. The company has a substantial overdraft facility which the directors wish to retain although ultimately they would like to reduce it. The bank is pleased that the company

will be presenting audited financial statements to support its request to retain the overdraft facility, but have indicated that they are hoping to see a “healthy set of figures”.

7. There is no specific audit deadline particularly because this is the first audit of the company.

**YOU ARE REQUIRED TO:**

- a) indicate whether the fact that this is an audit required by the company’s Memorandum of Incorporation and not by virtue of the company’s public interest score, will have any effect on your assessment of
  - i the risk of misstatement in the financial statements
  - ii the audit strategy and audit plan. Justify. (4)
- b) based on the information given above, evaluate the risk of material misstatement in the trade debtors (accounts receivable) account balance at 31 March 2016. (12)
- c) discuss the *nature* of testing you will incorporate into your audit plan for the 31 March year end audit of debtors (accounts receivable). (8)
- d) explain why your audit team may have difficulty in testing the *completeness of sales* at Wallandall (Pty) Ltd. (4)
- e) describe how you would perform subsequent receipts testing and comment on whether subsequent receipts testing will identify fictitious debtors. (6)
- f) describe the procedures you will carry out in respect of the allowance for bad debts. (11)

**8.22**

**(25 marks 30 minutes)**

PumpIt (Pty) Ltd is a wholesaler of industrial pumps of all shapes and sizes. It is a subsidiary of a listed company and is required to have its annual financial statements externally audited. The financial year end is 31 March. The audited financial statements must be lodged with the holding company twelve working days after the year end. To address this tight audit deadline, your team’s audit strategy was to conduct as much work as possible at an interim audit at the end of January, and then perform roll forward procedures on the two months prior to year end.

At the interim audit you spent some time on verification of the debtors balance at 31 January 2016. This included a positive debtors circularisation. This circularisation produced satisfactory results but resulted in a small number of adjustments to the debtors ledger and debtors control accounts becoming necessary. The client was in agreement with these adjustments. You have now returned for the final audit and are about to commence procedures on the debtors control account for the months of February and March 2016. The debtors control account appears in the general ledger as follows:

Date	Account	Ref	Amount	Date	Account	Ref	Amount
1/02	Balance	b/d	5 472 915	28/02	Cash	CRJ73	2 187 840
28/2	Credit Sales	SJ47	2 531 804	28/02	Credit Notes	CNJ17	104 145
25/3	Credit Sales	SJ52	2 183 727	28/02	Special discount	J43	81 000
31/3	Mightyflow CC	SJ44	92 150	15/3	Note 2		
	Note 1			31/3	Adjustment	J45	87 200
31/3	Credit Sales	J47	352 214	31/3	Note 3		
	Note 4			31/3	Cash	CRJ79	2 946 906
					Bad debts	J49	225 413
					Note 5	c/d	5 000 306
			<u>10 632 810</u>				
	Balance	b/d	5 000 306		Balance		<u>10 632 810</u>

James Jett the debtors controller at PumpIt (Pty) Ltd, has supplied you with the following information:

- Note 1. A pump to the value of R92 150 was loaned to Mightyflow CC in March on trial with the understanding that if the pump met Mightyflow CC needs, the CC would purchase the pump.
- Note 2. This was a special discount given to Maxipressure (Pty) Ltd. The discount of 25% of the unit sale price of the pump was granted because the pump was damaged.
- Note 3. This amount represents the adjustments arising from the debtors circularisation conducted by the auditors at the end of January 2016.
- Note 4. This journal entry raises the sales made between 25 and 31 March 2016. The sales journal was closed off on 25 March. The last invoice number on 25 March was X3792 and the last delivery note D4918.
- Note 5. This represents a write off of the full amount owed by Waterworx (Pty) Ltd. The company has gone into liquidation and the liquidator has informed PumpIt (Pty) Ltd that creditors are unlikely to receive any more than 25% of the amount owed to them. The financial director of PumpIt (Pty) Ltd is of the opinion that the company will receive nothing.

**YOU ARE REQUIRED TO** describe the procedures you will conduct relating to the debtors control account of PumpIt (Pty) Ltd at 31 March 2016.

**8.23**

**(38 marks 45 minutes)**

Your audit firm has performed the audit of Talking Heads (Pty) Ltd for many years. The company, which started out as a small family owned retailer of ladies hats, has grown into a large business selling all kinds of headwear to numerous different markets.



These include the mining industry, safety, fashion, sport and government/provincial departments. The financial year-end of the company is 31 March and you are currently (early April) part of the audit team working on the 2016 year-end audit. You have been assigned to the audit of the revenue and receipts cycle. Accounts receivable is, along with inventory, a material amount in the statement of financial position.

At the end of June 2016, Talking Heads (Pty) Ltd became a wholly owned subsidiary of Apparal Ltd, a holding company with numerous subsidiaries in the clothing and textile sector. Although no major changes took place in the management structure of Talking Heads (Pty) Ltd, the Apparal Group's business practices have had a significant effect on Talking Heads (Pty) Ltd.

1. Apparal Ltd, the holding company, places great pressure on its subsidiary companies to achieve monthly revenue and profit targets. Directors and managers of the subsidiaries are not paid bonuses for achieving targets (they are, however, well remunerated), but poor performance is likely to result in the removal or demotion of the respective directors and/or managers.
2. To bring Talking Heads (Pty) Ltd into line with other subsidiaries, Apparal Ltd instructed the board of Talking Heads (Pty) Ltd to extend the payment terms from 60 days to 120 days and increase credit limits of existing debtors. They also instructed the company to make creditworthiness checks on new customers less stringent in an attempt to increase the customer base and turnover. Talking Heads (Pty) Ltd had previously applied strict credit control policies.
3. From the start of the new financial year (April 2016) Talking Heads (Pty) Ltd introduced a computerised telephonic sales (telesales) operation, appointing Andy Capp as the telesales manager. All account holders receive a catalogue which provides an inventory code number, description and price for each product available from Talking Heads (Pty) Ltd. Telephonic orders from customers are directed to the four telesales operators who key in all necessary information directly into the system via their terminals to initiate the sales process. The telesales system has been fully integrated with other relevant applications. (Talking Heads (Pty) Ltd's accounting systems are fully computerized.)

The accounts receivable masterfile contains the following information :

- account number
- account holder's name and details
- amount owed
- ageing of amount owed i.e. 30, 60, 90, 120 days, over 120 days
- credit limit and credit terms
- handed over to attorneys (a date entered in this field indicates that the debtor has been handed over for collection)

**YOU ARE REQUIRED TO:**

- a) discuss the risk of material misstatement relating to accounts receivable reflected in the statement of financial position of Talking Heads (Pty) Ltd at 31 March 2016. Your answer should conclude as to whether the risk has increased, decreased or remained the same, compared to the prior year. (6)

- b) describe the audit procedures (including any risk assessment procedures) you would conduct in respect of the allowance for bad debts made by Talking Heads (Pty) Ltd at 31 March 2016. (15)
- c) describe the internal controls you would expect to find in respect of the new computerized telesales system to ensure that telephonic orders are valid, accurate and complete. (17)
- Do not concern yourself with inventory availability or back orders.

## 8.24

(35 marks 42 minutes)

Your firm holds the appointment of auditor of Paperwait (Pty) Ltd, a company which sells paper (of all kinds) to printers, companies, stationery shops etc. You have been assigned to the audit of the revenue and receipts cycle for the year end 31 May 2016. This will be the third year that you have worked on this audit and revenue and receipts in particular, and you have come to respect Monty Zuma, the accounts receivable manager, as well as the other financial staff for their hard work, honesty and competence.

All of the company's financial systems are computerised. Interim audit work carried out during the year has confirmed that the systems are well designed and that they operate effectively.

The company has a large customer base. It does not export, selling exclusively to the local market, but on a national basis.

Although the company is financially sound, with a strong customer base, competition in the market has become very fierce within the last 12 months. Paperwait (Pty) Ltd has responded to this by improving its service, e.g. prompt delivery, frequent calls on customers, and by increasing customer credit limits and extending payment terms.

Current assets in the draft financial statements are as follows:

	2016	2015
	R'000	R'000
Inventory	5 876	4 486
Accounts Receivable	7 921	6 729
Bank	<u>497</u>	<u>268</u>
	14 294	11 483

The debtor's masterfile consists of the following fields:

debtor's account number	:	e.g. Mul 303
name	:	e.g. Multicopy
address and contact details	:	4 Press Way, Pinetown, 3016 etc
total amount owed	:	R426 013
age of total amount owed	:	current, 30 days, 60 days, 90 days and over
credit limit	:	e.g. R500 000
credit terms	:	e.g. 60 days



status of account : the letter “h” (for hold) is entered in this field if there is a problem with the account.

The company’s software also has an enquiry facility which enables a user to print out a detailed account reflecting all the transactions with the debtor for the preceding twelve months.

For a number of years the company has set its allowance for bad debts at year end by applying the same percentages each year to the aged breakdown of the total amount owed by debtors. The percentages used in prior years are as follows:

Current	-	0%
30 days	-	2%
60 days	-	5%
90 days and over	-	15%

Once the allowance has been calculated, it is approved at the monthly directors’ meeting.

In discussion with your manager at a planning meeting, you decided that to test existence of debtors at year end, you would not obtain direct confirmation of balances from debtors by circularisation or other means, but would adopt other procedures to test existence.

Your firm has excellent audit software which you and your audit team are able to make use of. Included in your workpapers from the prior year’s audit, is a list of Paperwait (Pty) Ltd’s debtors and their balances at 31 May 2015 held on a memory stick.

During October 2015, Marcel Roux, the financial director of Paperwait (Pty) Ltd decided that the company should connect to its bank (Stanwest Bank) via the Internet to enable it to obtain “up to the minute” information about its bank account, download bank statements and make electronic funds transfers. The major reason for this decision was that Paperwait (Pty) Ltd had requested its debtors to pay their accounts by making payments directly into Paperwait (Pty) Ltd’s bank account and not to send cheques through the post. In late October, Stanwest Bank installed the necessary software onto Paperwait (Pty) Ltd’s local area network. This menu driven software is used with success by many of the bank’s clients.

#### **YOU ARE REQUIRED TO:**

- a) identify the controls which you would expect to find in place at Paperwait (Pty) Ltd to prevent the unauthorized downloading of bank statements via the Internet. (7)
- b) discuss the risk of material misstatement pertaining to accounts receivable as reflected in the 31 May 2016 financial statements based on the information given above. (8)
- c) describe the audit procedures you would carry out in respect of the verification of the accounts receivable balance at 31 May 2016. You are only required to consider the *existence* and *valuation* assertions. (20)

You are a member of the audit team currently engaged on the 31 March 2016 external audit of Style Council (Pty) Ltd, a large supplier of clothing to the retail trade. Fashion garments make up a significant portion of Style Council (Pty) Ltd's sales. Style Council (Pty) Ltd does not manufacture garments but acquires its inventory from local manufacturers. The company is financially sound and the directors run the company in terms of strong ethical business principles. You have been assigned to the year-end audit of trade debtors and during late March, you attended a meeting at which the internal audit manager and the financial controller of Style Council (Pty) Ltd, as well as your audit manager, were present. At the meeting the following information was forthcoming:

1. It is anticipated that the balance on the trade debtors account at year end will be about R7 million, making up a very significant portion of current assets.
2. The company has a wide range of debtors both in terms of rand value and in nature and size of customer. For example, the company supplies large retailers (e.g. Edgars) as well as medium to small clothing shops and fashion boutiques.
3. From the 1st January 2016, the company converted its computerised trade debtors and related applications onto a new computer system. Good systems development controls were implemented before installation and both internal audit and your firm's computer audit division were involved in the project. Since the conversion, internal audit has continued to perform post implementation reviews on the system.
4. As part of the post implementation review, internal audit conducted positive debtors circularisations at 31 January and 28 February. In view of this, your audit manager has instructed you not to carry out a debtors circularisation for purposes of this audit. Other members of your audit team have conducted tests of controls, as well as some roll forward tests, on the revenue and receipts cycle (and related applications) for January, February and March. These tests have proved successful. This section of the audit team will also perform sufficient "cut-off" tests on the relevant cycles at 31 March.
5. The audit deadline is 31 May 2016 and is not considered to be particularly tight.
6. The following fields are contained on the debtors masterfile:
  - \* account number
  - \* name
  - \* address
  - \* total amount owed
  - \* total amount aged: current, 30 days, 60 days, 90 days, 120 days and over.
  - \* credit limit
  - \* credit terms
  - \* status query code 1 = unresolved dispute with debtor  
code 2 = internal letter of demand sent  
code 3 = handed over to lawyers for collection

**YOU ARE REQUIRED TO:**

- a) comment on whether the risk of material misstatement relating to trade debtors at 31 March 2016 should be regarded as low, medium or high, based on the information given above. (6)
- b) comment on whether the fact that there is no strict audit deadline affects *audit risk*. (2)
- c) describe the conversion controls which would have been put in place when converting Style Council (Pty) Ltd's previous debtors system onto the new system, to have made it a successful conversion. (8)
- d) describe the substantive procedures you will conduct (both manual and computer assisted) to verify that trade debtors are fairly presented at 31 March 2016. (24)

## **CHAPTER 9**

# **PAYROLL AND PERSONNEL CYCLE**



## 9.1

(15 marks 18 minutes)

The following documents/records are found in most businesses. Some are applicable to the payroll cycle and some are not

* cash receipt	* masterfile amendment form
* income tax tables	* cheque requisition
* clock card	* internal order
* union fee deduction return	* batch control sheet
* employment contract	* purchase journal
* goods received note	* credit note

### YOU ARE REQUIRED TO:

- a) indicate which of the above documents/records will be used in the payroll cycle, and for each document/record identified, provide a brief description of what it is used for. (8)
- b) state the order in which the documents/records will be used in the cycle and indicate which function(s) will use them. (7)

## 9.2

(15 marks 18 minutes)

The functions within the payroll cycle for a company with a reasonably large workforce will be as follows:

1. personnel
2. timekeeping
3. payroll preparation
4. payment preparation and payment
5. deductions: payment and recording

The following actions/policies/controls are procedures carried out at Hastings (Pty) Ltd, a manufacturing company with a large number of hourly paid employees:

1. The factory security personnel observe the clocking in and out of factory workers each day. Employees must insert their clockcard into a timing device to record their times of entry or exit.
2. Background checks are carried out and interviews are conducted with prospective employees.
3. The head of the payroll section reviews the period-to-period wage reconciliation.
4. Before entering their unique passwords to effect the electronic transfer of amounts into employees' bank accounts, the senior members of management who authorize payments scrutinize the supporting documentation carefully.
5. The financial accountant confirms by inspection of the documentation, including payment records that deductions (such as PAYE) have been paid to the correct bodies (e.g. SARS) timeously.

6. To enter (key in) the hours worked from the clockcard, the wage clerk must first key in the individual's employee number.
7. The factory foreman authorizes all overtime by signing the clockcards before they are sent to the wage section.
8. A copy of all warning letters given to employees arising out of disciplinary hearings is filed in the employee's personnel file.
9. A clockcard is prepared for each employee for the wage period (two weeks); each card is carefully checked to the masterfile of employees before being handed to the factory administration clerk to be placed in racks at the entry/exit point.
10. At the end of the wage period the factory administration clerk divides the clockcards into batches, creates various control totals e.g. record count, and enters the details onto a batch control sheet.

**YOU ARE REQUIRED TO:**

- a) identify the function within which each of the above (1 to 10) will take place. (5)
- b) explain briefly the risk(s) which each of the above (1 to 10) is implemented to address. (10)

**9.3**

**(10 marks 12 minutes)**

**YOU ARE REQUIRED TO** select the most appropriate answer for each of the following:

1. In the context of a company's payroll system, a "fictitious employee" is best described as
  - 1.1 a non-existent person to whom a wage or salary is paid
  - 1.2 an illegal immigrant who is employed by the company and is paid a wage or salary
  - 1.3 an individual who works full time at the company but is employed by a labour broker
  - 1.4 a living person or a non-existent person who is paid a wage or salary by the company but is not employed by the company.
2. The major benefit of a biometric scanning timing device over a clock card system is that use of the biometric device
  - 2.1 records entry and exit times more accurately
  - 2.2 allows the automatic download of hours worked directly onto the system
  - 2.3 eliminates the opportunity for an employee to clock fictitious hours for an employee who is actually absent from work
  - 2.4 allows the company to reduce supervisory level employees.
3. The assertions relating to the salaries account heading are
  - 3.1 rights, occurrence, completeness and validity
  - 3.2 occurrence, completeness, accuracy, cut-off and classification
  - 3.3 occurrence, completeness, allocation and existence.

- 3.4 cut-off, completeness and accuracy.
- 4. Discussions held between the human resource manager and the auditor pertaining to the appointment policies of the company will generally be regarded as
  - 4.1 tests of controls
  - 4.2 an “other” audit procedure
  - 4.3 a “further” audit procedure
  - 4.4 a risk assessment procedure.
- 5. Inspection of a sample of employee masterfile amendments forms for the signatures of two senior employees authorizing the amendment will be a
  - 5.1 substantive test
  - 5.2 test of controls
  - 5.3 test of detail
  - 5.4 risk assessment procedure.
- 6. Comprehensive analytical procedures conducted on the monthly salary expense account heading will be a
  - 6.1 substantive procedure
  - 6.2 test of controls
  - 6.3 test of detail
  - 6.4 evaluating and concluding procedure.
- 7. For a new employee to be successfully entered on the employee masterfile, the payroll software requires that the employee’s identity number and income tax reference number be entered in the designated fields. This programme control would be regarded as a
  - 7.1 regulatory check
  - 7.2 dependency check
  - 7.3 mandatory field check
  - 7.4 authorisation check.
- 8. When entering (keying in) normal hours worked from a clockcard, the payroll software will not allow the data entry clerk to enter a number greater than 80 in the “normal hours worked for the 2 week period” field for an individual employee. This programme control is described as
  - 8.1 an alphanumeric check
  - 8.2 a mandatory field check
  - 8.3 a limit check
  - 8.4 a validation check.
- 9. The implementation of the two signatory principle by requiring that an EFT payment is both “authorized” and “released” (by different employees) is regarded as
  - 9.1 an access control
  - 9.2 a detection control
  - 9.3 a custody control
  - 9.4 an output control.
- 10. Downloading a bank statement which can be used to confirm the accuracy, completeness and validity of EFT salary payments is



- 10.1 an authorization control
- 10.2 a detective control
- 10.3 a corrective control
- 10.4 a general control.

#### 9.4

(18 marks 22 minutes)

#### YOU ARE REQUIRED TO:

1. state whether the following sentence is true or false and justify your answer. The major difference between wages and salaries is that wages are paid in cash and salaries are paid by electronic funds transfer or by cheque. (2)
2. identify the main functions into which the payroll cycle of a large manufacturing company should be divided. (2)
3. explain the control objectives of completeness, accuracy and validity in the context of wages paid on the basis of hours worked. (3)
4. describe briefly the assertions relating to the wages account heading. (3)
5. briefly describe the three common methods used by companies to record hours worked by hourly paid employees. (4)
6. explain the term “cashless wage system”. (1)
7. explain briefly why the payroll cycle of a large organization will be susceptible to fraud if internal controls in the cycle are not strong. (3)

#### 9.5

(12 marks 14 minutes)

Freezit (Pty) Ltd manufactures refrigerators at its factory in a small town in KwaZulu Natal. The company has about 150 hourly paid employees and around 25 salaried personnel. Although salaries are paid by EFT directly into employees bank accounts, hourly paid workers require that their wages be paid in cash. A sound control environment has been created within the payroll cycle and appropriate control activities (as listed in (i) to (v) below have been implemented.

- (i) good segregation of duties
- (ii) isolation of responsibility
- (iii) sound access/custody control
- (iv) authorisation/approval
- (v) frequent and regular comparison and reconciliation

Consider each of the following:

1. Employees in the personnel department are regularly sent on courses to update their knowledge on disciplinary procedure and wage negotiation.

2. The production foremen check the “hours worked” calculations entered on the clockcards by the factory administration clerk, for all employees in their sections. They sign each clock card in the designated space.
3. Freezit (Pty) Ltd makes use of an independent security firm to, inter alia, cash the wages cheque and conduct the wage payout.
4. Access to the prepare payroll module of the wage application is restricted to Matt Ebersohn the senior wage clerk.
5. Each foreman is provided with a schedule which reflects the prior wage period’s (two weeks) net wages and the current wage period’s net wages for his section, and details how the difference came about. The schedule is reviewed by the foremen and confirmed against relevant supporting data where necessary e.g. records of employee absenteeism.
6. Once he has prepared the payroll, Matt Ebersohn, the senior wage clerk presents the payroll to Rob Reitz, the wage payroll administrator, to review and sign.
7. The bank’s software which enables Freezit (Pty) Ltd to make EFTs is loaded only on the terminals of the financial manager and the head of the personnel department.
8. Cedric Seal, the financial manager and the production manager attend every wage payout as observers.
9. At the conclusion of the wage payout, the security company hands all unclaimed wage packets to Rob Reitz, wage payroll administrator. He agrees the details on the paypackets e.g. name and section, to the payroll ensuring that there is an unclaimed packet for all employees who have not signed and vice versa. If all is in order Rob Reitz and the security company sign the unclaimed wage register.
10. A directors minute must be obtained when a senior salaried employee is appointed.

**YOU ARE REQUIRED TO** indicate which of the above (1 to 10) contribute primarily to the sound control environment, and which are examples of control activities as listed in (i) to (iv) above. Identify the type of control activity into which the procedure falls.

## 9.6

**(20 marks 24 minutes)**

The following actions/policies/procedures have been implemented at Skinman (Pty) Ltd, a manufacturer of shoes, bags, etc from animal hides.

1. The production manager and his foreman prepare and authorize a schedule of any overtime to be worked during the upcoming week.
2. All employees, regardless of their status in the company must display their unique identification card on their clothing when they are on the company’s premises.

3. Each hourly paid employee must place his thumb on a biometric scanner to gain access to the work place and to record his time of arrival. (The same process is carried out to record time of departure.)
4. Before wages are processed, the production manager carries out an on-screen approval of overtime hours recorded.
5. To effect an EFT payment into a salaried employee's bank account both the human resource director and the financial director must enter their passwords and an additional "once off" password provided by the system.
6. Salaried employees are issued each month with a *sealed* salary advice which provides a breakdown of the amount paid into their bank accounts.
7. Employees in the human resource department are sent on an annual labour law seminar which covers changes in laws and regulations pertaining to employment.
8. When an employee is added to the employee masterfile, the employee's identity number is a mandatory field.
9. The human resources manager scrutinizes the log of amendments made to the employee masterfile.
10. The system produces an exception report of any wage amounts calculated which appears unreasonable in terms of the grade of that employee.

**YOU ARE REQUIRED TO:**

- a) indicate whether each of the above (1 to 10) is a general control or an application control. (10)
- b) discuss whether each of the above is a detective or preventive control. (10)

**9.7**

**(12 marks 14 minutes)**

You are the senior on the audit of Diggers (Pty) Ltd a construction company with a medium sized workforce. Wages for the current financial year reflected in the final trial balance amount to R7 321 421 and you asked your junior trainee what the assertions relating to this account heading are. He responded as follows:

- |            |   |
|------------|---|
| Accuracy:  | the wage amount of R7 321 421 is accurate, in other words all wages have been included in the amount.                               |
| Valuation: | wages are paid according to the different grades of employee. More senior employees are paid more because they have a higher value. |
| Rights:    | employees have the right to be paid in terms of their employment contracts.   |

Obligation: Diggers (Pty) Ltd have a legal obligation to pay wages and in the case of the current financial year that obligation is for R7 321 421.

Validity: all amounts included in the total of R7 321 421 are for work actually performed by employees during the year.

**YOU ARE REQUIRED TO** comment on your trainee's understanding of the assertions. Justify your answer.

**9.8**

**(34 marks 41 minutes)**

1. Deepdiggers Ltd, a mining company, has a large workforce of around 5000 workers, many of whom are migrant workers from rural regions and neighbouring countries. The company has a formal risk assessment process which includes a risk committee which meets twice a year to identify and assess risks faced by the company, and consider whether the risks are being appropriately responded to. The risks relating to human resources are always an item for discussion on the agenda.

**YOU ARE REQUIRED TO** describe briefly five risks which a company such as Deepdiggers Ltd might face relating to its workforce. (5)

2. Magoo (Pty) Ltd has a workforce of approximately one hundred hourly paid employees. Hours worked are recorded using a conventional clockcard and clocking device system, but the preparation of the payroll is computerised and wages are paid by EFT. Wages are paid every two weeks. At the conclusion of the wage period, the factory administration clerk Joel Jantjies, carries out various control procedures on the clockcards for the preceding two weeks, batches them, and takes them himself to Brandon August the wage clerk, for entry into the system.

**YOU ARE REQUIRED TO :**

- a) describe the control procedures which Joel Jantjies should carry out on the clockcards prior to batching them. (3)
- b) describe the batch controls which should be carried out on the clockcards up to the point they are accepted by Brandon August. (8)
3. Glasscon (Pty) Ltd, a manufacturer of glass containers, has recently been awarded a major contract which will require the company to employ approximately thirty new hourly paid factory workers. With recruiting procedures completed, the newly appointed personnel must be added to the employee masterfile. The company's payroll cycle is fully computerised.

**YOU ARE REQUIRED TO** describe the controls which should be carried out to ensure that only validly appointed new employees are added to the employees masterfile and that all details pertaining to the additions, are accurately and completely recorded. (12)

4. Hourly paid employees at Bingo (Pty) Ltd record their hours worked on clockcards. Each employee's hours are then entered onto the system by the wage clerk.

**YOU ARE REQUIRED TO** briefly describe six programme (automated) controls which will contribute to ensuring that hours are only entered by the wage clerk for valid employees, and that hours entered are accurate and complete. (6)

## 9.9

**(50 marks 60 minutes)**

Woodcrate (Pty) Ltd manufactures large wooden boxes and pallets which are sold to the transport industry. The company's head office is in Johannesburg (most transport companies operate out of Gauteng), but its factory is located in a very small Eastern Cape town. This location was chosen because of its proximity to forestry areas (e.g. Sappi and Mondi) and to a good pool of labour.

You are a member of the finance and administration department at head office and have been asked by the newly appointed financial controller to evaluate the wage system.

Accordingly you arranged to visit the factory and meet Max McCarthy the general manager, to gather information about the system. This meeting provided very little information. Max McCarthy informed you that all he did was sign the wage cheque, "Joe Percy the senior administration clerk leaves the wages cheque on my desk on a Thursday afternoon and I sign it so that the cash can be drawn to make up the pay packets on Friday morning. I suggest you talk to Joe Percy." At your meeting with Joe Percy he provided you with far more information as follows:

1. The factory employs about one hundred semi-skilled workers. Box and pallet construction is labour intensive and this number can fluctuate.
2. The senior staff at the factory consists on Max McCarthy (general manager), Carlton Smith (factory foreman), Ken Ncgobo (inventory controller) and Joe Percy himself (senior administration clerk). Joe Percy is assisted by Buzi Gumede, a general administration clerk.
3. All accounting systems with the exception of wages, are run at head office. All matters pertaining to factory employees and the processing and payment of wages are dealt with at the factory.
4. Woodcrate (Pty) Ltd's head office banks with Nedbank. However, the only banking facilities in the small town in which the factory is located, is a branch of FNB. Factory employees insist on being paid in cash and to make this possible, head office has arranged a large overdraft facility at FNB. The weekly wage cheque, cheques for paying over deductions, e.g. PAYE, and other incidental running costs are drawn against the overdraft. Each Friday morning Joe Percy phones head office and informs the accountant of the total amount of cheques drawn for the week. The accountant then arranges for this amount to be transferred to the FNB account to reduce the overdraft. The approved signatory on the FNB account is Max McCarthy. The monthly bank statement and paid cheques from FNB are sent to him. He writes up a simple cash book, reconciles it to the bank statement and prepares a summary of

expenses for the month. The summary is faxed to the head office accountant. The bank statements, paid cheques and weekly payrolls are filed by Buzi Gumede.

5. The wage week runs from Thursday morning to the following Wednesday afternoon. Clocking in is not supervised and workers are responsible for clocking themselves in and out of the factory by passing their clock cards through a clocking device at the factory exit/entry point. The clock card records the time of entry and exit.
6. On Wednesday afternoon, when all employees have left, Joe Percy's assistant, Buzi Gumede, collects the clock cards from the racks at the entry/exit point and replaces them with new clock cards for the following wage week commencing the next day. Clock cards are prepared by Joe Percy (see point 7), or Buzi Gumede if Joe Percy is not available.
7. Wages are processed on a stand alone computer. The wage application is menu driven. To prepare the upcoming week's clock cards, Joe Percy loads blank clock cards into the printer and selects the appropriate module from the wage application menu. The clock cards are then printed for all employees listed on the employee masterfile. The wage week, name and employee number are printed on the clock card. A clock card cannot be printed if the employee is not on the employee masterfile.
8. On Thursday morning Buzi Gumede calculates the hours on each clock card, both normal and overtime, enters the totals in the appropriate spaces on the clock card and initials each card. She then passes the clock cards to Joe Percy.
9. When Joe Percy receives the clock cards from Buzi Gumede on a Thursday morning he selects the "prepare payroll" module from the menu and proceeds to enter the normal and overtime hours for each employee from the clock cards into the computer. If an invalid employee number is entered, it will be rejected. Once the hours from all the clock cards have been entered, the computer reads each employee's hourly wage rate from the masterfile, calculates gross wages, effects deductions for PAYE, UIF etc, and compiles the payroll. A copy of the payroll is printed out as well as a pay slip and envelope for each employee's wages. The wage application software includes an appropriate range of programme controls for data input and processing.
10. Carlton Smith (factory foreman) decides if additional factory employees are to be hired. The company does not employ "casual" labour and all employees must have a South African identity number. New employees are interviewed by Carlton Smith and must sign an employment contract. Once this has been done, Buzi Gumede accesses the "masterfile amendment" module of the wages application and adds the new employee to the employee masterfile. The employee number is automatically generated by the computer. If an employee is dismissed or resigns, Carlton Smith prepares a "resignation/dismissal form" which is signed by the employee and Carlton Smith and is given to Joe Percy. He in turn amends the employee masterfile to record the dismissal/resignation.
11. Joe Percy writes a cheque for the net wages and prepares a coinage schedule, and as indicated earlier, has the cheque signed by Max McCarthy. (He also prepares the cheques for deductions made from employees which must be paid over to other parties, e.g. PAYE to SARS and ensures the amounts are paid over by due date.)



12. Early on Friday morning, Joe Percy and two factory security guards, cash the cheque at the FNB branch and return to the factory with the money in a locked portable cashbox. Only Joe Percy and Buzi Gumede have keys. The cashbox is handed to Buzi Gumede. She checks the cash in the cashbox to the amount of the cheque in the presence of Joe Percy before she makes up the pay packets.
13. At 3.30pm on Friday, Carlton Smith, Joe Percy and Buzi Gumede conduct the wage payout.

**YOU ARE REQUIRED TO *identify* and *explain*** the weaknesses in Woodcrate (Pty) Ltd's internal control process for the (wages) payroll cycle. Your explanation must convey why you believe the weaknesses you have identified, are weaknesses.  
You are not required to make recommendations.

**9.10**

**(45 marks 54 minutes)**

You are a newly appointed internal auditor at Calpak (Pty) Ltd. The company is a manufacturer of backpacks and bags for sporting equipment. The company employs approximately 120 hourly paid semi-skilled workers, equally spread over the three sections, cutting, stitching and finishing. Each section has a section supervisor who reports to the factory foreman. The wage payroll system is currently completely manual but management now wish to computerize the system. As the first phase of this exercise you have been asked to evaluate the system so that the company will have a better understanding of what weaknesses the computerized system must address. Your initial enquiries have revealed the following:

1. Wages are paid every two weeks. The wage period runs from a Thursday morning to a Wednesday afternoon two weeks later. The work day commences at 7.30am and employees work a daily eight hour shift.
2. On arrival at their section, employees report to their section supervisor who records their presence by ticking the appropriate column on the *daily time sheet*. (See 7 below)
3. Work periods are controlled by a factory siren (hooter). Employees commence work when they hear the siren at 7.30am and end the days shift at 4.30pm, again when the siren sounds. The siren is also used to control tea and lunch breaks.
4. Workers are not required to sign themselves out at the end of the day, but if they continue to work after 4.30pm, they must notify their section supervisor. On reporting for work the following day they must inform their section supervisor of the number of hours overtime they worked the previous afternoon/evening. The section supervisor records this on the daily time sheet against the employee's name.
5. Three administration clerks from the accounting department are responsible for certain payroll functions. An administration clerk is allocated to each of the three sections i.e. cutting, stitching and finishing.

6. Each administration clerk maintains a ledger of all wage earners in the section for which he is responsible. The factory foreman is responsible for hiring and dismissing staff (as well as receiving notices of resignation). When a change must be made to the employee ledger, the foreman sends a completed, pre-printed, sequenced “Employee Engagement / Dismissal / Resignation Form” to the section administration clerk. This contains full details of the employee, e.g. date of engagement/dismissal, grade and pay scale. The clerk updates his ledger, and files the instruction from the foreman.
7. On Wednesday morning the administration clerks prepare the daily time sheets for their section for the following wage period. Daily time sheets are preprinted and sequenced (each section has its own unique sequence). The sheets consist of a column for the names of employees in the section, as well as a column for each day of the working week in which the section supervisor can tick off each employee’s (daily) attendance and enter any overtime worked.
8. Before 7am on a Thursday morning, the administration clerks take the daily time sheets (for the following wage period) to the supervisor of the section for which they are responsible, and collect the completed wage period’s time sheets. The supervisor and the administration clerk sign the completed wage period’s time sheets to acknowledge the transfer.
9. The administration clerks then prepare the weekly payroll for their section. They calculate the normal hours worked (each “tick” represents 8 hours) and the overtime hours for each employee from the daily time sheets. The employees hourly pay rate is obtained from the employee ledger and overtime is calculated at the rate of one and a half times the normal wage rate. Using the relevant schedules and tables, the administration clerks calculate PAYE, UIF and medical aid deductions and calculate the net wage payable to each employee as well as the total wages (and deductions) payable for their section. The payroll is preprinted, well designed and pages are numerically sequenced in a bound book.
10. Once the payrolls for the three sections have been prepared, they are sent to the factory accountant who re-performs the calculations on the payrolls, makes any corrections, and signs the payrolls to acknowledge his control procedures. He then prepares and signs cheques for the net wages and all deductions to be paid over e.g. PAYE. The cheques are sent to the financial accountant for a second signature and the payrolls are returned to the respective administration clerks. The factory accountant also prepares a coinage schedule.
11. On receipt of the payrolls the administration clerks prepare a pre-printed paypacket for each employee in their section by writing the details of the employee and the period’s wages onto the paypacket.
12. On the Friday morning of a wage payout, Calpak (Pty) Ltd’s security section takes the cheque and the coinage schedule to the bank. The cash is placed in three numbered bank bags (per the instructions from Calpak (Pty) Ltd), sealed, and delivered to the administration clerks by security. The three administration clerks make up the paypackets for their section according to the payroll.



13. At 3pm on a payout Friday, the administration clerks (accompanied by a security guard) distribute the paypackets from three pay points within the factory. Wage earners must present their staff identity card, and sign the payroll next to their names on receiving their wages. As there are only approximately 40 wage earners per section, the payout is completed without significant delay. (Note: do not concern yourself with unclaimed wages.)
14. During the course of the following week, the administration clerks update the employee ledger with details of each employee's wages and deductions.

**YOU ARE REQUIRED TO:**

- a) *identify* and *explain* the weaknesses in the payroll cycle of Calpak (Pty) Ltd based on the information given above. Your explanation must convey why you believe that the weaknesses you have identified are weaknesses. (30)
- b) For each weakness, explain in general terms if, and how, a computerized wage system would address the weakness. (15)

**9.11**

**(40 marks 48 minutes)**

Times (Pty) Ltd is a manufacturer of timing devices. In addition to a large salaried staff, the company employs about 100 skilled and semi-skilled wage earners. As part of the planning for the audit, you obtained the following information:

1. The 100 employees are spread evenly over three sections.
2. Each section is headed by a foreman. The foremen report to Reagon Seconds, the factory manager.
3. The three sections are located in a single factory building and to enter or leave the building, hourly paid employees must pass a clock card through a clocking machine to record their time of entry or exit and to activate the control gate. The clock is located at the control gate. There is only one point of entry/exit.
4. The clocking procedure is observed by Ben Bigg the factory administration clerk who has a glass fronted office overlooking the clocking area.
5. Employees work Monday to Friday and are required to "clock-in" by 7am and "clock-out" at 4pm. Any additional time worked is regarded as overtime. Overtime work is carefully planned and scheduled by the section foreman. Reagon Seconds authorizes the schedule of overtime.
6. Wages are paid every two weeks and the clockcards for each wage period are prepared in the human resources department and sent to Ben Bigg with a listing of each employee for whom there is a card. Ben Bigg agrees the cards to the list, signs the list and retains a copy.

7. The wage period runs from Thursday morning until Wednesday afternoon two weeks later. Early on the Thursday morning Ben Bigg collects all the clock cards for the wage period just completed from the racks next to the clocking machine, and replaces them with the clockcards for the two week wage period commencing that morning.
8. Once the previous period's cards have been collected, various batch controls and other procedures are carried out before the clockcards are taken to the wage office by Ben Bigg.
9. The wage office is staffed by the paymaster, Jerome Jantjies, and his assistant, Preston Ngcobo. The wages are processed using application software developed and maintained by the company itself. Enhancements to the software are made from time to time by Times (Pty) Ltd's small information technology (IT) section to keep the application up to date with tax requirements and to provide management with better information for controlling wages, which is a major expense. The company runs all of its accounting applications on a local area network and the IT department is headed by Shakira Maharaj.
10. Preston Ngcobo is responsible for preparing the payroll. Once he has received the clockcards, he selects the "enter hours worked" module and then captures the employee number, as well as the normal and overtime hours from each clockcard. Once he is satisfied that the hours captured are accurate and complete, he selects the "process payroll" option to effect the processing of the payroll. The software is well designed and includes a number of programme (automated) controls to provide valid, accurate and complete capture and processing of data.

**YOU ARE REQUIRED TO:**

- a) explain the internal control objectives of validity, accuracy and completeness in the context of the payroll cycle. (5)
- b) describe the batch controls and other procedures which should be in place from the time Ben Bigg collects the completed wage period's clockcards from the racks, to the time Preston Ngcobo accepts the clockcards from Ben Bigg. (12)
- c) identify and explain the controls which should be in place to prevent unauthorized access to the wage application and its various modules on Times (Pty) Ltd's local area network. (8)
- d) briefly explain the following programme control and give an example of how each control could be used to assist Preston Ngcobo in capturing valid, accurate and complete data
  - \* mandatory field check
  - \* verification check
  - \* limit check
 (3x2) (6)
- e) describe the internal controls which should be implemented over enhancements to the wage application software. (9)

**9.12****(40 marks 48 minutes)**

Hay Sixteen (Pty) Ltd is a wholesale distributor of agricultural products. Its accounting systems are computerised and are resident on a local area network. The following information pertains to the company's computerised salary system:

1. All employees at Hay Sixteen (Pty) Ltd are salary earners. There are no hourly paid employees.
2. The company has a staff of approximately 75 employees.
3. All personnel matters are the responsibility of the company's human resource section which is headed by Katherine Ppear and staffed by Ian Patty and Kim Robbits.
4. Derek Dark is the financial manager and he has overall responsibility for all accounting and financial matters.
5. All salaries are paid by electronic funds transfer on the last Friday of every month.
6. The employee masterfile is maintained by the human resource department along with all relevant supporting employee documentation.
7. EFT payments are made via the internet. The company's bank has loaded its software onto the company's system to facilitate the payment of salaries by EFT and the downloading of bank statements and other documentation as required. There is also an enquiry facility on the company's bank accounts.

**YOU ARE REQUIRED TO** describe the application controls you would expect to find in place at Hay Sixteen (Pty) Ltd to ensure that salary payments are valid, accurate and complete.

**9.13****(10 marks 12 minutes)**

You have been assigned to the audit of salaries on the audit of Libvest Ltd, a large listed investment company. The company has approximately 5 000 employees, located in 10 offices around the country. As a result of information gathered when conducting "identifying and assessing the risk of material misstatement" procedures, it has been decided that some testing for fictitious employees should be carried out. You have been requested to select a sample of employees for verification. All salaried employees are listed in the salaried employees masterfile. The masterfile contains the following fields inter alia

1. Surname and initials
2. Bank account number (salaries are paid by EFT)
3. Taxation Reference number
4. Identity number
5. Grade, e.g. grade 1 – company director, grade 12 – junior clerk
6. Date of employment
7. Date of Resignation, Dismissal, Retirement
8. Home address

9. Work location – e.g. Cape Town office

Your senior has instructed you to extract any reports/samples from the salaried employees masterfile which could be used to gather evidence which might assist in determining whether the masterfile includes any fictitious employees, e.g. lists of employees (if any) whose records on the masterfile reveal information which may raise uncertainty as to their existence as valid employees of Libvest Ltd.

**YOU ARE REQUIRED TO** briefly describe the reports/lists/samples you would extract to comply with the instructions from your senior. Explain briefly why each list or sample would be selected. Include only reports/samples which could be extracted using the fields listed above (1 to 9).

**9.14**

**(30 marks 36 minutes)**

Canned Heat (Pty) Ltd manufactures heaters of various kinds, including domestic appliances, and industrial heating units. You have been included in the team for the current year-end (31 July) audit and are very pleased to have been placed in charge of the audit of wages. As Canned Heat (Pty) Ltd is labour intensive, “wages” is a major expense. The company is a subsidiary of a listed company and there is a tight reporting deadline.

Whilst conducting risk identification and assessment procedures in late April, you ascertained the following :

1. No major changes in the accounting system and related control activities have taken place since the prior year’s audit.
2. Generally internal controls are satisfactory,
  - 2.1 there is sound division of duties in the payroll and personnel cycle;
  - 2.2 employee hours are recorded using a conventional clockcard system. A reliable software package is then used for the processing of wages and the production of the wagesheets and related documentation, including “period to period” reconciliations;
  - 2.3 wages are calculated and paid (by EFT) every two weeks;
  - 2.4 the personnel department maintains a file for each employee in which important copies of documents pertaining to the employee are filed, e.g. employment contract, notification of wage rate and increases etc.
3. The company is split into four manufacturing divisions, each division having a number of cost centres.
4. Month to month production is reasonably constant throughout the year (inventory on hand is built up gradually throughout the year to meet winter sales).
5. The wage employee masterfile contains fields for name, personal details (e.g. identity number, tax reference number), grade, division, cost centre, relevant dates e.g. employment, resignation/dismissal, earnings and deductions, current week and year to date. Your firm’s audit software (which has good analytical facilities) is compatible with the client’s system.

Your scrutiny of the prior year audit work papers revealed that the further audit procedures conducted on the prior year audit of Canned Heat (Pty) Ltd's wages were based upon the following plan :

- \* A single two-week wage period in May was selected (in prior years, the overall audit strategy included an interim audit held during the month of May).
- \* During this two-week period, tests of controls on the payroll system were conducted.
- \* The wage payroll for the selected period was substantively audited in detail, and
- \* Using this (audited) two-week period as a base period, analytical procedures were conducted on the wage periods prior to the base period.
- \* At the year-end audit, wages paid subsequent to the base period were also compared to the base period.

At clients where "wages" is a major expense, your firm's strategy always includes testing for fictitious employees.

The prior year audit had been efficiently and effectively conducted. As part of the supervisory process at your firm, trainees are required to discuss the further audit procedures they plan to conduct with the audit manager prior to commencing the procedures. You decided it would be appropriate to adopt the same plan as used on the prior year audit on the current audit of wages.

At your meeting with the manager held at the end of April, he posed the following questions :

- a) How do you justify your decision to adopt the prior year's plan (as explained above) for the current year's wage audit of Canned Heat (Pty) Ltd? (7)
- b) What procedures do you intend to carry out to ensure that there are no fictitious employees on the payroll for the selected two week period? (8)
- c) Can you broadly describe the substantive tests of detail you will carry out on the selected period's payroll. (8)
- d) Can you outline briefly the analytical procedures you intend to conduct on wages once you have carried out the detailed testing of the base period. (3)
- e) What is our firm's responsibility in respect of the prevention and detection of wage fraud at Canned Heat (Pty) Ltd? (4)

**YOU ARE REQUIRED TO** respond to the questions posed by your manager.

## **CHAPTER 10**

### **THE ACQUISITION AND PAYMENTS CYCLE**

### **PURCHASES, CREDITORS AND ACCRUALS**



**10.1****(10 marks 12 minutes)**

The following lists identify a number of the departments and documents at Steelworks (Pty) Ltd, a supplier of steel products.

<i>Departments</i>	<i>Documents</i>
1. Receiving (Warehouse)	1. Purchase Invoice
2. Despatch (Warehouse)	2. Internal Sales Order
3. Marketing	3. Purchase Order
4. Administration (Warehouse)	4. Payroll
5. Buying/Ordering	5. Delivery Note (company)
6. Accounting	6. Delivery Note (supplier)
7. Human Resources	7. Goods Received Note
8. Wages	8. Cheque requisition
	9. Inventory Requisition

**YOU ARE REQUIRED TO:**

- a) identify, in order, the departments which would be involved in the acquisition of and payment for credit purchases in this company. (2)
- b) for each department identified, indicate which documents, if any, would be used/generated. (4)
- c) indicate, with a brief explanation, the sequence in which the documents would be used. (4)

**10.2****(15 marks 18 minutes)**

Plateglass (Pty) Ltd is a wholesaler of crockery and cutlery. Although small the company is well organized and there is a clear segregation of duties between the functions in the acquisitions and payments cycle. The only function in the cycle which is computerized is the payments of creditors who are paid by electronic funds transfer. The functions within the acquisitions and payments cycle are as follows:

- \* ordering
- \* receiving
- \* recording of purchases
- \* payment preparation
- \* actual payment and recording.

A system description reveals that the following control procedures/activities take place in the cycle:

1. When a supplier makes a delivery, the Plateglass (Pty) Ltd purchase order number reflected on the supplier delivery note is cross-referenced to a copy of the purchase order.



2. Gordon Marks, the warehouse manager makes out and signs a requisition for goods based on the re-order levels and re-order quantities reflected in the perpetual inventory records.
3. Any short deliveries are recorded on the supplier delivery note which is then signed by the supplier's driver.
4. Gordon Marks and Dave Gear, the chief buyer, evaluate the reliability of a supplier and the quality and price of the supplier's goods before the supplier is placed on the "approved supplier" list.
5. Copies of requisitions from the warehouse are filed numerically and cross-referenced to purchase orders.
6. The purchase invoices received from the supplier are matched to the corresponding goods received note, supplier delivery note etc.
7. A goods received note is made out and signed by the receiving clerk.
8. The general ledger account to which the purchase must be allocated in the purchase journal is entered on the purchase order.
9. The passwords of two senior officials are entered to effect the payment of creditors by EFT.
10. Before he approves the schedule of creditors for payment, Ben Moses the accountant, carefully examines the supporting documentation for any changes to creditors banking details.

**YOU ARE REQUIRED TO:**

- a) identify the function in which each of the procedures/activities listed above will take place. (5)
- b) briefly explain the reason for the procedure/activity. (10)

**10.3**

**(36 marks 43 minutes)**

1. Explain the terms "re-order level" and "re-order quantity" in the context of a company's acquisition cycle. (5)
2. Why is the acquisition and payments cycle regarded as a cycle which is particularly susceptible to fraud/theft by employees? (6)
3. In a computerised acquisitions and payments cycle (as with any other computerised cycle), the use of menus facilitate access control and segregation of duties. True or false? Explain. (3)
4. From an audit perspective which assertion relating to trade creditors is regarded as attracting the most risk? (1)

5. Moey Banton the senior accountant, regularly checks the log of amendments to the creditor's masterfile. Is this primarily
  - 5.1 a general control or application control? Justify. (2)
  - 5.2 a preventive control or detective control? Justify. (2)
6. The chief buyer requires access to the system so that he can fulfil his function of reviewing and approving purchase orders prepared by the purchasing clerk. To do this, he must **identify** and **authenticate** himself to the system and once he has done this, the system will **authorise** his access to programmes and data. Explain briefly how the three words in bold italics occur. (4)
7. Having cheques for payments to creditors signed by two signatories is an **access/custody control**. True or false? Justify. (2)
8. How is the "two signature principle" applied when creditors are paid by electronic funds transfer? (3)
9. Explain the use of "dongles" and "random number generators" in the context of an EFT payment system. (5)
10. Which limitation of internal control will result in the implementation of the "two signature principle" and the use of "dongles" and "random number generators" being **ineffective**. Justify. (3)

#### 10.4

(12 marks 14 minutes)

Select the most appropriate answer for each of the following (1 – 15):

1. In a typical acquisition cycle which one of the following documents will be generated by the supplier:
  - 1.1 requisition
  - 1.2 delivery note
  - 1.3 remittance advice
  - 1.4 goods received note.
2. Which of the following functions does **not** relate to the acquisitions and payments cycle:
  - 2.1 credit management
  - 2.2 receiving of goods
  - 2.3 ordering of goods
  - 2.4 all of the above relate to the cycle.
3. The record of the sequence of activities for a purchase transaction to be tracked from start to finish is referred to as:
  - 3.1 sequence testing
  - 3.2 document flow
  - 3.3 audit trail
  - 3.4 matching.

4. The initiation of a purchase order and the approval of the order are carried out by different people at BoysToys (Pty) Ltd. To which component of internal control does this relate:
  - 4.1 the information system
  - 4.2 monitoring of controls
  - 4.3 control environment
  - 4.4 control activities.
5. The assertions applicable to the trade creditors balance are:
  - 5.1 rights, completeness, existence and valuation
  - 5.2 completeness, occurrence, cut-off, and valuation
  - 5.3 obligation, existence, completeness and valuation
  - 5.4 occurrence, accuracy, completeness and valuation.
6. The assertion relating to trade creditors generally considered to be most at risk from the auditor's perspective is:
  - 6.1 occurrence
  - 6.2 cut-off
  - 6.3 existence
  - 6.4 completeness.
7. A trainee is vouching the purchase (transaction) of a large piece of machinery. What are the assertions relating to the purchase which the auditor should consider:
  - 7.1 occurrence, accuracy, existence and completeness
  - 7.2 occurrence, cut-off, accuracy, completeness and classification
  - 7.3 obligation, occurrence, valuation and classification
  - 7.4 completeness, cut-off, classification, accuracy and valuation.
8. The logging and follow up of amendments to the creditors masterfile is regarded as:
  - 8.1 a detective control
  - 8.2 a general control
  - 8.3 a preventive control
  - 8.4 an output control.
9. The intentional understatement of the trade creditors balance in the financial statements is an example of:
  - 9.1 management override
  - 9.2 collusion
  - 9.3 fraudulent financial reporting
  - 9.4 misappropriation of assets.
10. On the audit of Snapshot (Pty) Ltd the auditor inspected the agreements for two new loans which the company had raised, to determine inter alia, whether the agreements contained any loan covenants relating to the working capital ratios. This procedure would be regarded as:
  - 10.1 an analytical procedure
  - 10.2 a substantive procedure
  - 10.3 a risk assessment procedure
  - 10.4 a test of controls.

11. To test for the completeness of trade creditors, the direction of testing will be:
  - 11.1 from the list of creditors balances making up the creditors balance to source documents
  - 11.2 from source documents and records to the list of creditors balances
  - 11.3 an equal combination of 11.1 and 11.2
  - 11.4 none of the above.
12. With regard to the payment of creditors by EFT, physical devices such as “dongles” and random number generators which produce “one time” passwords are regarded as additional:
  - 12.1 identification controls
  - 12.2 authorisation controls
  - 12.3 authentication controls
  - 12.4 approval controls.
13. On an audit where the auditor has assessed the risk of material misstatement of the trade creditors as low, the auditor may justifiably decide:
  - 13.1 not to perform any substantive testing at all
  - 13.2 not to perform any substantive testing at all provided he has persuasive evidence that the controls had operated effectively for the period under audit
  - 13.3 perform only analytical procedures provided he has persuasive evidence that the controls had operated effectively for the period under audit
  - 13.4 not to perform any “further” or “other” procedures.
14. In the context of the audit of trade creditors, which of the following is most likely to be considered a **significant risk** by the auditor:
  - 14.1 a large increase in the trade creditors balance
  - 14.2 an increase in the number of approved suppliers
  - 14.3 a discernable trend by suppliers to tighten the terms of credit they allow
  - 14.4 a large increase in the number of purchase transactions being entered into with related parties.
15. When conducting audit procedures on the trade creditors account balance, the **extent** of the testing will be determined by:
  - 15.1 the allocation in the budget for the audit
  - 15.2 the audit strategy
  - 15.3 the assessed risk of material misstatement
  - 15.4 the assessed risk of material misstatement and the results of the tests of controls.

10.5

(10 marks 12 minutes)

The final trial balance of Croxley (Pty) Ltd for the current financial year end 31 March 2016 reflects the following

**Trade accounts payable      R7 211 313**

You asked a fellow junior trainee working on the audit of Croxley (Pty) Ltd, what the assertions pertaining to trade accounts payable are. He answered as follows:

Occurrence:	Croxley (Pty) Ltd is obliged to pay suppliers for the goods purchased.
Completeness:	all orders for goods placed by year end had been filled by suppliers.
Measurement:	I don't know what this means but I know it is an assertion.
Materiality:	the trade accounts payable at 31 March 2016 balance is material.
Existence:	Croxley (Pty) Ltd has not understated its trade accounts payable.

Fair presentation: the trade accounts payable balance is fairly presented.

**YOU ARE REQUIRED TO** comment on your fellow trainee's understanding of the financial statement assertions. Your answer must convey that you understand the assertions applicable to trade accounts payable.

## 10.6

**(15 marks 18 minutes)**

The following procedures were carried out on the audit of Canterbury (Pty) Ltd, a manufacturer of interior decorating products. Canterbury (Pty) Ltd is one of a number of subsidiaries in the HomeProducts Ltd group. The company purchases only from approved suppliers, both local and foreign.

1. Extracted a sample of foreign creditors and using the year end date foreign exchange spot rate and supporting invoices, reperformed the foreign currency conversion and compared the results to amounts recorded.
2. Obtained an understanding of how Canterbury (Pty) Ltd arranges Letters of Credit to facilitate credit terms from its overseas suppliers in Italy and France.
3. Compared the suppliers included on the suppliers' masterfile at the end of the year to the suppliers masterfile at the beginning of the year to identify new suppliers added during the year. Traced each addition to a masterfile amendment form and supporting approval documentation and inspected the relevant form for the appropriate authorising signatures.
4. Enquired of the order clerk as to what procedures he follows if he is given a verbal instruction to place an order without the required stores requisition.
5. Discussed the discount arrangements which Canterbury (Pty) Ltd has in place with its local suppliers, e.g. bulk discounts, early settlement discounts, etc.
6. Discussed and evaluated the user privileges assigned to each employee in the acquisitions and payments cycle with the head of the IT section.

7. Observed the “authorise” and “release” procedures being undertaken for the payment of a creditor by EFT, and confirmed by observation, that without the insertion of the “dongle” in the USB port, it is impossible to proceed with the payment.
8. Reperformed a sample of creditors reconciliations at year end.
9. Observed receiving clerks carrying out control procedures relating to the receiving of deliveries from suppliers, e.g. entry of purchase order number onto the system, comparison of quantity and description of goods delivered to the purchase order and suppliers delivery note, etc.
10. Obtained a list of all companies in the HomeProducts Ltd group from which Canterbury (Pty) Ltd makes purchases.
11. Inspected the report prepared by the group internal audit section relating to its evaluation of risk management in the acquisitions and payments cycle at Canterbury (Pty) Ltd.
12. Compared the list of creditors at the current year end to the previous year end list to identify creditors on the previous list who do not appear on the current list, and creditors whose balances are significantly smaller at the current year end.
13. Extracted a sample of purchases from the purchase journal and inspected the dates on the supplier delivery note, GRN and invoice, to confirm that the goods were received during the accounting period under audit.
14. Enquired of senior management as to their knowledge of any fraud or suspected fraud in the acquisitions and payments cycle.

**YOU ARE REQUIRED TO** indicate whether each of the procedures listed above is a risk assessment procedure, a test of controls or a substantive test. Where you identify the procedure as a test of controls, briefly describe the objective of the control being tested. Where you identify the control as a substantive test, identify the assertion to which the procedure relates.

## 10.7

**(34 marks 41 minutes)**

You are a trainee accountant currently engaged on the audit of Perky Pets (Pty) Ltd, a supplier of pet foods and requisites. You are working on the acquisitions and payments cycle and have just completed an internal control questionnaire as part of your system evaluation. Also on the audit team is Fabian Martin, a young, prospective trainee who is completing a six-week vacation job with your firm. As part of getting him involved, you randomly extracted a number of questions from the internal control questionnaire and entered them on a schedule.

You gave the schedule to Fabian Martin and asked him to indicate on the schedule whether or not he understood each question and to record any questions he had (see attached schedule). He has completed the task and returned the schedule to you (see next page).

**YOU ARE REQUIRED TO** respond to each of the questions raised by Fabian Martin.

*Schedule of questions raised by Fabian Martin*

<i><b>Questions extracted from Internal Control Questionnaire</b></i>	<i><b>Fabian Martin's Response</b></i>
1. Are all documents used in the cycle preprinted, numerically sequenced and multi-part where necessary?	1. I can understand the need for having preprinted, multipart documents but why must they be numerically sequenced? (3)
4. Are all blank (unused) documents used in the cycle, subject to sound stationery controls?	4. I understand that unused documents should not be left about – but can you describe what sound stationery controls would consist of? (5)
6. 6.1 Are preset re-order levels and re-order quantities used when ordering goods? 6.2 Before requisitioning goods, does the requisitioner confirm that the goods are actually needed where preset levels are used?	6. I understand how preset levels work but I can't see the point of the requisitioner confirming that the goods are needed – surely reaching the preset levels indicates that? (2)
8. Does the order department produce four copies of the purchase order as it has done in prior years, to be used as follows: Copy 1 – to the customer Copy 2 – to the receiving department Copy 3 – to the creditors section Copy 4 – filed in numerical sequence in the buying department?	8. This really seems like a waste of time to me. Obviously a copy should go to the supplier and I suppose that the order department should keep a copy, but can you explain to me what the receiving department and the creditors section do with their copies? (3) Also wouldn't it make more sense to file Copy 4 in alphabetic order by supplier name? (2)
11. Does the senior buyer authorize (by signing) all purchase orders made out by the buying clerks, before the orders are placed?	11. Again this seems excessive to me. What is the intention of this control? (3) Is it an example of isolation of responsibilities? (1)
13. When goods are delivered, does the receiving clerk make out a goods received note for each delivery?	13. Is this necessary? The supplier provides a document (supplier delivery note) which the receiving clerk keeps, so why introduce another document? (3)
15. Are goods transferred from the receiving bay into the warehouse as promptly as possible and does a warehouse assistant sign the relevant GRN, having checked the goods against the GRN?	15. What are these controls all about? (3)



18. Are purchase invoices received from the supplier, matched to supporting documentation by the creditors section?	18. <i>This seems straightforward but what documents are matched and what information are they matching?</i> (3) <i>What other controls are carried out on the purchase invoice by the creditors section?</i> (2)
22. Is the authority to sign cheques restricted to three senior employees, any two to sign each cheque, as in prior years?	22. <i>Obviously having two signatories to sign each cheque is a good safety measure. Is it an example of isolation of responsibilities?</i> (2) <i>Would it not be easier to have, say, six authorised signatories, any two to sign?</i> (2)



## 10.8

(30 marks 36 minutes)

You are the auditor of Spares (Pty) Ltd, a company which retails vehicle spares and accessories. The internal controls in the company are not very strong and although you have in prior years reported this to the managing director (Jody Shektar), not much has been done about it. Jody Shektar believes that his staff are trustworthy and that he himself would know if there was “anything strange going on”.

One of the company’s major suppliers is PimpMyRide CC which supplies Spares (Pty) Ltd with motor accessories. PimpMyRide CC invoices Spares (Pty) Ltd every fourteen days for goods delivered for the preceding fourteen days, and if this invoice is paid within seven days, Spares (Pty) Ltd is entitled to a very worthwhile discount. Spares (Pty) Ltd does not use electronic funds transfer (EFT) to pay its creditors but to ensure that the discount is not lost due to late payment, Spares (Pty) Ltd has made arrangements with its bank for a electronic transfer to be made from Spares (Pty) Ltd’s bank to PimpMyRide CC’s bank account if necessary. For each electronic transfer, the bank requires that its standard “Bank Transfer Form TT1” be completed and signed by the stipulated authority at Spares (Pty) Ltd, namely Jody Shektar the managing director. As these transfers are made reasonably frequently the bank has provided Louis Hamilton, the accountant at Spares (Pty) Ltd with a batch of blank Bank Transfer Forms.

During the course of the current audit, you were unable to find a supporting invoice for a bank transfer made to PMR CC, and on further investigation you discovered other such transfers. On following these up it was revealed that Louis Hamilton had been stealing from Spares (Pty) Ltd for a number of years by the following means:

1. Some years ago he had registered a close corporation and opened an account at his bank in the name of PMR CC.
2. When payment was due to PimpMyRide CC (about twice a month), Louis Hamilton would complete a Bank Transfer Form, attach it to the supporting invoice and present the documents to Jody Shektar. From time to time Louis Hamilton would make out the Bank Transfer Form to PMR CC (instead of PimpMyRide CC) and would leave the space for the bank account number blank. The first time he had done this he had assured Jody Shektar that PMR CC was the official abbreviation for PimpMyRide CC. On receiving the bank transfer form, Jody Shektar would glance at the invoice, agree the amount of the invoice to the transfer form and sign it. Louis Hamilton would then return to his office, fill in the appropriate account number (depending on whether the transfer form was made out to PMR CC or PimpMyRide CC) and personally take the form to the bank (as required by the bank who would take a copy of Louis Hamilton’s identity book and attach it to the bank transfer form).
3. On these occasions where the transfer form was made out to PMR CC, Louis Hamilton would take the invoice he had presented in support of the bank transfer, to Mary Macedes the creditors clerk, requesting that she obtain a cheque urgently so as not to lose the discount. Mary Macedes would check the invoice against other supporting documentation carefully, (i.e. supplier delivery note, goods received note and order) make out a cheque requisition and cheque to PimpMyRide CC for the amount of the invoice and take the cheque and cheque requisition to Lewis Alonso or Keke Mokoena, the company’s authorised cheque signatories. The signatories would check the details on the cheque against the requisition, including date, payee name and amount, confirm

that Mary Macedes had signed the requisition, and if all was in order, sign the cheque. The cheque would be returned to Louis Hamilton (who would take it to the bank and deposit it directly into PimpMyRide CC's account) and the documentation would be filed.

4. When writing up the cash payments journal Louis Hamilton would record the bank transfers to PMR CC as transfers to PimpMyRide CC but instead of posting them to the creditors control account, he would post (allocate) them to a suspense account which he used to record queried amounts, unresolved matters, etc.

You raised the matter with the managing director who requested that you advise him of the weaknesses in the system which may have contributed to/facilitated the theft by Louis Hamilton and to recommend improvements to the existing system which will reduce the risk of further similar thefts. Jody Shektar wishes to continue paying PimpMyRide CC by bank transfer and other creditors by cheque. He does not want to introduce a system of paying creditors via the internet.

**YOU ARE REQUIRED TO** respond to Jody Shektar's request.

## 10.9

**(30 marks 36 minutes)**

You have recently joined Countryboy (Pty) Ltd, a company which operates a large general dealer outlet in rural Eastern Cape, as an internal auditor. The company sells a wide range of products from bicycle parts to foodstuffs and clothing. Due to difficulties in staffing (and very erratic electricity supply) the company's systems are not computerised.

As your first assignment you have been asked to evaluate certain aspects of the acquisitions and payments cycle and recommend improvements which could be implemented. The financial director (also newly appointed) has acknowledged that aspects of the system are poor, but has stated that computerisation is not an option at this stage and that he does not want to employ additional staff. He is, however, prepared to change job descriptions, improve documentation if necessary and spend money on reasonable recommendations which you make.

The control procedures over ordering are sound. Due to the location of Countryboy (Pty) Ltd's premises, it has been necessary for the company to work closely with suppliers with regard to reliability, pricing etc, and as a result, purchases are only made from approved suppliers. Aspects of certain other functions within the cycle are described below:

### ***Receiving of Goods***

All goods ordered are delivered to the "receiving/dispatch" area which adjoins the company's warehouse. Receiving of goods from suppliers as well as deliveries/dispatches to customers by Countryboy (Pty) Ltd take place through this area.

When an order is placed, a copy of the purchase order is sent by the order department to the warehouse administration office where it is filed in numerical sequence. When a delivery from a supplier arrives, the vehicle is directed to the "receiving/dispatch" area. Here any one of the seven warehouse assistants receives the delivery. The warehouse assistants who are responsible for the receiving, dispatching and custody of goods, report to the warehouse

foreman. To receive a delivery, the warehouse assistant obtains the purchase order number from the supplier delivery note, and confirms by scanning through the purchase orders filed in numerical sequence in the administration office, that the delivery is in respect of a valid order. As the goods are being offloaded the warehouse assistant checks them against the supplier delivery note and at the same time completes a blank pre-printed sequenced goods received note. Any discrepancies are entered on the supplier delivery note and signed by both the warehouse assistant and the supplier's driver.

As most deliveries consist of numerous packages and boxes, the offloading and completion of the goods received note is a long process. This annoys many of the drivers who want to offload as quickly as possible so that they can start the long return journey. As a result, some of the warehouse assistants allow the supplier delivery staff to offload the goods in the "receiving/dispatch" area without conducting any checks at the time. Once the goods are offloaded, the warehouse assistant responsible signs the supplier delivery note and retains a copy. At a later stage, the warehouse assistant makes out the required goods received note, and as normal, moves the goods from the receiving/dispatch area into the warehouse.

### ***Preparation of cheques to pay creditors***

Manual Pettit, the financial accountant, keeps the cheque book locked away in the safe. On the 25<sup>th</sup> of each month, Jean Senna, the creditors clerk, presents Manual Pettit with a list of creditors due to be paid that month as well as the amounts they have to pay. (You may assume that the controls carried out by Jean Senna prior to preparing the list of creditors are satisfactory and that she signs the list). Manual Pettit then makes out a cheque for each creditor on the list, signs the cheque and enters the cheque number next to the relevant creditor's name on the list. Cheques are carefully made out in a manner which significantly reduces the risk of cheque fraud e.g. permanent ink, restrictive crossings etc. He then returns the cheques to Jean Senna who attaches a remittance advice to each and posts them to the creditor.

### **YOU ARE REQUIRED TO:**

- a) identify the risks which a company faces if it does not implement (put in place) sound control procedures over its "***ordering of goods***" function. (7)
- b) recommend improvements which should be made to the "***receiving of goods function***" at Countryboy (Pty) Ltd. Provide reasons for your recommendations. (18)
- c) recommend improvements which should be made to the "***preparation of cheques to pay creditors***" function at Countryboy (Pty) Ltd. You are ***not*** required to provide reasons for your recommendations. (5)

## **10.10**

**(40 marks 48 minutes)**

You are a member of the team engaged on the audit of 2<sup>nd</sup> Part (Pty) Ltd which sells second hand motor spares and accessories. The company purchases its inventory from two sources, namely, scrap yards and manufacturers of car spares and accessories, who sell their production overruns and slightly damaged inventory items to 2<sup>nd</sup> Part (Pty) Ltd.

You have been assigned to the year-end audit of the acquisitions and payments cycle and have ascertained, inter alia, the following information.

1. One of the major business risks faced by 2<sup>nd</sup> Part (Pty) Ltd is that the company may purchase parts and accessories which have been stolen from manufacturers, or which come from stolen or hijacked vehicles. To counter this, the company carries out a comprehensive investigation into their suppliers before conducting business with them. The company's accounting systems are fully computerised (they are run on a local area network (LAN) which links all departments/sections) and once a supplier has been approved, it is entered on the "approved supplier masterfile". The financial controller, Bernard Bunz, has emphasised the importance of dealing only with approved suppliers, and maintaining detailed supporting documentation for all purchases, due to the widespread dishonesty and criminal activity in the trade.
2. No inventory is purchased without an official printed order. Order forms are computer generated and cannot be created for a supplier not on the approved supplier masterfile. Orders are initiated on the strength of a signed requisition sent to the buying department by the warehouse manager.

Note: Suppliers, both scrap yards and manufacturers, regularly contact the warehouse manager to notify him of availability of second hand parts, overruns or damaged items. If the warehouse manager considers the item should be ordered, he negotiates the price which he then enters, with other details, on the requisition. Controls over the ordering function, both manual and computerised, are sound.

3. All deliveries from suppliers are routed to a physically secure Deliveries Bay for the unloading and receiving of goods. The three receiving clerks make use of a single terminal in the bay which is linked to the LAN. As goods delivered are mostly second hand or slightly damaged, receiving clerks do not perform quality checks on deliveries. All deliveries are sent with a computer generated copy of the goods received note, to the "Quality Check and Reconditioning" section where all items purchased are put into saleable condition, e.g. cleaned, rubber seals etc replaced, tested and repackaged. From this section they are moved into the warehouse, where they are stored by part number, description etc. (Any items which are "damaged beyond repair" are returned to the supplier.)
4. Hard copy of all documentation is sent to, or printed out in, the accounting department where it is matched and filed temporarily to await the supplier's invoice. The necessary checks are carried out before the purchase journal is written up. The supporting documentation is then filed alphabetically by supplier.

At an interim audit conducted earlier in the year, you had extracted a sample of purchase transactions for detailed testing. Although these tests had proved satisfactory, you decided to extract a small sample of purchase transactions from the purchase journal for the month of April (financial year-end 30 April) on which to perform detailed procedures. One of the purchase transactions selected, and for which you obtained the supporting documentation, was:

Creditor : Crash 'n Smash (Pty) Ltd  
Amount : R17 620.14

**YOU ARE REQUIRED TO:**

- a) discuss your audit firm's responsibilities in respect of the prevention and detection of fraudulent acts by 2<sup>nd</sup> Part (Pty) Ltd, (e.g. the purchase and sale of stolen goods). (5)
- b) explain why there is increased risk of unauthorised access to data and programmes in a networked environment (e.g. 2<sup>nd</sup> Part (Pty) Ltd's local area network). (3)
- c) state the controls which should be in place at 2<sup>nd</sup> Part (Pty) Ltd to ensure that additions to the "approved supplier masterfile" are valid, accurate and complete. (Do not concern yourself with controls or procedures to approve suppliers.) (10)
- d) discuss the manual and programmed (automated) application controls which you would expect to be in place for the receiving of deliveries from suppliers. (12)
- e) describe the procedures you would carry out on the supporting documentation for the April purchase transaction with Crash 'n Smash (Pty) Ltd of R17 620.14 to obtain evidence in respect of the *occurrence* and *accuracy and cut-off* assertions relating to this purchase. (10)

**10.11**

**(40 marks 48 minutes)**

Clearcut (Pty) Ltd is a company which manufactures a large range of garden equipment, eg. lawn mowers, edge trimmers etc. The company purchases all of its parts for manufacture from local suppliers. One of your firm's clients has entered into negotiations for the purchase of Clearcut (Pty) Ltd and as part of the exercise, your firm has been asked to evaluate the company's internal control systems to determine whether costs will need to be incurred to rectify any weaknesses. All cycles are computerized and are run on a local area network.

You have been requested to evaluate certain functions of the acquisitions and payments cycle, and have obtained the following information :

***Ordering***

1. A masterfile is maintained for the extensive range of parts used in assembly (manufacture). Each record in the masterfile contains a re-order level and a re-order quantity field for that part. Each morning Gilbert Simoni, the parts store administration clerk, extracts a (single part) printout of inventory items which have reached their re-order level. The printout reflects the part number, description and quantity to be ordered, as well as the supplier and supplier code. Gilbert Simoni signs and dates the printout and takes it to Bob Marli, the buying clerk.
2. During the course of the morning, Bob Marli produces a 4-part, multi-coloured purchase order (PO) for the items to be purchased. (Where different items are ordered from the same supplier, only one purchase order is made out). This he does by accessing the company's local area network using the general password "clearcut", and then selecting the acquisitions application from the menu which appears on the screen. To access this application, he uses a password known only to employees in the sections of the company which deal with acquisitions and payments. This password enables



these employees to access any of the various modules included in the acquisition and payments software.

3. When Bob Marli accesses the “prepare purchase order” module, whichever screen he is working at comes up formatted as a purchase order. He then enters onto the system, the details eg. name, address, code, of the supplier as well as the part number, description and quantity of each part to be purchased from that particular supplier. For the entry to proceed, a valid supplier code must be entered as Clearcut (Pty) Ltd purchases only from approved suppliers. When he has completed the entry of the parts to be ordered, he selects the “print” option and prints out all the purchase orders. The computer automatically prints the date on the purchase order and number sequences them (The computer stores the number of the last purchase order printed, and continues the numerical sequence as new POs are printed).
4. Once the POs have been printed, Bob Marli splits them into the 4 colours
  - white copies - go to the administration clerk for posting to the customer
  - pink copies - go to the goods receiving depot where the receiving clerk Ziggi Marli (Bob’s brother), files them in a pending file to await the delivery from the supplier
  - light blue copies - go to Norah Jones, a clerk in the creditors section. She files them to await the supplier documentation
  - yellow copies - remain with Bob Marli who files them in numerical sequence.

The transfer of documentation between departments is well controlled by using simple but efficient batch controls. Once the POs have been distributed, the printout produced by Gilbert Simoni, is thrown away.

### ***Masterfile amendments***

Clearcut (Pty) Ltd purchases from approved suppliers only. Pieter Tosh the company buyer, investigates potential suppliers for quality of product, reasonableness of pricing and reliability. If he decides that a new supplier should be added to the supplier masterfile, he accesses the “update supplier masterfile” module and adds the suppliers details, including a supplier code. He then accesses the inventory masterfile and inserts all the necessary details of the parts to be purchased from that supplier, ie. description and part number, re-order levels and re-order quantities, and supplier code. He also prints out a log of these entries (for both masterfiles) which he files in date order, in his office.

**YOU ARE REQUIRED TO *identify* and *explain*** the weaknesses in the internal control for the functions of Clearcut (Pty) Ltd’s acquisitions and payments cycle, described above. Your explanation must convey why you have identified the weakness as a weakness.

- Note
1. You are ***not*** required to make recommendations to address the weaknesses.
  2. Do not concern yourself with purchases of items not for manufacture, eg. office supplies, staff refreshments, etc.

Toy-Toy (Pty) Ltd is a wholesaler of toys. The company purchases its inventory from local companies which either manufacture or import toys. Little attention has been paid to the accounting and related internal control systems at Toy-Toy (Pty) Ltd over the last few years and evidence of this has started to show. You have been asked by the financial controller to review the company's systems commencing with the acquisitions and payments cycle.

### ***Ordering of goods***

The buying department consists of five buying officers and the senior buyer, Goliath Booysen. The toys which the company sells are broken down into five product categories, i.e. boardgames, balls, dolls, video games and model cars. Each buying officer is allocated to a product category and is responsible for purchasing inventory for his or her category. Goliath Booysen is responsible for monitoring and analysing the toy market and working with the sales department in deciding on new toy lines which should be purchased.

All the company's applications are resident on a local area network. To access the network employees must enter their user ID and a general password. However, access to the modules on the acquisition application is restricted to "ordering" and "receiving" employees by the use of a password known only to employees in these departments (and one or two senior personnel).

The inventory masterfile is divided into the five product categories. Each morning the buyers access the category for which they are responsible and based on the quantity on hand per the masterfile, decide whether to place an order. The inventory masterfile contains details of the company's preferred supplier and the buyers will normally place the order with that supplier. However, if the preferred supplier is "out of stock" the buyer will source the item from another supplier. If this is the case, the buyer will add the new supplier's details to the inventory masterfile. A supplier code must also be entered so that a computer generated purchase order can be printed.

To create the purchase order the buyer accesses the "create purchase order" module of the acquisitions software. The screen comes up formatted as a purchase order which the buyer completes by entering the details of the supplier and of the goods to be ordered, quantity, description etc. The supplier code must also be entered. Once all the details have been captured, a two-part sequenced order is printed out. The buyer mails the top copy to the supplier and files the second copy numerically in a lever arch file. Each buyer's purchase orders have their own numerical sequence. To ensure that they do not duplicate an order once it has been placed, the buyer updates the inventory masterfile by entering a date in the "pending order field".

### ***Receiving of Goods***

Goods ordered by Toy-Toy (Pty) Ltd are delivered in boxes which display the quantity and description of the contents of the box on the outside of the box, e.g. ten Leggo sets. Each delivery is supported by a supplier delivery note which lists the quantities and description of the goods being delivered.

All goods delivered are directed to the "Receiving Department", a physically secure area attached to the warehouse. Any one of the three receiving clerks will accept a delivery. The clerk will determine the validity of the order for the goods being delivered by entering the

purchase order number (taken from the supplier delivery note) into the computer via a terminal in the receiving department. If the purchase order is valid, the words “accept delivery” appear on the screen.

The receiving clerk then agrees the number of boxes delivered and the quantity and description of the goods as per the details recorded on the boxes, to the supplier delivery note. If there are any discrepancies, the receiving clerk changes the delivery note accordingly. He and the person delivering the goods will sign both the copies of the delivery note to acknowledge the changes.

The boxes are placed in a secure area until the warehouse packers have time to move them into the warehouse, unpack them and place the toys on their respective shelves in the warehouse.

At 3pm each working day, one of the receiving clerks (they rotate this function on a weekly basis) accesses the “create goods received note” module. The screen comes up formatted as a goods received note which the receiving clerk then completes taking the information from the supplier delivery notes. Once the goods received notes have been completed, the quantities on the inventory masterfile are automatically updated and the date in the “pending order field” is deleted to convey that the order has been received. The receiving clerk prints out one copy of the goods received note which is attached to the supplier delivery note and is filed sequentially and retained in the receiving department. (The goods received notes remain on the system to be accessed and printed out by the creditors/accounting department where they are matched to the supplier invoice when it arrives.)

**YOU ARE REQUIRED TO *identify* and *explain*** the weaknesses in the internal controls over those functions of the acquisitions cycle at Toy-Toy (Pty) Ltd described above.

**10.13**

**(36 marks 42 minutes)**

You are a member of the team on the audit of Lighttime (Pty) Ltd a manufacturer of a range of torches, lamps, light fittings etc. You have been assigned to the audit of the acquisitions and payments cycle. The following information pertains to the cycle:

1. All employees in the company are issued with strict ethical guidelines pertinent (relating) to their functions. In respect of the acquisitions and payments cycle this includes guidelines for the purchase order clerk and the purchasing manager on how to react if they are offered bribes or kickbacks by suppliers. Appropriate action is taken against any employees who transgress the guidelines, but no such action has been necessary during the year under audit.
2. Ongoing training is also provided to all employees in the cycle.
3. To initiate a purchase order, the factory clerk identifies materials required for manufacture from production schedules. If the required materials are not available in Lighttime (Pty) Ltd’s warehouse, he completes and signs a hard copy purchase requisition form for the materials not “in stock”. The requisitions are sent to Pete Peters the factory manager, who carefully checks that the goods are required, and that all the details on the requisition are accurate. He then approves the requisition by signing it.



The requisition will reflect the approved supplier code as well as the supplier's inventory code for the items to be ordered.

4. The purchase requisitions are then sent to Clive Crawley the order clerk. He accesses the "prepare purchase order" module on the system and compiles the purchase order. Before Clive Crawley emails the orders to suppliers, the orders are approved "on screen" by Dave Parker the creditors manager. Orders are only placed with approved suppliers (on the creditors masterfile). The ability to approve the purchase orders on screen is restricted to Dave Parker.
5. When the ordered goods are delivered (to a secure, separate receiving bay) Marcos Masters checks the goods against the supplier delivery note and relevant purchase order which he accesses on the system. The purchase order is displayed on his terminal screen as a goods received note and before he approves the GRN, Marcos Masters will check the goods delivered and amend quantities on the screen GRN if necessary. Goods which have not been ordered will not be accepted. Marcos Masters then prints out a GRN in duplicate. One copy is filed numerically in the receiving bay and the second copy goes with the goods when they are transferred to the warehouse. When Marcos Masters selects the "approve" option, the inventory masterfile is automatically updated.
6. Invoices from suppliers are sent direct to the accounting department where they are filed by Norman Anderson the creditors clerk. To determine whether the supplier invoice is valid and accurate, Norman Anderson accesses the purchase order file on the system relevant to the supplier invoice, and if a valid purchase order number has been entered, all the details of the relevant purchase will appear on screen, formatted as an invoice. Norman Anderson will then confirm that the detail of the on-screen invoice agrees exactly with the supplier invoice. The on-screen invoice is approved by a second creditors clerk. Once the approve option is "clicked on", the file of unpaid invoices and the creditors masterfile are updated.
7. Creditors are paid by electronic funds transfer. A schedule of payments is compiled in the creditors section by the creditors clerk and approved after meticulous scrutiny by Dave Parker the creditors manager. Once he has approved the schedule, he notifies Jake Lekota the chief accountant that the schedule is ready for payment to be made. From this point Dave Parker has nothing further to do with EFT payments to creditors, as he has no authorization privileges.
8. EFT payments are made over the Internet from the company's bank account. The company's bank has loaded the necessary software onto the terminals of Jake Lekota and Cyril Regis the financial director. A full range of controls over EFT payments have been implemented including the use of "dongles" which are issued to certain employees to effect EFT payments.

**YOU ARE REQUIRED TO:**

- a) discuss the control environment within the acquisitions and payments cycle at Lighttime (Pty) Ltd based on the information provided above. (8)
- b) identify two examples, one manual and one programmed (automated) of each of the control activities listed below, evident from the description of the cycle provided above.

- (i) isolation of responsibility
  - (ii) segregation of duties (4)
- c) explain how effective “on-screen” approval of purchase orders is achieved. (8)
- d) explain why, with regard to paying its creditors by electronic funds transfer, control over the creditors masterfile is very important. (4)
- e) explain how access to the function which allows EFT payments to be made from Lighttime (Pty) Ltd’s bank account on the internet will be protected. (12)

## 10.14

(35 marks 42 minutes)

On an interim audit during May 2016, you conducted verification procedures on the creditors control account of Wetfoot (Pty) Ltd at 30 April 2016. The company is a wholesaler of a large range of shoes and boots suitable for use in wet conditions, e.g. rubber boots used in the dairy industry, boots used by fishermen, etc. The company has a 30 June year end but a tight reporting deadline (Wetfoot (Pty) Ltd is a subsidiary of Actionwear Ltd) makes it necessary for an interim audit to be carried out two months before year end. You are now working on the year end audit and are about to perform roll forward tests on the two months (May and June) as part of your verification of the 30 June creditors control account. Wetfoot (Pty) Ltd closed its purchase journal on 25 June and closed the cash book on 30 June 2016.

The creditors control account in the general ledger at 30 June 2016 appears as follows and you have been given the explanations contained in the notes, by the accountant.

25 May	Reversal note 1	J61	62 693	1 May	Balance	b/d	2 372 119
25 May	Goods Ret note 2	J72	48 460	25 May	Purchases	PJ83	1 083 984
31 May	Payments	CB32	962 418				
31 May	Discounts note 3	J74	21 208				
30 June	Payments	CB38	1 087 633	25 June	Purchases	PJ89	1 146 215
30 June	Discounts note 4	J79	18 219				
30 June	Reversal note 5	J79	35 219				
	Balance	c/d	<u>2 366 468</u>				
			<u>4 602 318</u>	1 July			<u>4 602 318</u>
					Balance	c/d	2 366 468

Note 1: This amount relates to a batch of waterproof fishing boots which were a once off purchase from Fishfeet CC in January 2016. The boots were paid for in March 2015. Seven pairs were sold in May and all seven pairs were returned by the customers as the boots leaked. Fishfeet CC accepted responsibility and took the entire batch back and agreed to a full refund. Goods returned note 61.

Note 2: This represents goods returned to DairyBoots (Pty) Ltd. Goods Returned Note 63. Sizes printed on a batch of boots supplied were incorrect. DairyBoots (Pty) Ltd took the boots back.

Note 3: This represents the total of discounts from three suppliers for early settlement of amounts owed to them and paid in the May creditors payments. Early settlement discounts are not offered by any other suppliers.

Note 4: This represents the total discounts from the same three suppliers (see Note 3) for early settlement of amounts owed to them and paid in the June payments.

Note 5: This amount represents an overcharge on a May invoice for R137 125 from Mud and Manzi (Pty) Ltd. When placing the order with this company, Bob Bass the buyer, claims that the price of the boots purchased was agreed at an amount of R101 906 as entered on the order form. Mud and Manzi (Pty) Ltd claim that Bob Bass was warned that, as the boots are imported, prices could go up unexpectedly. Bob Bass does not recall this. Wetfoot (Pty) Ltd will not pay the additional R35 219 based on the fact that the price entered on the order was R101 906.

Wetfoot (Pty) Ltd does not have a list of approved suppliers. The buyer Bob Bass, decides on what should be purchased. The company does not import directly, preferring to source its goods from local suppliers. After finding a suitable source, Bob Bass completes a preprinted, sequenced order form, signs it, and faxes it to the supplier. A copy is sent to both the receiving and accounting sections. When the goods are delivered, Gordon Watts the warehouse controller, checks the delivery for quantity, description and any obvious damage against the order and the supplier delivery note. Once he is satisfied with the delivery, he signs both copies of the supplier delivery note and retains one copy. He then makes out a preprinted, sequenced goods received note and signs it before attaching a copy of the GRN to the supplier delivery note and sending it to the accounting department.

He also retains a copy of the GRN filed in numerical sequence. In the accounting section Paula Yawa the creditors clerk matches the order, goods received note and suppliers delivery note to the suppliers invoice when it arrives. She then checks that all details are correct e.g. prices, any discounts, calculations etc, before entering them onto the system to create the monthly purchase journal and update the creditors masterfile.

Wetfoot (Pty) Ltd pays its creditors by electronic funds transfer. Before compiling an on screen list of payments to creditors, Mavis March reconciles each creditor's account with the creditor's statement. This list is sent on the local area network to Clarence Carter the financial controller, who checks the list of payments carefully to the hardcopy supporting documentation before "releasing" the funds for payment. (To release funds, both Mavis March and Clarence Carter must have entered their passwords). The list of EFT payments is sequentially numbered and a hardcopy is printed out, signed by Clarence Carter and filed. The documentation for all payments on the list is cross referenced to the list.

**YOU ARE REQUIRED TO** describe the audit procedures, including the roll forward procedures, you will conduct on the creditors control account for the period 1 May to 30 June 2016 as part of your verification of the year end balance.

10.15

(45 marks 54 minutes)

**Part A**

(30 marks 36 minutes)

You are a member of the team on the audit of Sporting Life (Pty) Ltd, a wholesaler of a large range of sports goods purchased from both local and foreign suppliers. You have been assigned to the 30 April 2016 year-end audit and are currently (late May) assisting with the audit of various aspects of the acquisitions and payments cycle. You have obtained the following information, inter alia, whilst assisting with risk assessment procedures.

1. The company has had a successful trading run for the last few years and with the current high level of interest in sport, the board of directors has decided to build an additional warehouse. This warehouse will be used exclusively for receiving, storing and dispatching imported sports goods. The company's bankers will supply the necessary finance, provided that the 30 April 2016 financial statements satisfy certain existing loan covenants relating to working capital ratios.
2. Sporting Life (Pty) Ltd is a "family owned" business and most management positions/directorships are held by members of the Clarkson family. Accounting systems are sound and a strong control environment exists. Your manager has been in charge of the audit for some years and has got to know the company's business very well.
3. The balance on the trade creditors account at 30 April 2016 was R9 267 914 (2015 – R11 900 418), a material amount in the context of the business.
4. The company's systems are all computerized and are resident on a local area network. Applications are menu driven.
5. Purchase orders are generated on the system by the buying clerks and approved on the system by the senior buyer, Polly Clarkson.
6. The creditors masterfile is an extremely important component of the system (all purchases). Purchase orders can only be generated for suppliers listed in the masterfile, and payments to suppliers (made by electronic funds transfer) can only be made to suppliers (creditors) on the creditors masterfile.

**YOU ARE REQUIRED TO:**

- (a) comment on the risk of material misstatement at financial statement level for the 30 April 2016 audit. (6)
- (b) comment on the risk of material misstatement in the trade creditors account in the 30 April 2016 annual financial statements. (6)
- (c) explain the process of online approval of purchase orders. Include in your answer the application controls which should be in place. (9)
- (d) describe the internal control procedures you would expect to find in place at Sporting Life (Pty) Ltd to ensure that the additions of new suppliers to the creditors masterfile are *valid*. (9)

**Part B****(15 marks 18 minutes)**

As part of your duties on the Sporting Life (Pty) Ltd audit you have been requested to audit a sample of the client prepared creditors reconciliations at 30 April 2016. You extracted a sample of reconciliations for audit, one of which appears below

***Creditors reconciliation : Racketman (Pty) Ltd : 30 April 2016***

Balance per creditors statement at 25 April 2016		R592 876
Less : payment : electronic transfer on 28 April 2016		<u>R134 533</u>
		R458 343
Less : invoice number 7493	<i>Note 1</i>	<u>R 76 913</u>
		R381 430
Less : Goods returned note 1017	<i>Note 2</i>	<u>R 46 290</u>
		R335 140
Add : Invoicing error	<i>Note 3</i>	<u>R 13 320</u>
Balance as per creditors ledger 30 April 2016		R348 460

*Note 1*        The goods relating to this invoice were only received by Sporting Life (Pty) Ltd on 7 May 2016 due to a strike at the Racketman (Pty) Ltd warehouse.

*Note 2*        The consignment of tennis racquets relating to this invoice was delivered to Sporting Life (Pty) Ltd on 15 April 2016. However on unpacking the racquets in May, it was discovered that they were cracked. Racketman (Pty) Ltd acknowledged that the damage was caused in its warehouse and have agreed to take back the entire consignment and credit Sporting Life (Pty) Ltd. Racketman (Pty) Ltd's invoice number 7216. This is expected to be resolved in July 2016.

*Note 3*        Racketman (Pty) Ltd undercharged on its invoice number 7001. 100 rugby balls were charged at R14.80 each instead of R148.00 each, inclusive of VAT.

**YOU ARE REQUIRED TO** describe the audit procedures you would conduct in respect of the reconciliation presented above.

**10.16****(32 marks 38 minutes)**

You are a senior on the audit of Wheelies (Pty) Ltd, a company which manufactures a large range of cycling accessories e.g. clothing and components. You have been assigned to the audit of the acquisitions and payments cycle for the financial year-end 31 March 2016. The audit is due to be completed by the end of June 2016. You have gathered the following information from a number of sources.

1. The company has numerous suppliers due to the fact that its products are manufactured from a wide range of materials and components. All suppliers are local. The company's output and product range have remained reasonably constant over the last few years.

2. The company's accounting systems are computerized and the creditors (supplier) masterfile contains the following fields for each creditor:
  1. Supplier code
  2. Supplier name
  3. Supplier details : address, contact numbers etc.
  4. Total amount owed
  5. Total amount owed broken into days outstanding  
i.e. 30 days, 60 days, 90 days, 120 days and over
  6. Credit terms e.g. 60 days, 5% discount for settlement within 30 days
  7. Query: (a correspondence reference number is entered in this field if the account is under enquiry)
  8. Banking details necessary to pay the creditor by EFT.
3. When suppliers deliver to Wheelies (Pty) Ltd, details of the order are called up on screen (using the Wheelies (Pty) Ltd order number on the supplier delivery note), the goods are counted and checked and a goods received note is generated. One copy of the GRN is attached to the signed supplier delivery note and sent to the creditors' payments section where it is filed alphabetically to await the supplier invoice.
4. When the audit team attended the year-end inventory count on 31 March 2016 Gregg Minnaar the audit senior, recorded, inter alia, the number of the last goods received note for the year (X 7392). He also obtained a print out off the system of GRNs for which no invoice had been received at year-end.
5. The "trade creditors and accruals" balance in the trial balance at 31 March 2016 is R6 329 167 (2015 R8 183 888).
6. A detailed list of creditors balances at 31 March 2015 (prior year) is included, on disk, in the prior year audit work papers. Your firm has audit software compatible with the client's system and you make use of it where it is efficient to do so.
7. The creditors' section is headed up by Lance Pantani who has three creditors clerks reporting to him. Month end creditors' reconciliations are carried out by these clerks and reviewed by Lance Pantani.

During discussions with the audit team about the further audit procedures to be adopted, one of the trainees raised the question of whether it would be appropriate to circularize creditors to confirm their balances. Although your firm had not carried out this procedure in prior years, you decided to perform a **positive** circularization on creditors listed at 31 March 2016 as risk assessment procedures had suggested that a risk of understatement of creditors might exist. Due to the large number of creditors, you decided to select a sample for this circularization.

#### **YOU ARE REQUIRED TO:**

- a) discuss briefly the requirements which should be met to ensure that any 3<sup>rd</sup> party confirmation obtained by the auditor, ranks highly on the hierarchy of audit evidence. (3)



- b) indicate, giving brief reasons, which creditors you would include in the sample of creditors to be positively circularised. (5)
- c) provide three different pieces of information which the auditor might obtain when conducting *risk assessment procedures* to suggest that creditors may be understated. (4)
- d) describe the further audit procedures you would conduct to verify the “trade creditors and accruals” balance of R6 329 167 in the annual financial statements of Wheelies (Pty) Ltd at 31 March 2016. (20)

Note 1: You are *not* required to describe the procedures necessary to carry out the creditors circularization.

Note 2: You need only consider the *completeness* and *valuation* assertions.

**10.17**

**(37 marks 44 minutes)**

**Part 1**

**(20 marks 24 minutes)**

You are a member of the team on the 29 February 2016 year-end audit of Out 'n About (Pty) Ltd, a company which wholesales a range of products for outdoor activities. The company has a public interest score of 130. There are three directors, none of whom own any shares in the company. At the financial year-end the trade accounts payable balance reflected in the final trial balance, was R1 723 918 (28 February 2015 – R1 986 413). You have been assigned to the audit of the year-end balance. You reviewed the audit work papers and noted the following:

1. the acquisitions and payments cycle is divided into ordering, receiving, recording of acquisitions, payment preparation, payment and recording.
2. the company's systems are computerised but hardcopy of most internal documents e.g. purchase requisitions, purchase orders, goods received notes is printed out and efficiently filed.
3. external documents which are used in the system, include supplier delivery notes, supplier invoices and statements. All creditors are paid by EFT.
4. the audit workpapers contain lists of the company's trade accounts payable at 28 February 2015, as well as a client prepared list of trade accounts payable at 29 February 2016. The workpapers also include a list, extracted from the system, of the numbers of goods received notes which were unmatched to supplier invoices at year-end.
5. although the company sells goods manufactured in foreign countries, it does not deal directly with foreign suppliers choosing rather to source its products from local importers.

6. when auditing trade accounts payable, your firm conducts comprehensive procedures on the completeness assertion. The firm does not however circularise creditors other than in exceptional circumstances.
7. Out 'n About (Pty) Ltd's accountant, Ali Shaktar, compiles the annual financial statements.

**YOU ARE REQUIRED TO:**

- a) explain the meaning of the obligation and existence assertions in respect of trade accounts payable. (3)
- b) comment on whether Out 'n About (Pty) Ltd is obliged to have its financial statements externally audited. (2)
- c) describe the substantive audit procedures you would conduct in respect of the **valuation** and **completeness** assertions pertaining to the trade accounts payable balance at 29 February 2016. (15)

**Part 2**

**(17 marks 20 minutes)**

Whilst you were in the process of performing your audit procedures on the Out 'n About (Pty) Ltd's trade accounts payable, you noticed that Sportstravel (Pty) Ltd, appeared on the list of creditors at 29 February 2016. As you were aware that Sportstravel (Pty) Ltd's business was arranging tours to major sporting events around the world, you were curious as to why the company appeared as a creditor of Out n'About (Pty) Ltd. All you could find was a statement from Sportstravel (Pty) Ltd which reflected a balance owing of R102 927 at 29 February 2016. This amount agreed with the balance reflected on the list of trade accounts payable but there were no invoices to support the amount. You also noticed that in the purchase journal the amount had been allocated to the following accounts:

Account	P217 – Product sourcing costs	R90 286.84
Account	V001 – Vat	R12 640.16

When you queried this with the company accountant he informed you that all you needed to know was that the directors had taken a trip overseas to look for new outdoor products as they were thinking of starting to import goods. Not satisfied with this explanation you raised the matter with your audit senior who responded as follows:

“I know about this; the financial director had a chat to me and explained that the three directors, none of whom are shareholders in the company and their wives had not gone to look for outdoor products to import, but had taken a Sportstravel (Pty) Ltd tour to the Australian Tennis Open which they do not want the shareholders to know about. In any event as this matter did not really arise out of a specific audit procedure listed in the audit programme and was not a risk we identified when carrying out risk assessment procedures, you should just ignore it. The budget for this audit is very tight and I'm not going to be held responsible for going over budget because I changed the audit plan.”

**YOU ARE REQUIRED TO** discuss fully whether your senior's decision that the matter should be ignored, is acceptable. Your discussion must include the reasons for your decision.





## **CHAPTER 11**

# **INVENTORY AND PRODUCTION CYCLE**



### 11.1

(15 marks 18 minutes)

Toyco (Pty) Ltd manufactures unique toys in small batches and makes use of the following documentation:

- |                             |                                   |
|-----------------------------|-----------------------------------|
| * purchase order            | * supplier delivery note          |
| * picking slip              | * customer remittance advice      |
| * inventory adjustment form | * transfer to finished goods note |
| * sales invoice             | * clock cards                     |
| * production report         | * job cards                       |

All components used in the manufacturing process are received from suppliers at the central receiving bay and subsequently transferred to the components warehouse. Toys which have been manufactured are transferred from production to the finished goods warehouse. The company uses a “job cost” costing basis for accumulating costs and maintains computerized perpetual inventory records.

#### YOU ARE REQUIRED TO:

- a) identify from the list above, those documents which Toyco (Pty) Ltd would use in their *inventory and production cycle*, and briefly describe what each document is used for. (6)
- b) explain why a job costing system would be suitable for Toyco (Pty) Ltd. (2)
- c) indicate the cycle to which each of the documents you have not identified in (a) above, relate. (4)
- d) state the three broad objectives that a well designed, properly implemented internal control process for the inventory and production cycle will achieve. (3)

### 11.2

(24 marks 29 minutes)

1. To have a sound inventory internal control system, a company must have good internal controls in its acquisitions cycle and its revenue cycle. True or false? Justify. (2)
2. A strong control environment is not really important in the inventory and production cycle. True or false? Justify. (2)
3. List three assertions applicable to the inventory balance in the financial statements. (2)
4. Which assertion relating to inventory will be affected by:
  - 4.1 the theft of inventory items which is not discovered, assuming the company has a perpetual inventory system. (1.5)
  - 4.2 the company’s products are subject to rapid and frequent technological advances. (1.5)
  - 4.3 the company holds inventory on consignment in its warehouse on behalf of other companies. (1.5)
  - 4.4 the company sells only imported products. (1.5)

Justify your choice.

5. Suggest two ways in which a company could manipulate the balance on the inventory account to reflect an increased profit. (2)
6. A company may value its inventory at standard for financial reporting purposes. True or false? Justify. (2)
7. If the auditor's risk assessment procedures suggest that internal control in the inventory and production cycle is weak, he will:
  - 7.1 increase his test of controls.
  - 7.2 increase his substantive tests.
  - 7.3 perform only analytical procedures.Justify your choice and explain why you rejected the other options. (6)
8. When the auditor selects a sample of items in the warehouse and traces them to the inventory count sheets, is he testing for valuation, existence or completeness? Explain your answer. (2)

### 11.3

**(10 marks 12 minutes)**

You are a member of the audit team engaged on the audit of Origin (Pty) Ltd a wholesaler of a large range of items for the workplace.

The following procedures were carried out in respect of inventory for the 29 February 2016 financial year-end:

1. The audit team performed test counts by selecting items from the inventory sheets and counting the physical items.
2. The audit team selected inventory items from the shelves in the warehouse, counted them and agreed the quantity to the inventory sheets.
3. The senior on the audit team worked her way through the warehouse looking for evidence of damaged, dust covered inventory.
4. A junior trainee checked the number sequence on the inventory sheets for missing sheets.
5. The junior also checked the extensions (quantity x price) on the inventory sheets and cast the total column.
6. The senior enquired from the inventory controller as to whether
  - 6.1 Origin (Pty) Ltd held consignment inventory on behalf of anyone
  - 6.2 anyone held consignment inventory on behalf of Origin (Pty) Ltd.
7. The senior obtained a sample of sales invoices for March and compared the selling price of the items sold to the 29 February 2016 inventory sheets.

8. The senior scrutinized the minutes of directors meetings and bank confirmations to determine whether Origin (Pty) Ltd's inventory had been pledged as security.
9. The senior discussed with the inventory controller
  - 9.1 the method of allowing for inventory obsolescence
  - 9.2 the manner in which the inventory obsolescence write down is approved.
10. The senior inspected the accounting policy note for inventory in the annual financial statements.

**YOU ARE REQUIRED TO** indicate, for each of the above (1-10) procedures, the assertion to which the procedure relates.

#### 11.4

**(15 marks 18 minutes)**

The following audit procedures were carried out during the year-end audit of Foodfans (Pty) Ltd, a food wholesaling company.

1. Inspected a random sample of inventory adjustment forms for authorising signatures of the warehouse manager and the financial accountant.
2. Discussed the company's marketing strategies, products etc, with the marketing manager.
3. Observed pickers selecting items from the warehouse shelves as part of understanding the picking and dispatch process.
4. During the year-end inventory count, checked expiry dates on food stuffs.
5. Using audit software, reperformed the quantity x cost calculation for all inventory items on hand at the financial year-end and cast the total cost column.
6. Observed the client's personnel conducting inventory count procedures in compliance with written count instructions.
7. Traced a sample of inventory items to the suppliers invoice to establish whether the correct purchase price had been used in costing inventory.
8. At the year-end inventory count, traced a sample of inventory items in the warehouse to the perpetual inventory records.
9. Reviewed major contracts which Foodfan (Pty) Ltd had entered into with leading food chains.
10. Discussed the method and process for determining the allowance for inventory impairment with the audit committee at the commencement of the audit.
11. Enquired of the financial accountant as to whether any of the inventory had been offered as security.

12. Selected a sample of items from the perpetual inventory records and counted the items selected in the warehouse.

**YOU ARE REQUIRED TO** indicate whether each of the procedures listed above is a risk assessment procedure, test of controls or substantive procedure. For each substantive procedure, identify the inventory assertion to which the procedure relates.

**11.5**

**(10 marks 12 minutes)**

You are the senior trainee on the audit of Bubbles (Pty) Ltd, a company which manufactures and sells soaps and other cleaning materials. You asked a junior trainee to explain the assertions relating to Bubbles (Pty) Ltd's inventory of R1 832 916 reflected in the financial statements at 31 March 2016. He responded as follows:

- Completeness: Only inventory which is complete is included in the figure of R1 832 916. Work in progress is excluded.
- Validity: Only saleable inventory is included. Any inventory which has expired because of deterioration, is excluded from the amount of R1 832 916 i.e. it is invalid.
- Rights: Bubbles (Pty) Ltd has a licence (the rights) to manufacture the soaps and cleaning materials which it sells.
- Existence: The inventory which is included in the amount of R1 832 916 actually existed at reporting date i.e. it had already been manufactured.

**YOU ARE REQUIRED TO** discuss your junior trainee's understanding of the assertions pertaining to Bubbles (Pty) Ltd's inventory, based on his response.

**11.6**

**(20 marks 25 minutes)**

You are a trainee accountant at a large firm of registered auditors which has a very varied client base. All of the companies listed below hold large quantities of inventory at their respective year-ends.

- Airtime Ltd:*** This company manufactures and sells a range of gasses to industry e.g. oxygen, carbon dioxide. The cost of the different gasses produced varies considerably as does their shelf life.
- Witehouse (Pty) Ltd:*** This company sells (only) "white goods" e.g. stoves, fridges, to the general public from a huge warehouse location in Gauteng. An efficient perpetual inventory system facilitates sound inventory control.
- Fishybusiness Ltd:*** This company cultivates edible fish at its fish farm in Zululand. Inventory consists of very young fish in tanks, larger fish in

man made lakes/ponds and harvested fish held in the company's temperature controlled warehouse.

***Secondhand Rose (Pty) Ltd:*** The company deals in second hand goods which it purchases from members of the public. Where necessary, items are repaired in the company's workshop.

**YOU ARE REQUIRED TO** categorise the risk of material misstatement applicable to inventory held by each of the companies above as low, medium or high, based on the information given above. Justify your choice.

**11.7**

**(20 marks 24 minutes)**

Soundwaves (Pty) Ltd wholesales a large range of hi-fi equipment, e.g. amplifiers, speakers, mixers, etc. The company holds a considerable quantity of high value inventory in its central warehouse.

1. The warehouse is monitored by close circuit television twenty four hours a day.
2. Sam Most, the warehouse supervisor has read only access to the inventory masterfile.
3. Warehouse personnel carry out inventory cycle counts on an ongoing basis.
4. When items are transferred from the goods receiving bay to the warehouse, the warehouse foreman signs an "inventory transfer note" which accompanies the goods.
5. Senior warehouse personnel are sent regularly on product training courses to make them more knowledgeable about the products the company sells.
6. The company's insurance company visits Soundwaves (Pty) Ltd every six months to assess the adequacy of the warehouse security conditions and to discuss with the senior personnel whether the company is adequately insured.
7. Any employee at Soundwaves (Pty) Ltd who is caught attempting to steal inventory is dismissed immediately.
8. Adjustments needed to the inventory records arising from cycle counts must be authorised by the warehouse supervisor and the financial accountant.

**YOU ARE REQUIRED TO:**

- a) indicate whether each of the above actions/policies/procedures (1 to 8) is a general control or an application control. (8)
- b) describe the purpose (objective) of each of the actions/policies/procedures (1 to 8). (12)



You are on the audit of EagleEye (Pty) Ltd a company which manufactures security devices, e.g. burglar alarm units, surveillance cameras, etc.

Some months prior to the audit, the company appointed Simon Brown as the internal auditor of the company. He reports to Krishen Vather the financial manager. Prior to his appointment as internal auditor, Simon Brown had been an administration clerk in the creditors section. However, due to a restructuring of the creditors section, his position had become redundant, and his options were either to leave the company or accept the newly created post of internal auditor. Although he has no formal training in auditing, Simon Brown is regarded as a competent and enthusiastic staff member who could develop into a satisfactory internal auditor.

It has also been decided that, as internal auditor, he could be used effectively if staff members in the accounting department are absent, on annual or sick leave, to carry out their responsibilities.

You had considered the possibility of relying on some of the work which Simon Brown had carried out relating to the inventory and production cycle and using him to assist with certain aspects of the year-end inventory audit, but decided at this stage it was not appropriate to do so.

In addition to your audit responsibilities, Krishen Vather has requested that you evaluate certain aspects of the production cycle and make recommendations for improvement where necessary. He believes that improvements are required and that the Board would be receptive to reasonable recommendations. He has provided you with the following narrative description:

***Systems description – production***

1. The company manufactures a standard range of products, each of which has its own product code.
2. Manufacture is carried out by ten technicians who each have their own workstation in the factory. The workstation consists of a bench and all the necessary equipment the technician requires to build and test the products.
3. The factory foreman, Frans Flinthoff, is in charge of the factory and reports to the production manager.
4. The sales department notifies the production manager of demands for the company's products on a weekly basis. (This procedure works well).
5. A large "production blackboard" is positioned at the entrance to the factory. This blackboard displays each workstation number and the name of the technician assigned to that workstation. Below these headings are columns to enter the date, product code and quantity of the product to be manufactured.
6. Each Monday morning the production manager assigns work to the technicians by updating the date, product code and quantity columns on the blackboard.

7. All of the technicians are trained to manufacture all of the company's products and have an assembly manual to which they can refer if necessary.
8. Components for manufacture are kept in a warehouse adjoining the factory. As technicians generally know what components are needed to manufacture each product (they can also refer to the assembly manual), they will personally select the components from the warehouse shelves as they require them.
9. Once the technician has constructed and thoroughly tested a batch of items, he loads them onto a trolley and takes them to the finished goods warehouse.
10. On arrival at the finished goods store he unloads the items in the receiving area and returns to his workstation.
11. Before the end of each working day a warehouse clerk who is responsible for keeping the components warehouse and finished goods warehouse clean and tidy, takes the items manufactured from the receiving area and places them on the allocated shelves in the warehouse. No perpetual inventory records are maintained.

**YOU ARE REQUIRED TO:**

- a) fully justify your decision not to rely on the work of Simon Brown, the internal auditor, on the audit of EagleEye (Pty) Ltd. (15)
- b) identify the weaknesses in those aspects of the production cycle described above, and for each weakness make suitable recommendations for improvement. (Do not concern yourself with the costing of manufactured items). (20)

**11.9**

**(30 marks 36 minutes)**

You are a trainee accountant in a large firm of auditors. The firm has a very diverse portfolio of clients, one of which is Celtec (Pty) Ltd a wholesaler of cellular telephones. The company is not particularly well run and you are somewhat concerned about the 31 March 2016 year end inventory count as you have just received the following e-mail from Michael Message, the inventory controller at Celtec (Pty) Ltd giving you details about the year-end inventory count.

- 1.1 Celtec (Pty) Ltd will allocate eight hours to the inventory count from 8am to 4pm on 30 March 2016. The warehouse will be divided into eight sections, each to be counted by a different team. Sixteen staff members including myself will be allocated to count the inventory. We will be divided into eight teams of two. The first team will count their section from 8am to 9am, and the second team will continue from 9am to 10am and so on. Thus, as one team finishes their section, another team will commence.
- 1.2 All teams will assemble at 7.45am on the day of the count and I will inform them on which section to count and who makes up the teams. My counting partner and I will count for the first hour as I am due at a seminar on cell phone technology from 10am

to 3pm. While one person counts, the other person will record the results of the count on blank lined paper which they will be given.

- 1.3 No deliveries will be made from Celtec (Pty) Ltd on the day of the inventory count, but obviously we cannot control deliveries from suppliers. I will be instructing the receiving clerks (none of whom will be counting) to receive goods in the normal manner and transfer them onto the shelves in the warehouse so that they are included in the physical count.
- 1.4 Once each team has completed its count, one of the team members will place the count sheets on my desk. When I return from the seminar I will adjust the perpetual inventory records to agree with the count sheets; I will obtain the cost price from the latest invoice for each inventory line e.g. Nokia 20P, and write it onto the count sheets. Over the weekend I will do the extensions (quantity x price) for each inventory line and cast the sheets. By Monday morning you should have the completed sheets reflecting the total value of inventory.

If you have any problems with the above, please feel free to contact me.

**YOU ARE REQUIRED TO *identify* and *explain*** the weaknesses evident from Michael Message's e-mail in respect of the proposed inventory count and costing of inventory.

**11.10**

**(35 marks 41 minutes)**

You are the manager on the audit of Firezone Ltd. The company is a wholesaler of numerous products related to domestic and industrial heating, fire extinguishers and other fire fighting chemicals and equipment. The company's year-end is 31 July. The senior on the audit was taken ill shortly before the financial year-end and you had no choice but to put a far less experienced trainee Ted Mitton, in charge of the audit.

Pertinent information about the company's inventory is as follows:

1. Inventory is kept in a single warehouse in Durban.
2. The warehouse is divided into six sections according to the type of goods stored e.g. domestic heaters, chemicals etc, and is neatly stacked.
3. The majority of items are packaged in sealed boxes or cartons.
4. Some of the chemicals have a limited shelf life. Where this is the case, the expiry date is stamped on the container.
5. Firezone Ltd holds inventory on consignment from Bushblaze Inc, an Australian firefighting company.

You asked Ted Mitton to submit a report to you on his attendance at the year-end inventory count. The report contained the following information.

1. The inventory count took place over two afternoons, from 1pm to 5pm on 30 and 31 July. This was to enable the company to receive and dispatch goods during the morning.
2. The count was carried out by the six warehouse employees who usually pick the goods to fill orders. This worked well because they are familiar with the nature of the inventory and where everything is stored.
3. The pickers decided amongst themselves which section of the warehouse to count. Maggie Motolo, the warehouse administration clerk, printed a list off the computerised perpetual inventory system (inventory sheet) of each item (description and quantity) in the section chosen by the picker. The numerically sequenced inventory sheets were handed to the pickers who then counted each item in their section of the warehouse, ticking off the quantities on the inventory sheets once they had counted the item.
4. If the count quantity differed from the quantity on the inventory sheet, the counter (picker) highlighted the item and quantity and wrote in the number he had counted.
5. At the conclusion of the count on the second day, the counters returned the inventory sheets to Maggie Motolo who identified the highlighted items and amended the quantities on the perpetual inventory records to reflect the actual quantities on hand.
6. Prior to the count, I confirmed with the financial accountant that we would be attending the inventory count. He confirmed the dates and times with me.
7. I was assisted at the count on both days by Zane Mulla (also a second year trainee) and we carried out the following procedures:
  - 7.1 accompanied each picker for a short period of time on each day to observe them counting.
  - 7.2 allocated the six sections between us, compiled a count workpaper by selecting inventory items (on a random basis) from the counters' inventory sheets, and performed a physical count of the items selected.
  - 7.3 we entered the count quantity for each item counted on our workpaper (which is attached).
  - 7.4 observed Maggie Motolo adjust the quantities on the perpetual inventory records.
  - 7.5 I initialed each of the inventory sheets and left them in the custody of Maggie Motolo.

**YOU ARE REQUIRED TO:**

- a) discuss the weaknesses in the year-end inventory count, based on the information given above. (17)
- b) state whether you would be satisfied with the procedures conducted by the trainee accountant in connection with the year-end inventory count at Firezone Ltd. Fully justify your answer. (18)

You are a member of the team on the year-end audit of Kitchenstuff (Pty) Ltd. The company has a 31 July 2016 financial year-end. In late June you were informed by your audit manager, that you would be in charge of the audit team attending the inventory count and that you would assist with certain other aspects of the inventory audit. You have gathered the following information :

1. The company operates out of a single very large “warehouse type” outlet in a shopping centre in Gauteng, which consists of a showroom and adjoining warehouse. The internal control process is sound.
2. The company sells a large range of general kitchen appliances both large and small, e.g. fridges, stoves, microwaves and expensive knives etc, some of which are imported. Material quantities of inventory are held.
3. A well designed computerized perpetual inventory system is maintained and physical control over inventory is efficient, the only weakness being, in your firm’s opinion, that cycle counts are not conducted. Other than fridges, stoves, etc on the shop floor, inventory is kept in its original packaging. The warehouse is well laid out, with different appliances being kept in designated areas and stacked by make and model. Despite the sound controls, inventory does get damaged and dented and there are always items which do not sell as well as expected.
4. The year-end inventory count is planned for the close of business (4.00 pm) on 31 July.
5. The directors are anxious that the financial situation of the company be presented as favourably as possible.
6. The company hold an extensive line of expensive cooking pots on consignment for Modernpots CC. It does not sell any other cooking pots.
7. The method for counting inventory will be as follows :
  - 7.1 sequenced inventory count sheets will be printed off the inventory masterfile but will reveal only the inventory item number, description and location of the inventory. The theoretical quantity on hand will not be shown
  - 7.2 the warehouse will be divided into 10 designated areas and ten, 2-man teams will perform the count
  - 7.3 as each item is counted, the first count team member will attach a bright pink label to it and the second member will record the quantity of the items on hand on the inventory sheet
  - 7.4 once the count is completed, the count teams will return the inventory count sheets to Freddie Sithole the warehouse manager, who will be in charge of the count
  - 7.5 whilst the count teams have a break, the quantities recorded on the inventory count sheets will be compared to the quantities recorded on the inventory masterfile (using a simple programme), and a list of differences will be printed out. The count teams will then recount/follow up on items for which there is a difference. Where there are physical quantity errors, they will be corrected on

the inventory count sheets so that by the end of the count, Freddie Sithole will be satisfied that the inventory count sheets accurately represent the physical inventory on hand.

8. Subsequent to the inventory count, any quantity differences resulting from errors in the perpetual inventory records, will be investigated and the masterfile amended accordingly. Once this has been done the final inventory count sheets will be produced and the value of inventory calculated from the inventory masterfile.
9. Around mid-July, count teams were provided with written count information and instructions by Freddie Sithole.

### **YOU ARE REQUIRED TO**

- a) discuss whether the risk of material misstatement relating to Kitchenstuff (Pty) Ltd's inventory balance at 31 July 2016 should be regarded as low, medium or high, based on the information given above. In your discussion deal with all the assertions directly related to inventory. (12)
- b) describe the procedures you would have carried out in your capacity as audit team leader, prior to the year-end inventory count. (7)
- c) describe the procedures the audit team will conduct when attending the 31 July 2016 inventory count at Kitchenstuff (Pty) Ltd. (12)
- d) describe the procedures you will conduct to confirm that Kitchenstuff (Pty) Ltd has the **rights** (of ownership) for the inventory reflected in the financial statements at 31 July 2016. (4)
- e) explain why conducting cycle counts would be beneficial to Kitchenstuff (Pty) Ltd. (3)

### **11.12**

**(35 marks 42 minutes)**

You are a member of the computer audit team of Imzy and Taheer. One of your firm's clients, Marbles (Pty) Ltd, a wholesaler of toys is intending to introduce a computerised accounting system which will result in the buying, warehousing, despatch, sales, payroll and accounting departments being linked on a local area network.

As part of an exercise to educate staff and gain their interest in the project all employees have been asked to communicate any concerns or problems which they might have about the introduction of the system. Generally their staff responded very positively with the exception of Marcus Welby, the warehouse manager. Marcus Welby who has been with Marbles (Pty) Ltd for many years is responsible for the receipt, custody (storage) and despatch of inventory. He has a large staff who report to him including five receiving clerks, six warehousemen and three despatch clerks.

Marcus Welby's submission concerning his problems with the proposed computerisation included the following:

"I am particularly concerned that the introduction of the computer will reduce the control I have over my department.

1. I believe in good old fashioned books and paper which I can see and read, everything will now be "on the system". (3)
2. With so many terminals about, linked to other departments there is going to be unauthorised access to the inventory records. (12)
3. With five receiving clerks operating three terminals in the receiving department I won't be able to pinpoint responsibility. (3)
4. Receiving clerks are bound to make numerous errors when using the terminals which will result in incorrect GRNs etc being printed and which will go undetected. (8)
5. Amendments to my inventory ledger can now be made without my authority or even without me knowing about it. (4)
6. I also fail to see how this computerisation will enhance the effectiveness of our physical inventory control which it is claimed will be the case." (5)

As you are very knowledgeable about the proposed system, you have been asked to discuss Mr Welby's concerns with him.

**YOU ARE REQUIRED TO** respond to Mr Welby's concerns explaining to him, inter alia, the controls which would be put in place which would address the concerns he has raised.

**11.13**

**(40 marks 48 minutes)**

You are the senior in charge of the 29 February 2016 year end audit of Parts 'n Pieces (Pty) Ltd a motor spares and accessories company. Parts 'n Pieces (Pty) Ltd uses a computerised perpetual inventory system and carries out regular physical inventory test checks (cycle counts) rather than a count at the year-end. Your firm does not attend these cycle counts. Pre-numbered goods received notes are used to record receipts of inventory while pre-numbered stores goods issue slips are used to record issues of goods from inventory. The company makes use of an on-line data entry and validation system whereby the transactions, once recorded onto the manually prepared source documents, are input individually into the system via terminals located in the inventory section.

The following information is held on the inventory master file:

<i><b>Field</b></i>		<i><b>Example</b></i>
Inventory number	:	SP2673
Inventory category	:	accessories
Inventory description	:	chrome exhaust cap
Inventory location	:	W4
Quantity on hand	:	150
Unit of issue	:	single item



Unit selling price	:	R120.52
Unit cost (calculated as weighted average)	:	R73.20
Date of last receipt	:	13/01/2016
Date of last sale	:	18/02/2016
Date of last physical inventory count	:	31/11/2015
Date of last inventory adjustment	:	n/a
Year-to-date sales quantity	:	925
Year-to-date purchases quantity	:	1035
Code number of last supplier used.	:	Exh 321

Your firm has a range of audit software suitable for use on the inventory masterfile and you are competent to use it.

### **YOU ARE REQUIRED TO:**

- a) discuss, briefly, the matters an auditor would consider in deciding whether or not to use CAATs on an audit. (Note: answer in general terms not specifically in respect of the audit of Parts 'n Pieces (Pty) Ltd.) (10)
- b)
  - i) detail the information you could extract from the inventory master file, for the year-end verification of inventory.
  - ii) explain what you would do with the information obtained. (30)

**11.14**

**(40 marks 48 minutes)**

Kaplan and Co are the auditors of Roadsport (Pty) Ltd, a company involved in retailing standard lines of imported motor vehicle components. The company, which is profitable but illiquid, operates in Johannesburg and has a branch in East London. The branch in East London clears the crates through the harbour and holds them in Roadsport (Pty) Ltd's warehouse, usually for several weeks, before despatching them, on request, to Johannesburg in their original crates. Roadsport (Pty) Ltd entered into negotiations with Nedwest Bank in an attempt to borrow a substantial sum of money to alleviate the shortage of working capital.

Kaplan & Co was engaged to report on a set of financial statements at 31 December 2015, to be used in support of the loan application made to Nedwest Bank. The firm has three partners and in past years one of the three partners (and two trainees) have visited the East London branch to conduct financial year-end (30 June) inventory verification procedures, as inventory is crucial to the fair presentation of the annual financial statements for this client. Due to his extremely busy schedule during December and January, Don King the engagement partner for this client decided to engage a registered auditor in East London, to assist with inventory verification. As he did not know any registered auditors in East London, he looked at a list of practitioners supplied by the South African Institute of Chartered Accountants and selected Henry Cooper, a sole practitioner.

Don King phoned Henry Cooper and asked him if he would carry out an inventory verification (quantity only) on 31 December 2015, at Roadsport (Pty) Ltd's warehouse in East London. Henry Cooper readily agreed and shortly thereafter, Don King sent him a short email confirming the engagement and stating that all that was required, was for Henry Cooper to check the quantity of a sample of components from the client prepared inventory sheet to the



physical inventory on hand and do anything else he considered necessary. The inventory sheets would be given to him by the warehouse manager on the 31 December. Henry Cooper was further instructed to return the inventory lists direct to him (Don King).

One of Henry Cooper's junior trainees duly arrived at the client on 31 December and introduced himself to the warehouse manager. On seeing numerous crates of various sizes the trainee decided that all he needed to do was to check a large sample of crate numbers printed on the crates in the warehouse to the inventory sheets to confirm that they were all listed.

On 2 January 2016, Henry Cooper's trainee left a phone message at Don King's office indicating that all inventory was accounted for and that the inventory sheets would be mailed to Don King shortly by the warehouse manager.

The inventory sheets did not arrive, and as he was pressed for time Don King, accepting that all inventory was accounted for, checked the client's valuation of the inventory (from head office documentation), which he found to be satisfactory, completed all other audit procedures and issued an unqualified audit report. On the strength of the audit report, Nedwest Bank made the loan to Roadsport (Pty) Ltd.

Shortly thereafter, a massive fraud was uncovered at Roadsport (Pty) Ltd. In the investigation, it was established that the warehouse manager in East London had been selling quantities of Roadsport (Pty) Ltd's inventory for his own account, for a number of months. He had concealed the resulting inventory shortages by packing crates from which he had taken components, with bricks and carefully resealing the crates. When components were required in Johannesburg he simply removed any bricks from these crates and refilled them with components taken from other shipments before resealing them and despatching them. It was also established that he had never mailed the audited inventory sheets to Don King.

As a result of the fraud Roadsport (Pty) Ltd went insolvent and was liquidated and Nedwest Bank suffered financial loss.

**YOU ARE REQUIRED TO:**

- (a) critically examine the performance of Don King and Henry Cooper (and his trainee) with regard to this engagement, based on the information given in the question. (16)
- (b) for each criticism you have raised in (a) above, state what should have been done by Don King and Henry Cooper (and his trainee) respectively. (24)

**11.15**

**(30 marks 36 minutes)**

You are engaged on the 31 March 2016 audit of Formweld (Pty) Ltd a company in the light engineering sector. You have been assigned to the audit of inventories. Towards the end of the financial year, the company was involved solely in the manufacture of 20 pivot irrigation systems for Turner farms Ltd, a commercial farming company. At year-end, four of the twenty systems ordered had been completed and were awaiting collection. Six were "work-in-progress" and manufacture of the balance of 10 had not commenced.

All materials used in the manufacture of the systems are purchased locally, with the exception of the high pressure pumps which were imported as a batch of twenty from Speck Pumps Inc in Germany.

The company operates a job costing system. Each unit is treated as a separate job and costs and other information are recorded on a numerically sequenced “job card” on which costs are recorded.

Prior to the commencement of the manufacture of the units, a “materials and labour schedule” is prepared by the company’s engineer and cost accountant. This document details the estimated manufacturing hours for the different grades of employee working on the unit and the description and estimated costs of materials to be used.

At year-end the chief engineer, John Graham, estimated the stage of completion of the six units in progress and provided you with the six job cards updated to the 31 March 2016. The year-end inventory count took place on the last day of the year.

Prior to the year-end, you evaluated the underlying internal control systems and conducted tests of controls. You have concluded that the accounting system and related controls at Formweld (Pty) Ltd are sound.

The job card for the seventh unit (unit 7) which is included in work in progress at 31 March appears below (see next page).

**YOU ARE REQUIRED TO:**

- a) describe the audit procedures you would have conducted at the year-end inventory count in respect of work-in-progress. (5)
- b) describe the audit procedures you will conduct in respect of the costs relating to the seventh irrigation system (unit 7) included in work-in-progress at 31 March 2016. (25)

***Note job card on next page.***

Formweld (Pty) Ltd Box 10, Willerton Pietermaritzburg.					Job Card no: 3276
Customer :   Turnerfarms Ltd Product   :   Pivot Irrigation System Unit 7					
Employee	Grade	Wage week	Hrs	Rate	R
Preston	skilled	49-52	136	R80	10 880
Dhlamini	skilled	49-52	136	R72	9 792
Clark	skilled	52	16	R90	1 440
Costas	unskilled	49-52	136	R25	3 400
John	casual	51	40	R10	400
					R25 912
<i>Materials</i>					
Description		Requisition	Amount		
Speck Pump V32791		SR 2891	54 292		
Pivot Arm		SR 2782	18 610		
Piping & Joints		SR 2798	21 839		
Consumables		SR 2781	4 923		R99 673
<i>Overheads</i>					R14 200
<i>Additional Costs</i>		Pivot Arm. This pivot arm fell off the forklift whilst being transported to the workshop from stores. Damaged beyond repair.			R18 610
<i>Stage of Completion</i>		At the 31 March 2016 unit 7 was 80% complete			
Signed: <i>John Graham</i>					
Total					R158 395

### 11.16

(44 marks 52 minutes)

You are the senior in charge of the audit of BBike (Pty) Ltd, a wholesaler of bicycles and related products, e.g. cycling accessories. The company has a turnover of approx R120 million per annum and the value of inventory on hand at 31 March 2016 was R30 836 000. In terms of the company's Memorandum of Incorporation, the company must be audited annually.

The current year-end audit workpapers revealed the following:

1. The company sells both cheap (“low-end”) and expensive (“high-end”) bicycles. Low-end bicycles are sold to chain stores around the country, whilst high-end bicycles are sold only to specialist bicycle retailers. In terms of quantity, more low-end bicycles than high-end bicycles are sold.
2. Within each category of bicycle there are numerous makes and models with differing costs and selling prices.
3. Every high-end bicycle has a manufacturer’s serial number stamped on its frame for identification purposes. These bicycles can cost BBike (Pty) Ltd anything between R15 000 and R40 000 landed cost (in their warehouse).
4. All bicycles are imported; low-end bicycles from Taiwan/China and high-end bicycles from France, USA or Italy.
5. The inventory masterfile contains the following fields:

Item code	see note 1 below
Model/Description	note 2
Category	note 3
Frame number	note 4
Name of supplier	
Quantity on hand	
Unit cost	note 5
Date of last receipt and GRN	
Date of last sale and invoice number	
Selling price	
Discontinued item	note 6

Note 1: the item code is assigned by BBike (Pty) Ltd.

Note 2: describes the bicycle, part or accessory.

Note 3: there are four options only, high-end (H) low-end (L) parts (P) and accessories (A).

Note 4: used only for high-end bicycles (every high-end bicycle is treated as a unique inventory item).

Note 5: for high-end bicycles the cost of the specific bicycle is used; for all other inventory items, weighted average is used.

Note 6: several times a year BBike (Pty) Ltd is sent written notification from its various suppliers, listing inventory items which have been discontinued. On receipt of this notification, the date of notification is entered into the “discontinued item field”. Once an inventory item has a date in this field, the BBike (Pty) Ltd sales staff (who have read access to the inventory masterfile) are encouraged to make deals with their customers to move these items. If necessary they can make the sale at a price of up to 20% below the cost reflected in the masterfile. Although new models of high-end bicycles are introduced annually, BBike (Pty) Ltd never treats high-end bicycles as discontinued items.

6. Each bicycle is delivered by the suppliers to BBike (Pty) Ltd in a cardboard container. The description of the bicycle e.g. model, make, serial number (where applicable) is

printed on the box. Before any goods are taken into the warehouse, the BBike (Pty) Ltd item code is written onto the container/box in which the goods were delivered.

7. Your audit team attended the annual inventory count held on 31 March 2016. The only query which arose from the inventory count was that the audit team, on opening one of the high-end bicycle containers, discovered that expensive parts had been stolen off the bicycle and the container resealed. On investigation, the warehouse manager established that all the expensive parts had been stolen off thirty three high-end bicycles stored in an isolated section of the warehouse. He prepared a schedule which identified each bicycle which had been affected, as well as the description and cost of the parts which had been stolen and would have to be replaced before the bicycles could be sold. Fortunately in removing the parts from the bicycles, the perpetrators had not damaged the bicycles. Your audit team was satisfied that all bicycles affected and all parts stolen, had been included on the schedule.

Your audit team makes use of audit software wherever possible. Your hardware and software is compatible with BBike (Pty) Ltd's system.

**YOU ARE REQUIRED TO:**

- a) outline the internal controls which should be in place to ensure that invalid "updates" are not made to the "discontinued item field". (6)
- b) identify the reports which your audit team could have generated off the system to assist them at their attendance at the inventory count on 31 March 2016. (8)
- c) describe the audit procedures your audit team would conduct in relation to the **valuation** assertion relating to BBike (Pty) Ltd's inventory at 31 March 2016. You may assume that all quantities in the inventory masterfile have been correctly adjusted to account for discrepancies identified at the inventory count. (30)

**11.17**

**(40 marks 48 minutes)**

You are a member of the team on the 31 July year-end audit of Bookbox (Pty) Ltd. You have been assigned to the audit of inventory.

Bookbox (Pty) Ltd is a wholesaler of books. The company sells books on a wide range of topics, e.g. fictions, sport, business, but does not sell text books. You have been provided with the following information :

- 1. The year-end inventory count will take place after hours on Wednesday 28 July. The company does not conduct cycle counts during the year.
- 2. The company's inventory records are computerized and their software is compatible with your firm's audit software. (Once the year-end inventory masterfile is finalized, it is downloaded onto the audit team's laptops for audit interrogation).
- 3. The company purchases its books from publishing houses, both local and foreign. In excess of five thousand titles are on hand and quantities and unit costs can vary

significantly. The company attempts to sell only “popular” titles, avoiding specialist titles for which there is little demand.

4. All titles are listed on the inventory masterfile which contains the following information :
  - 4.1 Title and author
  - 4.2 Publisher and country of publisher
  - 4.3 ISBN number (a number unique to each book title)
  - 4.4 Unit cost in rand
  - 4.5 Selling price
  - 4.6 Quantity on hand, e.g. 100 copies
  - 4.7 Category, e.g. business, sport
  - 4.8 Date of last sale
  - 4.9 Quantity sold year to date.
5. The warehouse is well laid out. Each category of book is kept in a designated area. Within each category’s designated area, books are stacked in boxes, alphabetically by author.
6. You have carefully reviewed the company’s inventory count instructions and are satisfied that an accurate, efficient count will take place. Count teams will record count quantities on pre-printed inventory sheets and the count will be controlled by Barry Potter the financial controller, and Jakes Mda the warehouse manager. You and other team members will attend the inventory count.
7. Once any discrepancies between theoretical and actual quantities have been resolved the necessary amendments to the inventory masterfile will be made. At the same time amendments will be made for all damaged inventory. All damaged inventory is regarded as unsaleable and is sent to a waste paper depot for recycling. Masterfile amendments are authorized by Barry Potter and Jakes Mda.
8. The company values its inventory on the FIFO basis.
9. The value of inventory per the inventory masterfile at year-end, is reduced by a writedown for slow-moving inventory. The basis of the writedown, which is usually material, is as follows :
  - 9.1 the selling price of all titles for which there have been no sales for the nine month period prior to year-end, is reduced to the special “stock clearance” selling price of R50 per unit, regardless of the title’s unit cost (there are no titles which have a unit cost of less than R50).
  - 9.2 the company’s customers are provided with a list of these titles and are notified that they can be purchased on a “whilst stocks last” basis. The offer is valid only for August.
  - 9.3 at the end of August, the unsold books are donated to charity.
10. Books sold at the “stock clearance” price are invoiced on unique sequenced “stock clearance invoices” to distinguish them from normal sales.

It has been agreed with your audit manager that your audit of inventory will take place during the early part of August but that you will return in the first week of September, to conduct audit procedures on the writedown of slow moving inventory.

**YOU ARE REQUIRED TO:**

- a) describe the procedures you will conduct in respect of the *completeness* assertion for Bookbox (Pty) Ltd's inventory at 31 July 2016. (6)
- b) describe the procedures you will conduct in respect of the valuation of Bookbox (Pty) Ltd's inventory before the writedown for slow moving inventory is affected. (20)
- c) describe the procedures you will conduct in respect of the writedown for slow moving inventory at 31 July 2016 when you return to the client in early September. (14)

## **CHAPTER 12**

# **FINANCE AND INVESTMENT CYCLE**





**12.1****(25 marks 30 minutes)**

1. The finance and investment cycle has certain unique characteristics which result in transactions in this cycle not being subjected to normal routine internal controls. What are these unique characteristics? (3)
2. What are “compensating” controls? (1)
3. Outline the compensating controls which may be implemented in this cycle. (4)
4. The risk of material misstatement can generally be regarded as low in this cycle. Comment. (3)
5. What does impairment of an asset mean? (2)
6. What are the assertions which relate to transactions which take place in this cycle? (2)
7. What is an intangible asset? Give two examples. (2)
8. How is property, plant and equipment defined? (2)
9. What conditions must be met if the cost of an item of property, plant and equipment is to be recognized as an asset? (2)
10. Can the following costs be included in the cost of an item of property, plant and equipment
  - 10.1 costs of preparing the site for building a new warehouse.
  - 10.2 architects fees for the design of the warehouse.
  - 10.3 costs incurred in bringing the provincial minister of industry to open the new warehouse.
  - 10.4 costs of engaging an electrical engineer to carry out a final quality control check on the warehouse cooling system?
  - 10.5 VAT on the materials used in construction of the warehouse. (4)

**12.2****(20 marks 24 minutes)**

1. Briefly describe four situations at various audit clients which may suggest that the risk of material misstatement in the account heading “plant and equipment” should be assessed as high. (Assume the account heading to be material). (4)
2. In terms of IAS 16 – Property, Plant and Equipment, a company can chose to value its assets using the cost model for some assets and the revaluation method for other assets. True or False? (2)
3. If the cost model is selected for valuation of PPE, the auditor must give attention to how the cost of the asset is made up. Which of the following costs may be included in the cost of the asset? Justify.
  - 3.1 import duties for components of the asset. (1)

- 3.2 costs associated with the throwing of a concrete deck on which the plant will be placed. (1)
- 3.3 costs of bringing out an engineer from Germany to oversee the installation. (1)
- 3.4 the costs of training the maintenance crew who will maintain the machine. (1)
4. IAS 16 requires that “each part of an item of property, plant and equipment with a cost that is significant in relation to the total cost of the item shall be depreciated separately”. Illustrate this requirement with an example of its application in a large manufacturing company. (3)
5. When the auditor conducts procedures to identify any unrecorded disposals of plant and equipment, for which assertion(s) relating to plant and equipment, is he gathering evidence? (1)
6. Landlines Ltd has 10 000 shares in a company listed on the JSE, 5 000 shares in a company listed on the London Stock Exchange and several investments in local private companies. All investments have been held for a number of years. How should these investments be valued at year-end. (3)
7. Blogg (Pty) Ltd has a computerised fixed asset register. You have the necessary software to scan the entire register for error conditions. List four error conditions you might encounter. (2)
8. An asset leased by the company on an operating lease can be included as part of the company’s plant and equipment in the statement of financial position. True or false?(1)

### 12.3

**(15 marks 18 minutes)**

Whilst carrying out the audit of property, plant and equipment, motor vehicles and investments at DeadC Ltd, a manufacturing company, the auditor carried out the following procedures:

1. Physically inspected a sample of items of equipment selected from the fixed asset register, agreeing their asset numbers and description to the register and assessing their condition.
2. Reviewed the purchase journal for large amounts, traced the amounts and details to the supplier invoice to determine the nature of the goods supplied and confirmed that the amounts had been correctly allocated to the appropriate account in the general ledger.
3. Selected a sample of additions to plant and equipment from the fixed asset register and traced each addition to the supporting purchase contract to confirm that the documentation was made out to DeadC Ltd and was signed by an authorised signatory.
4. Inspected payment records to confirm that DeadC Ltd was not behind on monthly payments for a delivery vehicle purchased on installment.
5. Inspected a sample of lease agreements which had been capitalised to confirm that the risks and rewards of ownership of the leased asset had passed to DeadC Ltd.

6. Evaluated the process by which DeadC Ltd identifies and quantifies impairments.
7. Inspected a relevant stock exchange publication to confirm the market value of listed shares held by DeadC Ltd at year-end.
8. Confirmed by discussion with the directors that the patent on a piece of equipment designed and patented by the company during the year has a useful life of fifteen years.
9. Inspected brokers notes from the firm of stockbrokers used by DeadC Ltd to confirm details of cost, brokerage fees and date of purchase of shares purchased during the year.
10. Inspected the vehicle registration documents for all vehicles owned by DeadC Ltd and physically inspected a small sample of the vehicles.
11. Obtained a confirmation direct from Compushare of dematerialized shares held by DeadC Ltd.
12. Enquired of the financial manager as to how the cost of the “significant parts” of one of the company’s items of plant was determined.
13. Reperformed the impairment calculation for all impairments of items of plant and equipment.
14. Evaluated the risk of manipulation of the non-current asset balances by overstatement.
15. Inspected the share certificates for shares held by DeadC Ltd in a private company for authenticity and to confirm they were made out to DeadC Ltd.

**YOU ARE REQUIRED TO** identify the assertion(s) to which each of the procedures listed above (1 to 15) relates.

#### 12.4

**(15 marks 18 minutes)**

The following procedures were carried out during the audit of the finance and investment cycle at Transit Ltd, a large manufacturing company.

1. Evaluated the company’s procedures for identifying contingent liabilities.
2. Whilst conducting a physical inspection of plant and equipment, enquired about, and looked for evidence of plant and equipment which did not appear to be in use.
3. Compared the schedule of interest paid to the schedule of loans and vice versa.
4. Obtained a written representation from management that they had reassessed the useful life and residual values of the company’s plant and equipment.

5. Inspected the terms and conditions of a recently signed agreement for a loan to one of Transit Ltd's subsidiary companies to determine whether the loan was an "arms length" transaction.
6. Evaluated the evidence presented by the directors that one of the company's patents has a useful life of eight years.
7. Evaluated the assumptions used by the directors in placing a "fair value" on a ten percent shareholding the company owns in Apex (Pty) Ltd.
8. Carefully read the note describing a contingent liability, paying careful attention to the factual information included in the note.
9. Reviewed the cash receipts journal, minutes of directors meetings and other financial records for evidence of unrecorded loans.
10. Traced the proceeds of the sale of an item of machinery to the cash receipts journal and the bank statement.
11. Reperformed the debenture calculation for interest paid during the year to debenture holders, and traced the amount from the cash book to the interest account in the general ledger.
12. Inspected the Memorandum of Incorporation for any conditions which may have affected the issue of shares carried out by the company during the year.
13. Confirmed by inspection of the dates on the supporting documentation, that the issue took place during the year under audit.
14. Inspected the title deeds for a vacant piece of land in an industrial park purchased during the year by Transit Ltd.
15. Sent a written request to all the directors of Transit Ltd requesting them to confirm details of any loans they may have received from the company, or that they had not received any such loans.

**YOU ARE REQUIRED TO** identify the assertion(s) to which each of the procedures listed above (1 – 15) relates.

**12.5**

**(12 marks 15 minutes)**

You are the senior on the audit of Records (Pty) Ltd. You are working on the audit of the finance and investment cycle for the financial year-end 31 March 2016 and have asked your junior trainee to explain the assertions relating to the following account headings.

Interest Received	R 143 021
Long-term liabilities	R3 200 000

He responded as follows:

### ***Interest Received***

Rights:	Records (Pty) Ltd has the right to receive interest because it made the loan.
Accrual:	Interest which is owed to Records (Pty) Ltd at 31 March 2016 but has not yet been received, has been included in the balance of R143 021.
Obligation:	Entities which paid the interest are obliged to do so because they entered into a contract.
Valuation:	The amount of R143 021 is the correct amount of interest which has or should be paid to Records (Pty) Ltd in respect of loans they have made.

### ***Long-term liabilities***

Occurrence:	The loans have already been received by Records (Pty) Ltd i.e. they have occurred.
Validity:	The loans are not illegal and have not been obtained from illegal sources such as loan sharks.
Accuracy:	All details pertaining to the loan have been accurately disclosed in the financial statements.
Transparency:	Records (Pty) Ltd has declared all loans in its financial statements i.e. they are not hiding any amounts the company owes.

**YOU ARE REQUIRED TO** indicate whether your trainee has an adequate understanding of the assertions. Justify.

## **12.6**

**(20 marks 24 minutes)**

1. Define property, plant and equipment in the context of IAS 16. (2)
2. What are the assertions which relate to property reflected in the company's financial statements? (2)
3. State the two measurement models which are acceptable for property, plant and equipment. (1)
4. The assertions relating to property, plant and equipment will depend on the measurement model selected by the company. True or false? Justify. (2)
5. Landgrab Ltd uses huge bulldozers to move sand and rubble on construction sites. It has recently purchased three new bulldozers at a cost of R4 000 000 each. The bulldozers have two significant parts: the chassis and structure of the bulldozer (R3 000 000) and the hydraulic lifting motor and gearing (R1 000 000). The useful life

of the chassis etc is estimated at 15 years and the useful life of the hydraulics is estimated at 5 years.

- 5.1 when is a part of an asset considered to be a “significant part”? (1)
  - 5.2 what is the reason for identifying parts of an asset as significant? (2)
  - 5.3 should the significant parts of an asset be recognized in separate accounts? (1)
  - 5.4 if a set of tyres for each bulldozer which last 5 months under normal conditions, cost R200 000 (R50 000 each), should the tyres be identified as a significant part and be recognized in a separate (asset) account? Justify your answer. (3)
6. If a large industrial company elects the cost model for its property, plant and equipment, can it include the following as part of the cost of a new machine:
- 6.1 VAT? (1)
  - 6.2 the cost of hiring a crane to position the machine on the factory floor? (2)
  - 6.3 producing an instruction manual for operators who will be working on the machine? (1)
  - 6.4 the annual insurance premium? (3)
7. Distinguish between the depreciable amount and residual value of an asset. (2)
8. Explain the relationship between the useful life of an asset and its depreciable amount.(1)

## 12.7

**(22 marks 26 minutes)**

Identified below are audit procedures commonly performed by auditors in relation to property, plant and equipment and investments.

1. Observe the internal auditors conducting interim identification tests on physical assets to and from the fixed asset register.
2. Observe the manufacturing process.
3. At year-end physically examine a sample of plant and equipment listed in the fixed asset register to ensure that the plant and equipment is still in operation.
4. Inspect the purchase agreements for additions to plant and equipment made during the financial year for the signature of the financial director.
5. Enquire of the operations manager as to the various geographical locations of the company’s plant and equipment.
6. Obtain a certificate of value from a sworn appraiser for property which has been revalued.
7. Reperform the plant and equipment depreciation calculations at year-end.
8. Compare the list of the company’s investments in other private companies for the current financial year prior to determining the further audit procedures to be conducted on share investments.

9. Inspect the directors' minutes to confirm that the Board has agreed to the disposal of items of plant and equipment.
10. Discuss the various methods of financing plant and equipment adopted by the company, with the financial manager.
11. Inspect the directors' minutes for evidence of whether a material item of the company's plant and equipment has been offered as security.
12. Read the minutes of the capital expenditure committee to obtain an understanding of the strategic planning for expansion of the company.
13. Select a sample of furniture and fittings and trace the items selected to the fixed assets register.

**YOU ARE REQUIRED TO:**

- a) identify with a brief reason, those procedures listed above which are risk assessment procedures. (10)
- b) state whether each procedure which you consider is *not* a risk assessment procedure, is a test of controls or a substantive test. (4)
- c) for each test of controls, identify the objective of the control being tested (validity, accuracy, completeness) and for each substantive test, identify the assertion to which it relates. Note: validity can be regarded as authority and occurrence. (8)

**12.8**

**(30 marks 36 minutes)**

In terms of its public interest score (below 100) it is not necessary for Nexis (Pty) Ltd to have its annual financial statements externally audited. Your firm has conducted the required independent review of the annual financial statements for the last two years. The shareholders however, have amended the Memorandum of Incorporation by adding a clause which requires that an annual external audit be conducted. The directors and particularly the financial director Zane Jubb, have shown their dissatisfaction with this decision claiming that an audit is a waste of time and money and something which the company, which is facing liquidity problems, can "do without". Zane Jubb who on the previous review engagements had been co-operative, aggressively informed you that, as this was not a "proper" audit he wouldn't be quite as accommodating with giving your team access to whatever they needed. He also remarked that "every rand you cost us in audit fees and expenses directly affects my directors bonus, so do not waste our time". None of the directors own shares in Nexis (Pty) Ltd.

Somewhat surprised by his attitude, you discussed the upcoming audit with your audit manager. One of his first questions was whether you thought that there may be some manipulation of the financial statements which you were about to audit. After some thoughts and more discussion you decided that there may be a risk of manipulation of the financial statements.



The draft statement of financial position for the upcoming audit reveals, inter alia, the following:

	R'000
Plant and Equipment	24 000
Long term loan liabilities	17 000
Finance lease liabilities	6 400
Listed investments	
: JSE	3 200
: Foreign markets (in SA rand)	4 850
Unlisted investment	
: Private companies	2 400
Property	
: Office block	3 200
: Manufacturing facility	4 100

**YOU ARE REQUIRED TO:**

- a) comment on Zane Jubb's statement that the upcoming audit was not a "proper audit". (3)
- b) identify and briefly discuss the factors which made you consider that there may be a risk of manipulation of the financial statements. (6)
- c) identify the ways in which the directors could manipulate the account headings relating to the finance and investment cycle. Identify the assertion affected by each method of manipulation. (13)
- d) discuss the **overall** response of your engagement partner to the risk of manipulation of the financial statements. (8)

**12.9**

**(40 marks 48 minutes)**

Blockbuster (Pty) Ltd is a large company which manufactures cement blocks, curbstones, pavers etc. The company has seven production yards, situated in Gauteng. Each yard is under the control of a production manager. You are in charge of the audit of property, plant and equipment for the year-end 31 March 2016, having worked on the audit for the past 2 years.

You have gathered the following information:

1. Early in the year the company established an internal audit department headed by Rudolf Adams, a young, recently qualified chartered accountant and staffed by 2 other members, both of whom are completing their accounting qualifications. Rudolf Adams reports to Daniel Mudow, the financial manager. Internal audit adheres strictly to a work schedule prepared by Daniel Mudow, whom your firm has found in the past to be very domineering, uncompromising and intolerant of criticism.
2. Blockbuster (Pty) Ltd has a large amount of money invested in "hi-tech" plant and equipment at the seven production yards. The accounting records are all

computerised. Plant and equipment is recorded in the plant and equipment masterfile which includes inter alia the following fields:

<i><b>Field</b></i>	<i><b>Example</b></i>
Asset number:	3-2075 (the first digit “3” indicates the production yard at which the plant is located).
Description:	compactor (where applicable serial numbers are included)
Date of Purchase:	1.04.2012
Supplier:	A G Berlin
Source:	“F” (F = foreign supplier, L = local supplier)
Cost:	R480 000 (this includes installation charges, where applicable)

3. Blockbuster (Pty) Ltd purchases all of its plant and equipment. It does not enter into lease agreements.
4. Any additions to plant and equipment must be included in the capital budget for the year. Before the order is placed, it must be approved, firstly by the capital committee, and then by the directors.
5. Blockbuster (Pty) Ltd maintains its plant and equipment very carefully, ensuring that it complies with the supplier’s maintenance requirements. From time to time foreign suppliers send out maintenance personnel and/or replacement parts for some of the equipment used by the company. All equipment is comprehensively insured.
6. Most of the large equipment used by Blockbuster (Pty) Ltd has to be installed. Some suppliers carry this cost whilst others require that Blockbuster (Pty) Ltd carry the cost. Detailed schedules of installation costs are prepared by the company.

You discussed the audit approach for plant and equipment with your manager. He decided that you should request Rudolf Adams and his team to assist you with the year-end audit by visiting three of the production yards to carry out certain procedures on the plant and equipment on your behalf. In addition your manager has specifically asked you to vouch purchases of plant and equipment from foreign suppliers.

As they have done in the past, Blockbuster (Pty) Ltd is prepared for you to interrogate their plant and equipment masterfile using your audit software.

#### **YOU ARE REQUIRED TO:**

- a) identify and discuss briefly, the factors you would consider in the assessment of the internal audit department at Blockbuster (Pty) Ltd. Where applicable, relate your answer to the information given in the question. (12)
- b) outline the procedures Rudolf Adams and his team could conduct when visiting the company’s production yards to assist in the audit of plant and equipment. For each procedure outlined, identify the assertion to which it relates. Detailed audit procedures are *not* required. (8)

- c) describe the procedures you would conduct to vouch additions to plant and equipment purchased from *foreign* suppliers for the year-ended 31 March 2016. (20)

**12.10**

**(40 marks 48 minutes)**

Megaloads Ltd owns a fleet of huge dump trucks which it uses to move iron ore and other bulk materials at remote mining and construction sites around Africa. The company's most recent purchase is a giant "Supatruck" which was purchased at the start of the current financial year. The cost of the vehicle is reflected in the fixed asset register at R8 402 400.

As part of the audit team responsible for the year end audit (30 June 2016) of non-current assets, your senior has asked you to carry out year end verification procedures on the Supatruck. He has indicated that in his opinion it will not be necessary for you to visit the Northern Cape. See point 1.5.

You have gathered the following information:

1. A schedule provided by the financial accountant revealed that the cost of the Supatruck was made up as follows:

**1.1 Purchase price** R7 440 250

The truck was purchased from Fiatrucks Inc, the manufacturer in Italy for 851 810 euros. Megaloads Ltd paid Fiatrucks Inc in full through its bank on 31 July 2015

**1.2 Shipping costs, clearing charges, import duties** R439 000

The importation of the truck was handled by a local company Seacarriage (Pty) Ltd who acted as both forwarding and clearing agents. Seacarriage (Pty) Ltd paid all parties involved on behalf of Megaloads Ltd and then invoiced Megaloads Ltd for the total amount owed including Seacarriage (Pty) Ltd's fees.

The Supatruck was loaded onto a ship on 1 July 2015 and shipped FOB. The Supatruck was cleared from the Durban Port on 31 August 2015. None of the charges/duties are refundable.

**1.3 Assembly costs** R96 200

This amount was paid to Fiatrucks (South Africa) (Pty) Ltd in respect of the final assembly and commissioning of the truck. Four engineers from the South African company performed this specialized work. Due to insurance and warranty restrictions, no Megaloads Ltd staff were involved in this activity.

**1.4 Driver and mechanic training costs** R40 000

This amount covers the cost of training four drivers to operate the Supatruck and three mechanics to service and maintain it. Training was provided by Fiatrucks (South Africa) (Pty) Ltd.

### 1.5 *Abnormal load transport*

R308 500

Although registered and licenced as a vehicle the Supatruck is not permitted to be driven on public roads and must be transported on a special purpose flatbed truck as an abnormal load.

Two payments were made to Outsize Flatbeds (Pty) Ltd.

- \* the first payment of R110 000 was in respect of moving the Supatruck from Durban to the company's head office and truckyard in Northern KwaZulu Natal for final assembly (see 1.3).
- \* the second payment of R198 500 was in respect of moving the Supatruck from the head office to a remote mine in the far Northern Cape on 1 November 2015.

### 1.6 *Unveiling of truck*

R78 450

This amount represents the cost of the truck unveiling ceremony held on the Northern Cape mine which has leased the truck and at which the Supatruck will operate for a period of 18 months. Costs include the transport, accommodation and entertainment costs of bringing provincial dignitaries to the ceremony.

R8 402 400

2. At the financial year end, the Supatruck was on the mine in the Northern Cape. It started operating on 2 January 2016 at the start of its 18 month contract. Up until 1 January the Supatruck had not been operated other than whilst minor tests were being carried out on it. On completion of the 18 month contract the Supatruck will be transported back to the head office for cleaning and routine maintenance before moving to its next contract.
3. Due to the rugged conditions in which the truck operated and the fact that it is normally in operation for eighteen hours a day, six days a week, its useful life is expected to be eight years. After eight years the Supatruck is expected to have a residual value of R500 000. The Supatruck is not worth rebuilding and will be sold off to be stripped for saleable parts and scrap.
4. The depreciation on the Supatruck for the financial year has been calculated by the accountant as follows:

	R
Cost of Supatruck	8 402 400
Less: residual value	<u>500 000</u>
	7 902 400
Depreciation 12.5% straight line	<u>987 800</u>
Carrying value at 30 June 2016	6 914 600

**YOU ARE REQUIRED TO** discuss the procedures you would carry out to satisfy yourself that the Supatruck is fairly presented in the financial statements at 30 June 2016.

Note 1: Structure your answer in terms of the assertions. Do not concern yourself with the assertions relating to Presentation and Disclosure.

Note 2: If, in your opinion, any adjustments are required to achieve fair presentation, these should be included in your answer.

**12.11****(34 marks 41 minutes)**

You are assisting on the 31 March 2016 audit of Woodrock (Pty) Ltd, a large industrial company. You have been assigned to the audit of land and buildings and long-term investments.

The draft financial statements reveal the following:

	2016	2015
Land and Buildings	18 420 000	15 200 000
Investments		
Listed shares	6 400 000	6 200 000

Norton Chipping, the financial manager, (and member of the budgeting and investment committees) has provided you with the following schedule:

1.	<b><i>Land and Buildings</i></b>	Cost
1.1	Factory situated on Lot 32 Industrial Park Jacobs Durban	R9 400 000
1.2	Office block 14 Sterling Street Beachhead, Durban.	R4 800 000
1.3	Vacant Land Lot 21 Horizon Park North Coast	R1 000 000
1.4	Apartment 214 The Drive Umshlali	R3 220 000
		<u>R18 420 000</u>

1.5 The movement on the Land and Buildings account relates to the purchase of Apartment 214, The Drive in Umshlali. This property was purchased so that business executives and others visiting Woodrock (Pty) Ltd could be accommodated for the period of their visits.

1.6 The vacant land situated on the North Coast is in an undeveloped industrial park. The property has been occupied in a “landgrab” and there seems little prospect of a settlement with the occupiers being reached in the near future. No development of the park (by the developers) as required, e.g. putting in electricity etc, has taken place.

1.7 The company does not depreciate its buildings.

2.	<b><i>Investments</i></b>	2016	2015
2.1	Listed shares – Johannesburg Stock Exchange	Fair value	Fair value
	Amaproprop Ltd – 15 000 shares	R3 200 000	2 850 000
	Comwaste Ltd – 5 000 shares	R 650 000	1 200 000

Listed shares – London Stock Exchange  
Anglomutual Ltd – 10 000 shares

<u>R2 550 000</u>	<u>2 150 000</u>
<u>R6 400 000</u>	<u>6 200 000</u>

Woodrock (Pty) Ltd categorise these investments as financial assets through other comprehensive income.

Woodrock (Pty) Ltd has well designed internal control procedures and a sound control environment.

**YOU ARE REQUIRED TO:**

- describe the audit procedures you will conduct on the land and buildings account at 31 March 2016. (22)
- describe the audit procedures you will conduct on the investments account at 31 March 2016. (12)

Do not concern yourself with the assertions relating to presentation and disclosure for (a) or (b).

**12.12**

**(46 marks 56 minutes)**

You are the auditor of Trashcan Ltd, a large company which deals in waste products and waste removal. The company has grown steadily over the past few years by expanding into new markets. This has created a need for the company to invest in new equipment and hence to raise finance. The success of the company has been, to an extent, due to the sound control environment which exists, as well as the compensating controls which have been introduced into the finance and investment cycle. All transactions in this cycle are dealt with by the “Capital Committee” which evaluates and controls all aspects of the transaction e.g. necessity, financing, authorisation.

You are currently (August) engaged on the 30 June 2016 year end audit and have been assigned to the audit of long-term loans which are reflected in the draft financial statements as follows:

	<b>2016</b>	<b>2015</b>
Long terms loans	6 045 520	3 985 000
Current portion of long term loans	322 970	630 000

Siya Nomvet, Trashcan Ltd’s financial manager has presented you with the following:

***Schedule of long term loans at 30 June 2016***

Loan Provider	Balance at 30.06.2015	Loans raised during the year	Repayments during the year	Balance at 30.06.2016	Note
Stanvest	1 985 000			1 985 000	1
Industrial Investments	2 000 000			2 000 000	2
Dev Cor Finance	630 000	-	630 000	-	3
CapVest		1 400 000		1 400 000	4
Lease Credit		983 490		983 490	5
	R4 615 000	R2 383 490	R630 000	R6 368 490	

**Note 1. Stanvest**

This loan was negotiated in 2012. Interest at 12% is payable in arrears on 1 January each year, the anniversary of the loan. The loan is repayable in full on 1 January 2019 and is secured by personal guarantees provided by the six directors of Trashcan Ltd.

**Note 2. Industrial Investments**

This loan was negotiated in 2014. Interest of 11% is payable in arrears on 1 July each year, the anniversary of the loan. There is no fixed repayment date and the loan is automatically extended on 1 July each year for a further year, provided Trashcan Ltd's audited financial statements for the immediately preceding year end, reflect the predetermined debt: equity and current ratios stipulated in the loan agreement. Should this not be the case, the loan becomes repayable immediately. The agreement also provides Trashcan Ltd with the option of repaying the loan at any time, provided three months notice is given. The loan is unsecured.

**Note 3. Dev Cor Finance**

This repayment made on 30 September 2015 represents the last of four equal instalments required to settle the original loan of R2 520 000 raised in 2011 at a fixed rate of 14%.

**Note 4. CapVest**

This loan was raised in January 2016 to finance the purchase of a metal waste crusher. The loan is repayable in seven instalments commencing in January 2017. Interest is payable in arrears at 12%.

**Note 5. Lease Credit**

This represents the capitalisation of a lease negotiated for the acquisition of a high temperature incinerator used in the processing of plastic waste. The lease was entered into on 2 January 2016. Five lease payments of R300 000 each are payable annually commencing on 2 January 2017.

During the year Trashcan Ltd also issued 10 000, R100 redeemable debentures. The coupon rate (interest) is 10% and the debentures are redeemable at R120. The issue was made on 1 July 2015 and the debentures are to be redeemed on 1 July 2018. Interest is payable on 30 June each year.

These debentures have been reflected in the financial statements at R1 000 000. Siya Nomvet believes that this is the correct amount, his opinion being that "this is the amount they were recognized at, there is no short term portion so what is the problem?"

**YOU ARE REQUIRED TO:**

- a) identify the assertion(s) generally regarded as being most at risk in respect of balances in the finance and investment cycle. Justify your answer. (6)
- b) identify and briefly explain the compensating controls which should be put in place in the finance and investment cycle to address the fact that transactions in this cycle are frequently not subjected to routine internal controls. (8)
- c) state the audit procedures you would conduct in respect of long-term loans as reflected in the financial statements of Trashcan Ltd at 30 June 2016. (26)



Do not concern yourself with:

- (i) the payment or accrual of interest.
- (ii) disclosure in the notes to the financial statements.

- d) state the amount at which the redeemable debentures should be shown at 30 June 2016, and explain to Siya Nomvet how and why you arrived at this amount. (6)

## 12.13

(57 marks 69 minutes)

Your firm which has offices in Durban, Johannesburg and Cape Town has recently been appointed as auditors of Glassguard (Pty) Ltd, a company which installs door and window glass. The company was formed many years ago by Dave Dean and, due to sound management and quality service, has grown steadily. Dave Dean has retained the major shareholding in the company and is also the Chairperson and Managing Director of the company. The other directors, all of whom are key to the success of the company, are Tom Perry the Operations Director, Peter Terry the Financial Director and Gordon Green the Marketing Director, all of whom have shares in the company. The company has thirty branches spread around the country and approximately 160 delivery vans which are used for transporting glass and installation crews to job sites. A branch manager is in charge of each branch.

The company's accounting records are computerised and are centralized at the head office in Durban. Branches submit details of operating costs (including running costs for each of their vehicles) to head office monthly.

Details of all of the company's vehicles are held in the Vehicle Masterfile which contains the following fields:

<i>Field</i>	<i>Example</i>
Registration number	ND 673 219
Engine number	327x29B418
Description	Isuzu 2.5 diesel
Location	Nelspruit
Cost	R150 000
Date of Purchase	1 Aug 2013
Depreciation rate	20% p.a. reducing balance
Current year depreciation	R24 000
Accumulated depreciation	R54 000
Book value	R96 000
Date of disposal/scrapping	date
Disposal Price	rand amount
Profit/Loss on Disposal	rand amount

All vehicles are purchased for cash from Tekwini Motors, a General Motors dealer in Durban, and are registered/licenced in Durban. No vehicles are leased. Before Glassguard (Pty) Ltd takes delivery, Tekwini Motors adapts the vehicles to facilitate the transport of sheets of glass.

Shatterprufe Shabalala, the company's financial controller has prepared the following schedules and notes for the 31 July 2016 audit.



### ***Motor vehicles – cost***

Opening balance	Additions	Disposals	closing balance
R24 200 000	R3 650 000	R2 520 000 (note 1)	R25 330 000

### ***Motor Vehicles – accumulated depreciation***

Opening balance	Provision	Disposals	closing balance
R8 742 000	R3 197 500	R907 200	R11 032 300

Note 1: The vehicles disposed of were 20 Corsa “bakkies” which had originally been purchased (at different times) for use at country branches. However, they had proved to be too small. The vehicles were placed on a vehicle auction in Durban and sold as a single lot for R1 400 000. Details of each vehicle are listed on the “Auctioneer’s Sale List.”

Note 2: In June 2016 one of the company’s new Isuzu bakkies (purchased 1 May 2016, cost R250 000) was extensively damaged (it cannot be repaired and has no scrap value) when it rolled backwards down a hill and was hit by a passing cement truck owned by Conmix. All of our vehicles are comprehensively insured but the insurance company has refused to pay out for the Isuzu or the R300 000 damage to the cement truck. A clause in the insurance contract states clearly that company vehicles may only be driven by a permanent employee of the company. In the case of this vehicle, a casual labourer who had been hired for the day was asked to move the vehicle in question. He did so, parked the vehicle but failed to engage the handbrake. A directors’ minute relating to this matter reads as follows:

“We have referred the matter to our lawyers who intend to contest the insurance company’s refusal to pay on the grounds that as no one was actually driving the vehicle at the time of the accident, the specific clause does not apply. Our lawyers will not comment on the likelihood of the case succeeding. We acknowledge that we are responsible for the damages to the cement truck but believe we are fully covered by insurance.

No entries will be made in the accounting records (including the Vehicle Masterfile) in respect of this matter for the 31 July 2016 financial year. We will treat this entry entirely as a 2017 matter assuming that a decision is reached in the courts in the new financial year.”

You have been placed in charge of the audit of Motor Vehicles (by far the largest account heading on the statement of financial position) and are about to commence work (early October) on the year-end audit. Your manager has indicated that a comprehensive audit of motor vehicles should be carried out. Your firm’s audit software is compatible with the client’s system and you intend to make use of it. You are located in the Durban office.

As you have a sound knowledge of statutory matters and corporate governance you have also been asked to deal with the following:

In April 2016 Glassguard (Pty) Ltd issued ten, 9% redeemable debentures of R100 000 each to 10 private investors to finance the purchase of “state of the art” machinery for the manufacture of armour plated glass. The debentures are repayable in five years time at a premium on redemption of 10%. There are no other debentures in issue.

Glassguard (Pty) Ltd put the supply of the armour plating machinery out to tender and the best tender was submitted by Namandla (Pty) Ltd, a black economic empowerment company. However, before Namandla (Pty) Ltd are prepared to do business with Glassguard (Pty) Ltd, it requires that Glassguard (Pty) Ltd undertakes to comply within a reasonable time, with the recommendations of the King III report on Corporate Governance in respect of, inter alia, the composition of its board of directors. As Glassguard (Pty) Ltd anticipates significant business dealings with Namandla (Pty) Ltd they are quite prepared to comply.

**YOU ARE REQUIRED TO:**

- a) state whether the risk of material misstatement in the motor vehicles account at 31 July 2016 should be regarded as low, medium or high. Justify your answer. (4)
- b) indicate, giving reasons whether Glassguard (Pty) Ltd’s decision to treat the matter described in Note 2 “entirely as a 2017 matter assuming that a decision is reached in the courts”, is appropriate. (8)
- c) describe the audit procedures you will conduct in respect of the assertions relating to the account heading “Motor Vehicles” reflected in the 31 July 2016 draft financial statements. (30)
- d) describe the audit procedures you will conduct in respect of the debenture issue. Do not concern yourself with assertions relating to presentation and disclosure. (10)
- e) advise Dave Dean on the changes that need to be made to the composition of Glassguard (Pty) Ltd’s Board of Directors so as to satisfy the recommendations of the King III. (5)

**12.14**

**(14 marks 18 minutes)**

You have been assigned to assist with the audit of certain aspects pertaining to the presentation and disclosure of the annual financial statements of Backstop (Pty) Ltd for the financial year-end 29 February 2016. The company manufactures helmets for various sporting activities.

You are currently busy with the presentation and disclosure of contingent liabilities. Note 20 to the financial statements reads as follows:

**Note 20 – Contingent liabilities**

- 1. The company has been sued by a customer who suffered facial damage and visual impairment when a cricket ball stuck him in the eye during a cricket match. He is claiming R800 000 from the company on the grounds that his helmet (manufactured by the company) was defective.

**YOU ARE REQUIRED TO:**

- a) state the assertions which relate to the presentation and disclosure of the annual financial statements. (4)
- b) define a contingent liability. (2)
- c) distinguish between a contingent liability and a provision. (2)
- d) describe the audit procedures you would conduct in respect of the assertions relating to the presentation and disclosure of the contingent liability described in Note 20. (6)

**12.15**

**(32 marks 38 minutes)**

You have been assigned responsibility for the identification of related parties (and material related party transactions) on the audit of Baggdad Ltd, a large diversified holding company. Management have supplied you with a list of related parties and you have carried out basic procedures in respect of the completeness of the list. You are about to instruct the audit team on the kind of transactions which they should look out for during the course of the audit which may indicate the existence of related parties not included on the list supplied by management.

**YOU ARE REQUIRED TO:**

- a) explain why the auditor is concerned about the identification of related parties. (3)
- b) define an arms length transaction (in terms of ISA 550 – Related Parties). (2)
- c) describe the procedures you would have adopted to determine the completeness of the list of related parties supplied by management. (7)
- d) describe to your audit team the kinds of transactions which may assist in identifying related parties not on the list supplied by management. (6)
- e) describe the action you would take if your procedures identified an undisclosed related party or significant related party transaction. (6)
- f) state the two matters to which reference should be made by the directors in the management representation letter in respect of related parties. (2)
- g) define a “related person” in terms of the Companies Act 2008 and indicate whether a related person should be regarded as a related party from an audit perspective. Do not concern yourself with juristic persons. (3)
- h) state whether the following would be regarded as “related parties” in respect of Baggdad Ltd:
  - i. Ed Reddy, the non-executive chairperson of the company.
  - ii. Jordan Ltd, an associate company of Baggdad Ltd.

- iii. King Carpet CC, a close corporation owned by the wife of Baggdad Ltd's financial director. (3)

**12.16**

**(30 marks 36 minutes)**

You are conducting the audit of Bakex (Pty) Ltd, a manufacturing company which has recently started buying and selling shares on the JSE.

The company is operating at a healthy profit level and material amounts of money have been invested with the intention of making good use of cash which is surplus to the company's requirements.

During your review of the procedures for buying and selling investments, you discover the following:

1. Share transactions are approved by the investment committee which consists of the financial director and the company secretary. No minutes of proceedings of the investment committee meetings are maintained for confidentiality purposes. The committee meets from time to time or if there is surplus cash in the bank.
2. The company deals with several different stockbrokers, so that different opinions about the market can be obtained.
3. The decisions taken by the investment committee are conveyed verbally to the assistant company accountant, Buller Sharp, by either member of the investment committee. Buller Sharp is then responsible for implementing the transactions by contacting one of the brokers. He has been assigned this responsibility because his brother is a successful stockbroker.
4. Buller Sharp places the instruction with the various stockbrokers by phone and keeps a rough diary recording such instructions.
5. Brokers notes (which record the transactions carried out by the brokers) for the purchase and sale of shares are sent directly to Buller Sharp who files them away after reviewing them. In addition, a monthly statement detailing the company's total shareholdings, transactions for the month and balance on the account is received by Bakex (Pty) Ltd. These are also kept by Buller Sharp.
6. As all share purchases must be settled with the broker within 7 days, an electronic funds transfer facility has been set up to pay brokers for shares they have purchased on behalf of Bakex (Pty) Ltd. To effect an EFT payment the EFT software which is loaded on Buller Sharp's terminal requires that the (confidential) password of two authorized employees be entered. Buller Sharp enters his password as the second authorisation. The first authorizing employee is Judy Hill, an administration clerk, but as all share dealings are regarded as being confidential, she is not shown any supporting evidence in respect of payments for such transactions. The entry of her password (which she does keep confidential) is simply to facilitate the process.

Somewhat concerned by the lack of control, you discussed the matter with the financial director of the company who agreed that perhaps they had not thought through the control requirements properly, possibly because although a material amount of money is likely to be invested, investments were not part of the company's core business. He has asked you to report your concerns and recommendations to him.

**YOU ARE REQUIRED TO** discuss the concerns you would raise and the recommendations you will make in your report, based on the information given in the question. Structure your answer in terms of the components of the internal control process.

**12.17**

**(23 marks 27 minutes)**

Microjoy (Pty) Ltd manufactures household appliances.

Set out below are certain material matters which have been identified on the year-end audit 30 April 2016.

- (1) The company provided a written unlimited guarantee to Oven (Pty) Ltd's bankers for the overdraft facilities of Oven (Pty) Ltd, a company with common shareholders to Microjoy (Pty) Ltd.
- (2) A court action against the company in respect of compensation of R2.5 million claimed by a former managing director, is in progress at 30 April 2016. Microjoy (Pty) Ltd's legal advisors are of the opinion that the claim cannot be satisfactorily defended but that the maximum compensation will be R1 million.
- (3) The Board of Directors approved the expenditure of R18 million for new welding stations per the minutes of the board meeting of directors held on 30 April 2016. The technical director is currently at an international trade show attending an exhibition of welding machines by suppliers to decide with whom the order for welding machines should be placed.
- (4) On 2 January 2016, Microjoy (Pty) Ltd took the decision to close a division of the company which manufactured electric braai ovens from 31 July 2016. On 15 February the staff were given notice of the formal plan for the closure and retailers were notified accordingly. At year-end the closure had not commenced and the estimated cost of discontinuing the division was, at this date, R1.5 million.
- (5) Microjoy (Pty) Ltd has sued a large retail chain for damages. Sales representatives at the retail chain have alleged to customers that on products which make use of microwave technology, Microjoy (Pty) Ltd's safety standards are inferior. Microjoy (Pty) Ltd's lawyers can offer no opinion on whether the company will be successful in its attempt to obtain R5 million in damages.

**YOU ARE REQUIRED TO:**

- a) describe the year-end audit procedures which would have identified the five matters above. (5)

- b) outline the treatment, if any, of the five matters in the annual financial statements of Microjoy (Pty) Ltd at 30 April 2016. Give reasons. (18)

**12.18**

**(37 marks 45 minutes)**

You are a member of the team on the audit of The Office (Pty) Ltd, a company in the Eastern Cape which manufactures office equipment for export. You have been given responsibility for the audit of certain aspects of the finance and investment cycle for the financial year-end 31 July 2016. One of those aspects is the audit of long term loans made by The Office (Pty) Ltd. In August 2015 the company had decided as part of its social responsibility, to make loans available to local enterprises to develop their businesses. In terms of the scheme these enterprises supply The Office (Pty) Ltd with certain of its materials for manufacture. They will also continue to supply other businesses. The company had not made any loans prior to the introduction of the scheme.

Minutes of the Directors' Meeting held in August 2015 revealed the following:

1. The maximum loan to any single enterprise would be R250 000.
2. Loans would be repayable in full after 5 years.
3. Interest of 5% per annum would be payable annually in arrears on the anniversary date (date the loan was made) of the loan.
4. The loans would be unsecured.
5. No loan may be made to any enterprise in which a director (or his family) of The Office (Pty) Ltd has a financial interest.

Your audit manager has requested you to perform a detailed audit of the new loan scheme. To assist you in your audit Lewis Figo, the financial accountant of The Office (Pty) Ltd presented you with the following schedule.

***Loans made to external entities at 31 July 2016***

<i>Name</i>	<i>Date of Loan</i>	<i>Amount</i>	<i>Accrued interest</i>
KC and Co	1 Sept 2015	R250 000	R11 458
Chairlegs CC	1 Sept 2015	125 000	5 728
Savuka Enterprises*	1 Sept 2015	50 000	-
Sithole & Co	1 Nov 2015	75 000	2 812
Ndungane Glass	1 Nov 2015	150 000	5 626
Eastcape Resins	1 Feb 2016	250 000	6 250
Paruk Paint	1 Feb 2016	50 000	1 250
Bisho Handles	1 Feb 2016	50 000	1 250
Jabula Projects	1 March 2016	250 000	5 208
Oakwoods	1 May 2016	75 000	937
Wuzawork	1 May 2016	250 000	3 125
Team Transport	1 May 2016	150 000	1 875
		<u>1 725 000</u>	<u>45 519</u>
		<u>(50 000)</u>	
		<b><i>R1 675 000</i></b>	<b><i>R45 519</i></b>

\* This enterprise went insolvent in February 2016. The liquidator notified The Office (Pty) Ltd that nothing would be recovered. Amount was written off in June 2016.

**YOU ARE REQUIRED TO:**

- a) explain the terms validity (authorization and occurrence), accuracy and completeness in the context of the investment cycle. (4)
- b) discuss the risk of material misstatement associated with the account heading “Loans made to external entities” as reflected in the financial statements of The Office (Pty) Ltd at 31 July 2016. (5)
- c) outline the internal control procedures you would expect to find in place at The Office (Pty) Ltd to ensure that all loans made in respect of this scheme are valid. (8)
- d) describe the substantive audit procedures you would carry out in respect of “Loans made to external entities” and “Accrued interest” as reflected in the financial statements at 31 July 2016. Do not concern yourself with the assertions relating to presentation and disclosure. (20)

**12.19**

**(25 marks 30 minutes)**

**Part A**

The schedule of investments reproduced below has been handed to you by your audit manager. He has requested that you use the schedule to assist you in carrying out the necessary audit procedures to verify the client’s financial statement figures for investments. The client, JSS Wholesalers (Pty) Ltd which operates in the building industry invests from time to time in listed investments and has been audited by your firm for the past seven years. The company has a 31 December financial year end.

*Investments held : JSS Wholesalers (Pty) Ltd : 31 December 2015*

Company	Date Purchased	No. of shares	Cost	Market value at 31/12/14	Market value at 31/12/15
Engin Ltd	22 May 2013	1000	19 496	24 219	20 637
Fame Group Ltd	10 Nov 2015	2500	25 147	-	32 884
Oryan Ltd	15 April 2015	4000	20 057	-	12 215
Sandfontein Goldmine Ltd	7 June 2010	2000	47 267	22 338	14 390
<b>Totals</b>			<u>111 967</u>	<u>46 557</u>	<u>80 128</u>

Further investigation and preliminary enquiries have yielded the following relevant information:



1. All shares other than Sandfontein Goldmine Ltd are electronically registered with Computer Share Services, (i.e. no share certificates, electronic ownership). The Sandfontein Goldmine Ltd share certificates are kept in the company safe.
2. Paavo Nurmi, the financial manager of the company is in charge of all matters relating to investments.
3. All of the investments are in companies listed on the JSE and all of the holdings are very minor (considerably less than 1%) in relation to the total number of shares issued by each company.
4. All shares were purchased in the name of JSS Wholesalers (Pty) Ltd, through the company's brokers, Sharevest Inc.
5. Paavo Nurmi does not maintain a register of investments, but regards the above schedule as a complete listing of all the company's investments.
6. The company holds all investments for long-term capital growth and does not designate the shares as fair value through profit and loss. All of the companies, with the exception of Sandfontein Goldmine Ltd, have paid dividends regularly.

**YOU ARE REQUIRED TO** describe the audit procedures in respect of the balance reflected on the share investment account and in respect of dividends received at 31 December 2015 which you would carry out to satisfy yourself as to the fair presentation of all matters relating to investments in the financial statements of JSS Wholesalers (Pty) Ltd for the year ended 31 December 2015. (20)

### **Part B**

Clarens Morewa, a first-year trainee accountant who has been assigned to assist you with the audit procedures on investments at JSS Wholesalers (Pty) Ltd, raised the following query while you were explaining what was required of him:

"I know how to go about obtaining the fair value of listed investments, but what would we do if JSS Wholesalers (Pty) Ltd had some unlisted company investments too?"

**YOU ARE REQUIRED TO** outline for Clarens Morewa how you would audit unlisted investments. (5)





## **CHAPTER 13**

## **STATUTORY**



**13.1****(24 marks 28 minutes)**

1. What is the name of the Act which governs the auditing profession? (1)
2. What is the name of the body which inter alia, governs the registration of auditors? (1)
3. If a firm of registered auditors wishes to register with the professional body *in the form of a company*, what are the conditions which must be met? (4)
4. What does the term “designated auditor” mean? (2)
5. What is “improper conduct” with regard to a registered auditor? (2)
6. Jingles Mashaba, a lawyer, and Junior Jaxman, a registered auditor, wish to form a partnership to offer legal and audit services to various companies. They wish to register the partnership with the IRBA, will they be able to do so? Justify. (2)
7. To register as a registered auditor an individual must
  - 7.1 be a member of SAICA. True or false? (1)
  - 7.2 have completed a traineeship in public practice (TIPP) or a traineeship out of public practice (TOPP). True or false? (1)
  - 7.3 satisfy the requirements of the Audit Development programme. True or false? (1)
  - 7.4 not be or not have been at any time, an unrehabilitated insolvent. True or false? (1)
8. Under what circumstances may the IRBA specifically not register an individual? (3)
9. Define a reportable irregularity. (3)
10. Can a registered auditor perform the role of an "independent accounting professional" as defined in the Companies Regulations 2011? Explain. (2)

**13.2****(30 marks 36 minutes)**

1. The Auditing Profession Act 2005 applies only to those registered auditors who perform audits of public companies *not* private companies. True or false? Justify. (2)
2. The Memorandum of Incorporation of a company may include a clause which requires that if a reportable irregularity is discovered by the external auditor, it should be reported to the shareholders and not the IRBA provided the external auditor agrees to this at the time of discovering the reportable irregularity. True or false? Justify. (2)
3. The designation, Chartered Accountant (South Africa) is restricted to auditors registered with the IRBA. Comment. (2)
4. Mohammed Mubarak offers internal audit services to various companies. He is not registered with the IRBA. He wishes to advertise his consultancy in one of the following ways:
  - 4.1 “Mohammed Mubarak Consultants – registered internal auditors”.
  - 4.2 “Mohammed Mubarak Consultants – financial advisors and auditors”.

4.3 “Mohammed Mubarak Consultants – internal auditors and accountants”.

Indicate whether or not each of 4.1 to 4.3 is permissible. Justify. (5)

5. Mildred Tiles is the designated auditor of BuildwithBricks (Pty) Ltd a large brick and paver wholesaler. The company has elected in its MOI to have its AFS audited externally every year. Whilst conducting the current year’s audit, she discovered a reportable irregularity. However, she intentionally decided not to report it to the IRBA. Indicate whether each of the following (5.1 to 5.3) would be a justifiable reason for not reporting to the IRBA as required by the Auditing Profession Act 2005:

- 5.1 As BuildwithBricks (Pty) Ltd is audited because its MOI requires it to be, and not because its public interest score requires it, there is no duty on Mildred Tiles to report it to the IRBA.
- 5.2 The financial director requested Mildred Tiles not to report to the IRBA as the consequences of doing so could result in dismissals and other job losses at the company.
- 5.3 Mildred Tiles did not want to spend the hours following up on the reportable irregularity, writing reports, attending hearings etc, as she was under audit deadline pressure at a number of her other audits. (5)

6. Freeoites and Co, a large audit firm wishes to employ the following individuals to work on the audit of Anglotec Ltd, a listed company. Each of the individuals has a particular expertise required on the audit:

- 6.1 Hendrik Hertz, who does not have an auditing background but is a computer fraud expert. Hendrik Hertz was convicted five years ago for his involvement in a computer based fraud and has served a three year sentence. Since completing his sentence he has offered his services as a fraud investigator.
- 6.2 Jabu Motaung, who was registered with the IRBA before spending ten years in New York as a stock trader, during which time he allowed his registration with the IRBA to lapse.

Discuss Freeoites and Co’s intention to employ Hendrik Hertz and Jabu Motaung with reference to the Auditing Profession Act 2005. Indicate whether the two individuals could become partners at the firm. (5)

7. Maggs and Mabhida, a medium sized firm of registered accountants and auditors, wishes to incorporate (form itself into a company). The proposed **shareholders** will be:

- 7.1 **Archie Angel**: the current senior partner of the firm.
- 7.2 **Syd Sithole CA(SA)** : currently a senior member of an international bank who will leave the bank and join Maggs and Mabhida.
- 7.3 **Monty Maggs**: Registered Auditor and CA(SA): he is the son of the founding partner of Maggs and Mabhida. He currently has his own audit practice but will join Maggs and Mabhida to become the executive director of the new company.
- 7.4 **Aravinda Silva**: currently the other partner in Monty Maggs’ audit firm who will also join the new company, but will not be a director.
- 7.5 **Stix Martin**: an attorney who has expertise in company law.
- 7.6 The three other existing partners of Maggs and Mabhida.
- 7.7 Finance (Pty) Ltd, the company which will provide the initial finance for the new company to get started e.g. office lease, overdraft, purchase of computers etc (5% holding only).

Comment on the proposed appointment of each of the above as shareholders of the new company, Maggs and Mabhida Incorporated. (9)

### 13.3

(23 marks 28 minutes)

You are the auditor in charge of the year-end audit of Franschoek (Pty) Ltd, a fruit canning factory. Although Franschoek (Pty) Ltd is only required in terms of the Companies Regulations to have its AFS independently reviewed, the terms and conditions of its major long-term finance agreement require that the company have its annual financial statements audited by a registered auditor. During the course of the audit you discovered that the financial director and managing director (the two executive directors on the Board) both of whom own shares in the company, have been falsifying the monthly VAT returns by claiming VAT on purchases to which the company is not entitled. You are satisfied that a reportable irregularity (Sec 45) has taken place.

#### YOU ARE REQUIRED TO:

- a) identify and comment briefly on each of the matters which you would have considered in “satisfying yourself” that a reportable irregularity has taken place. (5)
- b) outline the procedure which you would have followed on satisfying yourself that a reportable irregularity was taking place. (7)
- c) state whether you would still report the irregularity if
  - i) the financial director and managing director were not shareholders of the company. (2)
  - ii) the financial director and managing director realised before you made your first report, that you suspected what was going on, and offered to notify SARS and pay all VAT and penalties owed. (2)
  - iii) you had discovered the fraud whilst conducting other work (non-audit work) for Franschoek (Pty) Ltd . (2)
  - iv) the managing director had in no way been involved in the fraud and could not reasonably be expected to be aware of it. (2)
- d) explain how you would respond to the argument that as this is not an audit required by the Companies Act 2008, you have no duty to report the irregularity. (3)

### 13.4

(28 marks 33 minutes)

You are the audit senior on the year-end audit of Kelvin Contractors (Pty) Ltd, a company which builds houses and duplex flats for clients. Your firm was appointed as auditor at the last annual general meeting of Kelvin Contractors (Pty) Ltd, as the previous auditor had resigned and emigrated to Australia. Jay Reddy and Clive Jones are the only executive directors of the company and both have small share holdings. The balance of the shares are held by a number of private individuals.

During the course of your audit, whilst examining the contract costing records, you noticed that the company frequently purchases greater quantities of building materials than are

required for the particular contract in terms of the bill of quantities. Clients are not given a detailed break down of costs (extra purchases) but the extra purchases are included in the quotes they are given. On discussing this with the financial director, Clive Jones, he informed you that this is done to counter damage to, and the stealing of, building materials held on site. However, the costing clerk told you that the excess building materials are used by the directors and the contracts manager to build other houses which are then sold privately by the three of them. Clive Jones dismissed this allegation as ridiculous and refused to discuss it any further. As you were not convinced by his response you contacted your audit manager who instructed you to carry out procedures to follow up the costing clerk's allegations.

On discovering your continued interest in this matter Clive Jones, in his capacity as the financial director, threatened to remove your firm from the appointment as auditor with immediate effect.

**YOU ARE REQUIRED TO:**

- a) identify the procedures you would carry out in following up the allegation made by the costing clerk; (8)
- b) discuss fully whether the situation described above constitutes a reportable irregularity in terms of the Auditing Profession Act 2005; and (12)
- c) discuss Clive Jones' threat to remove your firm from the appointment of auditor with immediate effect. (8)

**13.5**

**(30 marks 36 minutes)**

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:**

- a) discuss whether there is any merit in Franco Steyn's statement. (10)
- b) conclude on whether this matter would constitute a reportable irregularity. Justify your answer. (10)
- c) state the criteria which the designated auditor must satisfy before an unqualified audit opinion can be given. (6)
- d) comment on whether if BuilderBoy CC had a public interest score of 256, its annual financial statements would have to be externally audited or independently reviewed. (4)

**13.6**

**(30 marks 36 minutes)**

- 1. What is a public interest score? (3)
- 2. State three matters which will be affected by a company's public interest score. (2)
- 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)
- 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)
- 5. The Memorandum of Incorporation can stipulate other criteria to be used when calculating the public interest score. True or false? (1)
- 6. Calculate the public interest scores for the following companies, Tech (Pty) Ltd and Master (Pty) Ltd:

	Tech (Pty) Ltd	Master (Pty) Ltd
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

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



9. The Companies Act 2008 deals with three types of meetings, and at these meetings different resolutions can be passed. Spartan Ltd has fifty shareholders and twelve directors. The company is not listed on any stock exchange.

- 9.1 identify the three types of meetings which will be held at the company. (1.5)
- 9.2 indicate when each of the three types is held. (3)
- 9.3 give the quorum requirement for each of the three types of meeting. (4)
- 9.4 comment on whether a board meeting can be conducted by electronic communication. (2.5)

10. Distinguish between a public and a private company in respect of:

- 10.1 name (1)
- 10.2 number of directors (1)
- 10.3 offer of shares to the public (1)
- 10.4 company secretary (1)
- 10.5 audit committee (1)

### 13.7

(20 marks 24 minutes)

- 1. All **profit** companies must be externally audited by a registered auditor. True or False? Justify. (2)
- 2. What is a non-profit company? (2)
- 3. Comment on whether it would be acceptable for an office cleaning company to call itself Ethnic Cleansing (Pty) Ltd. (2)
- 4. If a private company has ("RF") attached to the end of its name, what does it mean? (2)
- 5. What is a personal liability company? (2)
- 6. What is the difference between a public company and a private company in terms of the Companies Act? (2)
- 7. An **unalterable** provision in the Companies Act 2008 can actually be altered. True or False? Justify. (2)
- 8. What is the lifespan of a company as a juristic person? (1)
- 9. Kent King owns 65% of the shares in KingKent (Pty) Ltd and 40% of the shares in SupaKing (Pty) Ltd, both of which offer financial advisory services. All remaining shares in both companies are held by other individuals who are not related to Kent King in any way. All shares in both companies carry equal voting rights. In terms of the Companies Act 2008, are the following related as defined? Justify your answers :
  - 9.1 Kent King and KingKent (Pty) Ltd (1)
  - 9.2 Kent King and SupaKing (Pty) Ltd (1)
  - 9.3 KingKent (Pty) Ltd and SupaKing (Pty) Ltd. (2)

10. What does the term “substantial compliance” mean? (1)

**13.8**

**(18 marks 22 minutes)**

1. In terms of the Companies Act 2008 the notice period for a meeting of shareholders of a public company is:
  - 1.1 28 business days
  - 1.2 15 business days
  - 1.3 21 business days.
2. The Memorandum of Incorporation can stipulate a shorter notice period for shareholders meetings. True or false?
3. In terms of the Companies Act 2008, the votes quorum required for a meeting of shareholders is:
  - 3.1 three quarters of the members entitled to vote, present in person, or by proxy.
  - 3.2 persons who can exercise 25% of all voting rights that can be exercised in respect of at least one matter to be decided at the meeting are present.
  - 3.3 50% of the total members present in person.
4. Loans by a subsidiary to a director of its holding company are prohibited unless:
  - 4.1 a directors’ resolution authorising the loan, is passed by 75% of the directors
  - 4.2 a special resolution is obtained.
  - 4.3 the company granting the loan satisfies the liquidity/solvency test.
5. A company’s MOI may stipulate that the granting of financial assistance by the company can be solely authorized by a directors’ resolution. True or false?
6. A company is permitted to provide financial assistance to a person for the purchase of:
  - 6.1 shares in its holding company
  - 6.2 shares in itself
  - 6.3 shares in its subsidiary company.
7. To qualify for the appointment as company secretary to a public company, the applicant must:
  - 7.1 be a member of the Chartered Institute of Secretaries
  - 7.2 be a member of the South African Institute of Chartered Accountants
  - 7.3 have the requisite knowledge of and experience in relevant laws.
8. A private company
  - 8.1 restricts the right of transfer of its shares in its Memorandum of Incorporation
  - 8.2 prohibits any offer of its shares to the public
  - 8.3 may not issue shares to its directors.
9. A company’s Memorandum of Incorporation is binding between the company and each shareholder and each director. True or false?
10. In terms of the Companies Act 2008 the Memorandum of Incorporation of a company may be amended if:

- 10.1 consent is obtained from 100% of the shareholders
  - 10.2 a special resolution is passed
  - 10.3 the majority of the shareholders (i.e. over 50%) are in agreement with the alteration.
11. When a company wishes to acquire (buy back) its own shares, it must:
- 11.1 obtain a directors' resolution authorizing the transaction
  - 11.2 comply with any relevant sections of its MOI
  - 11.3 be liquid (able to pay its debts in the ordinary course of business) but not necessarily solvent at the time of acquiring the shares.
12. Every company, other than a private company with less than three shareholders, must file an annual return with the Commission. True or false?
13. Which of the following persons may be appointed as a director?
- 13.1 a body corporate (juristic person)
  - 13.2 a rehabilitated insolvent
  - 13.3 a person who has been convicted of fraud in England and imprisoned for two years without the option of a fine, but who completed his sentence a year ago.
14. Which of the following may be appointed as auditor of a company (provided they are suitably qualified and registered)
- 14.1 a body corporate
  - 14.2 the son of the company's production director
  - 14.3 a person who was formerly an employee of the company in a senior position, but who left the company six years ago to return to the auditing profession.
15. The authority required for sale of the major assets of a company is:
- 15.1 a directors' resolution
  - 15.2 a special resolution
  - 15.3 an ordinary resolution.

**YOU ARE REQUIRED TO** select the correct answer(s) for each of the above questions. Note that for some of the multiple choice questions there may be more than one correct answer.

**13.9**

**(17 marks 21 minutes)**

The Companies Act 2008 contains provisions which are alterable and others which are unalterable. The directors of Jordan Ltd are considering including the following clauses/requirements in the company's Memorandum of Incorporation:

- 1. changes to the MOI can be made by the board of directors provided there is 100% consent with no director abstaining.
- 2. the notice period for meetings of shareholders will be 20 business days.
- 3. the audit committee must consist of at least five members.
- 4. par value shares will be issued.

5. a shareholder will have the right to inspect (right of access to) the minutes of meetings of the full board of directors, but not to the minutes of the audit committee.
6. the directors may give authority for the sale of the major assets of the company.
7. the approval required for the issue of shares to a director will be, in all instances, an ordinary (shareholders) resolution.
8. the “votes” quorum for a meeting of shareholders will be 20% of all voting rights that can be exercised in respect of at least one matter to be decided at the meeting.
9. for an ordinary resolution of shareholders to be approved it must be supported by 33⅓% of the voting rights exercised on the resolution, and for a special resolution 75% of the votes must support the resolution.
10. the company need not appoint a company secretary if an audit committee has been appointed.

**YOU ARE REQUIRED TO:**

- a) explain the term alterable provision. (2)
- b) indicate, giving brief reasons, whether the proposed clauses/requirements listed above would be acceptable for inclusion in the Jordan Ltd’s Memorandum of Incorporation. (15)

**13.10**

**(30 marks 36 minutes)**

A friend of yours, Carmen de Villiers, has recently been appointed by the shareholders as a director of Tracshion Ltd, a large electronics company which specializes in tracking systems on vehicles. The company is not listed. Carmen de Villiers is technically well qualified and is considered to be an important individual with regard to the future of the company, particularly its research and development programmes.

However, Carmen de Villiers has not filled the role of a company director before, and whilst excited about her promotion, is concerned about her responsibilities as a director, particularly arising from the Companies Act 2008. She tells you that she has heard that the Act has sections dealing with standards of directors conduct and that if she doesn’t perform she can be removed from the board and dismissed from the company. She also tells you that she has heard that she can be put on probation as a director by the chairman of the board or declared delinquent. She has put the following questions to you.

1. Can I be removed from the board and dismissed from the company if I don’t perform as a director? (6)
2. If I don’t think things are going well can I resign as a director without leaving the company? (2)
3. What are the standards of conduct with which I must comply as a director? (13)

4. Can I be put on probation by the chairman? (3)
5. Is there anyone in the company that I can officially approach to help me understand my duties and responsibilities? (3)

**YOU ARE REQUIRED TO:**

- a) respond to Carmen de Villiers' questions. (27)
- b) list the five moral duties which Carmen de Villiers should display as a director of Tracshion Ltd in terms of the King III Report. (3)

**13.11**

**(30 marks 36 minutes)**

You are the technical manager in the audit firm of Faber & Mkhize. The following matter has been referred to you:

Tracy Good, a well known sports personality, has decided to retire from professional sport to enter the business world. Emily Park a friend of hers, who owns a small pharmaceutical business, has developed a new treatment for removing unwanted facial hair. Tracy Good and Emily Park have decided that they need to raise approximately R4 million to finance a venture which will manufacture and distribute products for the new treatment. They intend inviting fifteen of Tracy Good's close associates in the sports world to invest in the venture and share in the expected profits. Although she is confident that the venture will be a success Tracy Good would like to assure her associates that the most they could possibly lose, would be the amounts that they invest. Emily Park has suggested that they should form a private company for this enterprise. Tracy Good therefore approached your firm to advise her as to:

- a) whether a private company, partnership, close corporation or public company would be the best form of business enterprise, and if so, why. (10)
- b) the procedure for incorporating a *private company* including an indication of the documents involved and briefly what the documents contain. (12)
- c) whether you would act as tax advisor and conduct the audit of the new enterprise, assuming that they form a private company. (8)

**YOU ARE REQUIRED TO** draft a letter to Tracy Good which provides detailed advice on the questions she has raised.

**13.12**

**(20 marks 24 minutes)**

You are the auditor of Craft (Pty) Ltd, a manufacturing company in the marine engineering sector. The Memorandum of Incorporation contains, inter alia, the following clause:

"Any director or prescribed officer of the company who has a personal financial interest in a contract in which this company has entered or will enter, either directly or indirectly, shall comply with the Companies Act 2008. The contract will be binding provided that the

authority of the company in general meeting is obtained by poll for the contract prior to the contract being entered into."

Your scrutiny of the minutes of directors' meetings reveals that the company entered into a contract with Marine (Pty) Ltd for the purchase of 10 highly sophisticated and expensive radar systems valued at approx R1million each. Tony Teak, is a director of Craft (Pty) Ltd, and his brother Terry is the majority shareholder of Marine (Pty) Ltd.

**YOU ARE REQUIRED TO:**

- a) discuss the requirements of the Companies Act 2008 in relation to the contract entered into by Craft (Pty) Ltd with Marine (Pty) Ltd, particularly in view of the relationship between Tony and Terry Teak. (12)
- b) comment on whether the shareholders' meeting to ratify the contract could be held by electronic communication. (5)
- c) distinguish between voting on a show of hands and by poll. (3)

**13.13**

**(45 marks 54 minutes)**

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:**

- a) explain to John Wayne how the external audit of Canyon (Pty) Ltd's annual financial statements can become a requirement in terms of the company's Memorandum of Incorporation. Your answer must include details of meetings which may have to be held e.g., quorums, notice, etc. (12)
- 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 III). (15)
- c) advise John Wayne on whether Doc Hudson could be removed from his position as a director of Canyon (Pty) Ltd. (8)
- d) advise John Wayne as to which, if any, of the five firms/individuals listed for appointment as auditor for the voluntary audit, would be suitable for appointment. (10)

**13.14**

**(35 marks 42 minutes)**

You are the senior-in-charge of the audit of Teknifast Ltd, the holding company of a group of companies which manufactures, wholesales and retails a range of fasteners, joiners and adhesives. All companies in the group have significant net worths but like most companies experience liquidity problems from time to time.

1. The group **structure** is as follows:
  - 1.1 Teknifast Ltd's holdings in subsidiaries
    - 1.1.1 Metalmatch (Pty) Ltd 80%
    - 1.1.2 Sticky Stuff (Pty) Ltd 70%



1.2 Metalmatch (Pty) Ltd's holdings in its subsidiaries

1.2.1	Gloochem (Pty) Ltd	65%
1.2.2	Nutsenbolts (Pty) Ltd	58%

2. **Directors**

<b><i>Teknifast Ltd</i></b>	<b><i>Metalmatch (Pty) Ltd</i></b>	<b><i>Sticky Stuff (Pty) Ltd</i></b>	<b><i>Gloochem (Pty) Ltd</i></b>	<b><i>Nutsenbolts (Pty) Ltd</i></b>
Jones	Jones	Donovan	Juries	Wilson
Bolden	Donovan	Ambrose	Snyman	Campo
Sepeng	Dravid	Jacobs	Dravid	
Donovan	Singh			

3. Your firm holds the appointment of auditor of all companies in the group with the exception of Nutsenbolts (Pty) Ltd. Prior to becoming a subsidiary, Nutsenbolts (Pty) Ltd was owned by Wilson and Campo, (the two existing directors), and Berk. Berk, Wilson and Campo have each retained a 14% shareholding and it was informally agreed that for as long as they remained as shareholders, the company would retain its own auditors. Co-operation between yourselves and the other firm of auditors has always been very professional.

4. **Company Secretary**

Alex Fergoosen is the company secretary of Teknifast Ltd and is responsible for secretarial matters for all companies in the group.

It is the policy of your firm that on all audits, transactions and matters which have statutory implications be referred to an experienced, senior member of the holding company audit team.

The following transactions/matters have been referred to you.

- (i) A loan of R500 000 made by Metalmatch (Pty) Ltd to Donovan at the prime interest rate. (9)
- (ii) A loan of R1.2 million made by Metalmatch (Pty) Ltd to Bouncers (Pty) Ltd, a company recently formed by Ambrose and his business partner (who is in no way connected with the group) to manufacture glue resins. Ambrose owns 76% of the shares and his partner 24%. (5)
- (iii) A loan of R4 million by Gloochem (Pty) Ltd to Juries to purchase an apartment (flat) in Detroit, USA. Juries is the technical director of Gloochem (Pty) Ltd and is required to spend approximately a week each month in Detroit. Juries also has a house in Johannesburg. (4)
- (iv) The minutes of a meeting of the directors of Teknifast Ltd (the group holding company) indicated that the directors of Teknifast Ltd were intent on removing Campo from his position as director of Nutsenbolts (Pty) Ltd prior to the expiry of his term of office. The reason stated in the minutes was that he did not appear to support the "Teknifast Group" corporate identity although his performance as a director was very



satisfactory. Nutsenbolts (Pty) Ltd's Memorandum of Incorporation does not include any special provision which gives any person powers to remove a director. (8)

5. *The Memorandums of Incorporation* of all companies in the group stipulate that when making loans or providing assistance to directors, the requirements of the Companies Act 2008 must be satisfied. No additional restrictions or requirements are included.

**YOU ARE REQUIRED TO:**

- a) discuss your firm's right of access in respect of the accounting records, financial statements, books and documents of Nutsenbolts (Pty) Ltd. (4)
- b) indicate the conditions which must be satisfied by Alex Fergoosen, the company secretary, with regard to his residency and his professional qualification. (3)
- c) explain why all transactions with statutory implications are referred to an experienced senior member of the audit team. (2)
- d) discuss the legality/permissibility of each of the loans described from (i) to (iii) above in terms of the Companies Act 2008. (18)
- e) discuss the procedures which must be followed to achieve Teknifast Ltd's intention to remove Campo from his position of director of Nutsenbolts (Pty) Ltd. (8)

**13.15**

**(20 marks 24 minutes)**

Kwin (Pty) Ltd is a wholesaler of medical supplies. Due to sustained growth in the business, the directors have decided that additional shares in the company should be issued to raise the amount of R10 million needed to fund a proposed expansion of the business. The directors have considered various other financing options but have decided that a share issue would be the best option. Dick Kwin the financial director, has approached you for some initial advice on the issue and has provided you with the following:

- 1. Kwin (Pty) Ltd has 350 000 ordinary no par value shares in issue. The authorized share capital is 400 000 ordinary no par value shares. All shares are of the same class.
- 2. The 350 000 shares are held as follows:
  - : 90 000 by BioMed (Pty) Ltd
  - : 45 000 by each of three of the directors of Kwin (Pty) Ltd. (The two other directors do not hold any shares)
  - : 50 000 by a share scheme trust for employees of Kwin (Pty) Ltd
  - : 75 000 by eight private investors who hold various quantities of the shares (totalling 75 000).
- 3. The intention is to issue a further 250 000 shares at R40 a share. Shares would be offered to the existing five directors and the private investors in equal quantities, but not to BioMed (Pty) Ltd or the share trust scheme.

4. The MOI requires that the issue of shares be carried out in terms of the Companies Act 2008. It contains no additional requirements relating to the issue. Ordinary resolutions and special resolutions must be approved by 50% and 75% of the voting rights respectively.

**YOU ARE REQUIRED TO** advise Dick Kwin on the statutory requirements applicable to this proposed issue. Your answer must cover, inter alia, notice requirements for meetings, quorum requirements, etc.

**13.16**

**(32 marks 38 minutes)**

You are a senior trainee accountant in your audit firm's technical department. Your responsibility is to advise fellow staff members out on audit, on statutory and corporate governance matters. One of the firm's clients is the Bathtime Group. All companies in the group manufacture, retail or wholesale bathroom requisites, baths, showers, taps, tiles, plumbing etc.

The group is structured as follows: Bathtime (Pty) Ltd holds 60% of Tapturners (Pty) Ltd, 80% of C-Ramics (Pty) Ltd and 70% of Pipes and All (Pty) Ltd. C-Ramics (Pty) Ltd holds 100% of the shares in Tile-Extras (Pty) Ltd.

Your firm holds the appointment of auditor for all companies in the group and the various audit teams are currently engaged in the 30 September year-end audit. You have received the following queries:

1. ***From Sam Mashaba, on the audit of Pipes and All (Pty) Ltd.***

We identified an amount of R4.6 million in trade creditors owed to Atimes2 CC. This represents the purchase during August, of a machine which manufactures joiners for copper plumbing pipes. The machine has been installed. However, it appears that Atimes2 CC is fully owned by Aeron Sibaya and Andre Booth, two of the four directors of Pipes and All (Pty) Ltd. Neither of them are shareholders of Pipes and All (Pty) Ltd. The purchase documentation e.g. purchase order, delivery note, invoice and entries in the records are all correct and R4.6 million is the fair price for such machines. Do I have any further responsibilities arising out of this transaction? (12)

2. ***From Daan Greef, on the audit of C-Ramics (Pty) Ltd.***

The company has made a number of loans during the past year. I have considered each of the loans but would like to raise queries with you in respect of one of them.

A loan of R150 000 to John Sepaka, the managing director of Tile-Extras (Pty) Ltd, who also sits on the Board of C-Ramics (Pty) Ltd. John Sepaka intends to use the loan to make a private investment. Is this loan acceptable, and if so what are the requirements of the Companies Act 2008? (8)

3. ***From Seb Rothman, on the audit of Bathtime (Pty) Ltd.***

During the year under audit the company undertook a buy back of its own shares. Prior to this buyback, the company had one million no par value shares all of which had been issued at R5 a share. 50 000 shares were bought back at R7 a share and the buyback was

effected by Isaak Shaai, the company secretary to the Bathtime group. Please could you advise me on the procedures I should conduct to audit the buyback. (12)

**YOU ARE REQUIRED TO** respond to the queries/requests from the audit teams.

**13.17**

**(38 marks 46 minutes)**

Saska (Pty) Ltd is a large company in the sporting goods sector. Ross McKewan, the sole non-executive director of the company, has consulted you regarding a number of concerns which he has, arising out of a recent meeting of the company's board of directors. None of the directors holds any shares in the company. Your discussions with Ross McKewan revealed that he had opposed the matters described below and a number of other matters, but that they had ultimately all been approved by the board of directors. He also informed you that Barry Black, the managing director, had ended the meeting by announcing that he could not work with a person who responded negatively to virtually everything that he proposed. He put it to the board that either Ross McKewan or he himself should leave the board. The rest of the board of directors unanimously resolved to remove Ross McKewan from the board with immediate effect.

***Matter 1***

A contract for R16 million, to refurbish the company's offices, had been awarded to Singer Designs, ahead of three other contractors who had tendered for the job. Ross McKewan had opposed this decision as he preferred a far less expensive proposal made by one of the other contractors. Barry Black was, however, very much in favour of the Singer Designs proposal and had convinced the rest of the board to vote accordingly. Ross McKewan had coincidentally found out, subsequent to the meeting, that Singer Designs was owned by Jackie and Cilla Black, Barry Black's daughter and wife respectively. (14)

***Matter 2***

Ben Johnson, the marketing director of Saska (Pty) Ltd, had asked at the board meeting whether it would be possible for the company to provide him with an interest free loan of R2m to assist him in the purchase of a new house, into which he and his family are planning to move. Barry Black had responded by telling Ben Johnson that he would, in his capacity as Chairman, personally authorise the loan (provided the other directors agreed). Barry Black added that he would probably arrange for the loan to be made by Calgary (Pty) Ltd, a wholly owned subsidiary of Saska (Pty) Ltd rather than by Saska (Pty) Ltd as Ben Johnson is not a director of Calgary (Pty) Ltd. (8)

**YOU ARE REQUIRED TO:**

- a) discuss the legality of Ross McKewan's removal from the board. (8)
- b) discuss Barry Black's compliance with the requirements of the Companies Act 2008 with regards to the contract awarded to Singer Designs and comment on the validity of the contract, in terms of the Act. (14)
- c) discuss the legality of the loan to be made to Ben Johnson. (8)

- d) comment on the composition and behaviour of Saska (Pty) Ltd's board of directors, in terms of the King III Report on Corporate Governance. (8)

13.18

(38 marks 46 minutes)

You are a manager in the audit practice of Kenyon and de Waal. As you are a specialist in company law, statutory matters are frequently referred to you. One of your clients, Cookware (Pty) Ltd has approached you for advice.

The directors, none of whom are shareholders, have put a proposal together which they wish to present to the shareholders. Although the company is not in a situation where a business rescue plan is required, the directors consider that the proposals will ultimately make the business more profitable.

The company manufactures household appliances but has been beset by labour problems and competition from cheap imports for some time. Their intentions are as follows:

1. The directors would dispose of the manufacturing plant and equipment and the factory building. The current warehouse would be retained as a warehouse for the proposed new line of business. (14)

2. The proposed new line of business would be the importation and wholesaling of electrical components for industrial and commercial air conditioning installations. The name of the company would be changed to Airware (Pty) Ltd.

Mark plan: New line of business (3)

New name of business (4)

3. As the production director, Ken King, would no longer have a role to play, he would resign and be paid out a R500 000 lump sum. He would use this money to buy shares in the company which would be issued to him by the directors. Ken King would not be employed by Airware (Pty) Ltd (the company's new name) but would retain his connection to the company through his shareholding and an appointment to the board as a non-executive director. (10)

4. A portion of the proceeds of the sale of the plant and equipment and the factory building would be used to redeem the R1.5 million redeemable preference shares which Cookware (Pty) Ltd has in issue. All the preference shares are held by the ordinary shareholders and the redemption is due shortly. (7)

Grant Cox, the director who came to see you, is certain that the twenty or so shareholders he expects will come to the meeting, will question him closely on the statutory implications of each part of the proposal. He also wants to be quite sure that he understands the implications and that the company complies with the requirements of the Act with regard to setting up meetings, quorums, voting, etc.

**YOU ARE REQUIRED TO** advise Grant Cox accordingly. You are *not* required to recommend alternative actions or proposals. You are also not required to deal with the actual disposal of the plant and factory building or the detail of Sec 164 of the Companies Act 2008.

You are a member of the technical department of your audit firm and are responsible for advising audit team members on any matter which they may raise with you. You are currently dealing with the following queries:

***Query from Sibio Zooma, senior in charge of the audit of Blondie (Pty) Ltd***

“This client is in financial difficulties and has entered into a subordination agreement with Midfield (Pty) Ltd, one of its creditors. I have found a list of the audit procedures I need to conduct on the subordination agreement in our audit manual, but am not entirely certain why some of the procedures are necessary. Please could you explain so that I know what I am doing! The procedures per our audit manual are as follows:

1. Obtain written confirmation from the subordinating party that it is entitled to subordinate the amount owed to it. (2)
2. Evaluate the financial position of the subordinating party. (3)
3. Consider the size of the amount subordinated as well as the period for which the subordination has been given.” (3)

***Query from Len Anton, auditor in charge of the Solidd group of companies audit***

“My team is auditing various loans and other statutory matters in this small group of manufacturing companies and we need some guidance. The structure, directors and shareholders of the group are as follows:

***Solidd (Pty) Ltd***

Shareholders : Brandon Else holds 60% of the shares  
 : 10 individuals who have no other connection with any company in the group, hold the remaining 40% between them.

Directors : Brandon Else, Jaque Challis, Jimbo Blake.

***Propps (Pty) Ltd***

Shareholders : Solidd (Pty) Ltd holds 55% of the shares  
 : Agamax CC holds 15% of the shares  
 (Agamax CC is owned by Andrea Agasey, Bryan Cox and Marie Peerce. They each have an equal members interest)  
 : 15 individuals who have no other connection with any company in the group, hold the remaining 30% between them.

Directors : Jimbo Blake, Andrea Agasey, Marie Peerce.

***8Man(Pty) Ltd***

Shareholders : Solidd (Pty) Ltd hold 60% of the shares  
 : 4 individuals who have no other connection with any company in the group hold the remaining 40% of the shares between them

Directors : Marie Peerce, Mark Willmott, Bryan Cox, Jaque Challis.

***Sidepocket (Pty) Ltd***

Shareholders : 8Man (Pty) Ltd 80% of the shares  
: 3 individuals who have no other connection with any company in the group, hold the remaining 20% of the shares between them

Directors : Jimbo Blake, Alex Higgins, Phil Taylor.”

Our queries are as follows:

1. “Propps (Pty) Ltd made a loan of R2.5m at market related terms and conditions to Solidd (Pty) Ltd. One of the trainees on the team is of the opinion that this loan is in contravention of the Companies Act. He believes that it is in effect, a loan to a “company controlled by a director of Propps (Pty) Ltd’s holding company and therefore prohibited. Can you resolve this for us please.” (7)
2. “Propps (Pty) Ltd made a loan of R10m to Agamax CC. The loan was at market related terms and conditions and is repayable in 3 years time. Please could you advise us whether this loan is permissible in terms of the Companies Act 2008 and describe the detailed audit procedures we should carry out to audit the loan transaction.” (15)

***Query from Maneeb Norris, senior in charge of the audit of Sidepocket (Pty) Ltd***

1. “As a result of an instruction from 8Man (Pty) Ltd, Sidepocket (Pty) Ltd had a piece of vacant land they owned (free of encumbrances) revalued. The company did not sell the property but distributed the amount by which the property has appreciated to the shareholders.

A total dividend of R4 million was paid out, R3.2 million to 8Man (Pty) Ltd and the balance to the minorities. Sidepocket (Pty) Ltd has had a very successful trading year.

Please could you advise us as to whether this unrealized profit can be distributed.” (6)

2. “Could you also advise us on whether the following persons (both individual and juristic) are related in terms of the Companies Act 2008.
  - 2.1 Bryan Cox and Propps (Pty) Ltd.
  - 2.2 Brandon Else and 8Man (Pty) Ltd.
  - 2.3 Solidd (Pty) Ltd, Propps (Pty) Ltd and Sidepocket (Pty) Ltd by virtue of Jimbo Blake.
  - 2.4 Sidepocket (Pty) Ltd and 8Man (Pty) Ltd.” (6)

**YOU ARE REQUIRED TO** respond to each of the queries/requests raised above.

**13.20**

**(33 marks 38 minutes)**

1. If all members agree, a close corporation may have fifteen members. True or false? (1)
2. What is the name of the document which would have been lodged with the Commission to register a close corporation? (1)



3. What information does this document contain? (4)
4. In terms of the Companies Act 2008, the requirement to lodge this document to form a CC was replaced by a requirement that an existing CC lodge a Memorandum of Incorporation with the Commission. True or false? Justify. (2)
5. A close corporation must include its full name, the fact that it is a close corporation and its registration number on all cheques, letters, invoices, delivery notes and receipts issued by it. True or False? (1)
6. All members of a close corporation must contribute an equal sum of money to the close corporation before a members interest can be allocated to that member. True or False? Justify. (2)
7. Can a private company with less than ten shareholders, convert itself into a close corporation? Explain. (2)
8. Can a close corporation have only one member? (1)
9. Member's interests will only total 100% if and when there are ten members. True or False? Justify. (1)
10. A new member of a CC may obtain his membership in one of two ways; what are the two ways? (2)
11. Can the members of a CC force one of the members to give up his member's interest? Justify your answer. (4)
12. Jimmy James has a 20% member's interest in Goals CC. He wishes to dispose of half of his interest to a colleague who is not a member of the CC. The remaining half of the interest will then become a jointly held interest with Jimmy James' private company, Tryline (Pty) Ltd. Is this proposal acceptable? Justify. (3)
13. What requirements of the Act must be met for a CC to purchase the interest of one of its members? (3)
14. A company which holds 55% of a close corporation's members interests is regarded as the CC's holding company. True or False? Justify. (2)
15. If a CC does not have an association agreement, what consent must be given for
  - 15.1 a disposal of the whole, or substantially the whole, undertaking of the corporation
  - 15.2 admitting a new member to the corporation
  - 15.3 calling a meeting of members
  - 15.4 acquiring a vacant piece of land. (4)

**13.21****(25 marks 30 minutes)**

The members of one of your clients, Renovations CC which carries out building alterations have heard that close corporations may eventually be phased out completely and as a result are considering converting their CC to a private company. The CC has six members and including the members, employs 30 people. The turnover of the company is expected to be around R15 million a year. They have put the following questions to you:

1. Can the members use the CC's existing founding statement and association agreement as the incorporating documents and just change the CC's name on the documents to Renovations (Pty) Ltd? (3)
2. Will the new company have to be externally audited? (6)
3. If the CC converts, can the new company have more than ten shareholders? (2)
4. Can Renovations CC purchase the member's interests of any of the existing members who may wish not to become shareholders of the new company? (4)
5. Will the new company be able to give financial assistance to any new shareholders in the company (excluding existing members of the CC) to purchase shares in Renovations (Pty) Ltd? (4)
6. If Renovations CC does not convert to a company, does it mean that no new individuals can be brought in as members of the CC in future? (2)
7. If the CC converts to a company, will each of the existing members who become shareholders be given an equal number of shares in the new company? (2)
8. We are aware that a company cannot hold a members interest in Renovations CC, but would a company be able to hold shares in Renovations (Pty) Ltd? (2)

**13.22****(32 marks 38 minutes)**

Castings CC is a close corporation which imports fishing equipment. The CC has eight members all of whom have approximately the same members' interest. Martin Orvis the managing member of the CC has become aware of amendments to the Close Corporations Act and the promulgation of the new Companies Act 2008, and feels that the CC should be converted to a company. He therefore asked you to attend a meeting of the members to answer various questions which the members had. You agreed and at the meeting at which all the members were present, the following questions were put to you.

1. Martin Orvis asked whether it was now compulsory for close corporations to convert to companies. (2)
2. Clark Jackson asked what the procedure was to convert. (5)
3. Graydon Sheridan indicated that he actually wanted to retire and asked whether he could rather sell his members interest to one of the existing members of Castings CC before



the conversion took place or whether he would have to become a shareholder in the company and then sell his shares? (2)

4. Zane Kershner asked whether Castings CC could not simply buy Graydon Sheridan's members interest. (4)
5. Martin Orvis asked whether the shares in the new company would have to be issued in the same proportion as the existing members interests. (2)
6. Jason Fiddle enquired as to whether the new company would be a public or private company, and that as he didn't really understand the difference, could you briefly explain it. (6)
7. Willie Wilson asked whether the CC would have to change its name if it converted. (3)
8. Mary Winston asked whether all the members would become directors of the new company. (4)
9. Gavin Gibb enquired as to whether the new company would have to have an accounting officer and wanted to know what happens to the assets and liabilities of the CC. (4)

**YOU ARE REQUIRED TO** respond to the questions listed above.

**13.23**

**(22 marks 26 minutes)**

You are one of six members of Baseline CC. The founding statement indicates that the business of Baseline CC is the resurfacing of tennis courts. This has proved to be very profitable. The technical and marketing side of the business is left to the other members of the corporation including Chris Cloete who is responsible for sales whilst you, being a chartered accountant, act as accounting officer to the corporation as well as carrying out the administration, accounting and statutory duties of the corporation, including compiling the annual financial statements. Baseline CC does not have an association agreement.

1. The members believe that with South Africa staging more and more international sports events there is a lucrative market for all types of sports surfaces, particularly synthetic surfaces. For Baseline CC to enter this market they will need to obtain the services of someone with the requisite experience. The members have decided that this person should become a member of the CC and should obtain an equal share. Chris Cloete, wishes to leave the CC and is prepared to negotiate the sale of his members interest with any interested buyers. Allan Emslie, who is experienced in marketing synthetic sporting surfaces wishes to purchase the interest but can only do so if Baseline CC agree to loan him the money.
2. It has been decided that the name of the corporation should be changed from Baseline CC to Sportsurface CC so as to better reflect the business of the corporation.
3. For the current financial year end Baseline CC has a public interest score of 83 but, in future years, this is expected to increase to over a hundred due to the expansion of the CC's operations.

**YOU ARE REQUIRED TO:**

- a) state the procedures you should carry out in respect of 1 and 2 above in your capacity as member in charge of administrative/statutory matters to comply with the Close Corporation Act. (15)
- b) state the duties with which you must comply in terms of the Close Corporations Act by virtue of your position of accounting officer. (3)
- c) state whether the CC must have its annual financial statements audited, independently reviewed or will require no external audit or review:
  - i) for the current year
  - ii) in future years (assuming the company expands as expected). (4)

**13.24**

**(26 marks 31 minutes)**

You are a chartered accountant and the financial advisor of Kwikstix CC, a profitable business which manufactures a range of construction toys which it sells through a chain of toy shops throughout the country. The close corporation currently has nine members but the members feel that to keep the business successful, it is necessary to introduce some new members to replace members who wish to sell their interests and to offer membership to a number of employees who have served the corporation well.

The existing members have asked you to comment on the following proposal:

- 1. Carl Prins, the production manager who has been with the corporation since it was formed in 1988, but has never been a member, will be offered the members interest of one of the members willing to sell their interest.
- 2. Two of the existing members will sell their interests in the company.
- 3. Toyjoy (Pty) Ltd, the company which distributes Kwikstix CC toy range, will become a member of the close corporation. The members believe that this will secure the distribution network.
- 4. Arnie Arrow, a young toy design engineer (whom the shareholders consider to be very important to the corporation) will become a member of the close corporation to head up the design and development department. As Arnie Arrow has no financial backing, the close corporation will lend him the money to purchase his interest.
- 5. The financial accountant and administrative manager of Kwikstix CC, neither of whom are currently members, will be offered a joint members interest in the corporation, to give them a stake in the CC.
- 6. You, as financial advisor, will be offered a members interest and will be appointed accounting officer of the close corporation to replace the existing accounting officer who is one of the members who wishes to retire.

**YOU ARE REQUIRED TO:**

- a) comment fully on the proposal presented to you, paying particular attention to the Close Corporation Act 1984. (16)
- b) present an argument to the members for converting Kwikstix CC to a private company. (10)

## **CHAPTER 14**

### **COMPLETING THE AUDIT**



**14.1****(10 marks 12 minutes)**

Once all the audit evidence has been gathered, ISA 700 – Forming an opinion and reporting of financial statements, requires that the auditor evaluates the audit evidence to form an opinion on whether the financial statements are prepared in all material respects in accordance with the applicable financial reporting framework.

1. Which member of the audit team is most likely to carry out this evaluation? (1)
2. In evaluating whether the financial statements are presented in accordance with the applicable financial reporting framework, what, besides accounting policies, will the auditor consider? (3)
3. When evaluating the accounting policies, what does the auditor consider? (3)
4. Besides the specific evaluations in (2) and (3) above, what else must the auditor consider before concluding on whether the financial statements have been prepared in accordance with the applicable reporting framework? (3)

**14.2****(18 marks 22 minutes)**

The auditor is not expected to conduct a continuing review of all matters to which audit procedures have been applied and for which satisfactory conclusions have been reached. However, the auditor must, inter alia

- \* consider whether uncorrected misstatements which have been identified during the audit result in a material misstatement of the financial statements
- \* consider the accounting policies adopted

**YOU ARE REQUIRED TO:**

- a) distinguish between “factual” and “judgemental” misstatements. (2)
- b) explain why the above distinction must be made by the auditor. (2)
- c) explain why the auditor may have difficulty in getting an audit client to accept a projected misstatement in the financial statements. (3)
- d) explain whether a significant risk identified in the planning of the audit, would have any effect on the evaluating and concluding stage of the audit. (2)
- e) explain briefly what characteristic distinguishes an “error” from a “fraud”. (1)
- f) explain why the materiality of an uncorrected misstatement is important for the auditor when evaluating and concluding. (2)
- g) briefly explain what the auditor will be concerned with when considering the accounting policies adopted by the client. (2)

- h) identify four circumstances which may cause the auditor to evaluate a misstatement as material even if the misstatement is lower than the quantitative final materiality limit.(4)

### 14.3

(20 marks 24 minutes)

Part of the evaluating and concluding stage of the audit process will be to evaluate the effect of uncorrected misstatements which have been identified on the audit. An important factor in this regard will be the materiality of the misstatement but it is by no means the only factor which comes into the evaluation. One might also assume that if a material misstatement has been identified that it could be corrected and that the directors would be willing to correct it.

#### YOU ARE REQUIRED TO:

- a) define a misstatement in the context of the audit. (2)
- b) state the two word term for a misstatement which is “clearly inconsequential, whether taken individually or in aggregate and whether judged by any criteria of size, nature or circumstances.” (1)
- c) explain why the directors may decide not to correct a material misstatement in the financial statements. (7)
- d) comment on the effect, if any, the following would have on the evaluation of the materiality of the misstatements. Consider each situation separately.
- i. if the correction is made, the financial statements will reflect a loss for the first time in ten years.
  - ii. the misstatement is in the “Operating and financial review report” which is included with the annual financial statements document but is not part of them.
  - iii. if the correction is made it will reduce bonuses paid to management and directors.
  - iv. if the correction is made it will reduce a special bonus which has been promised to hourly paid employees. Management have assured the auditors that if the bonus is not paid at the original amount, the employees will strike until the full amount is paid.
  - v. the misstatement arises from factual inaccuracies in the disclosure of related party relationships. (10)

### 14.4

(18 marks 22 minutes)

1. What is the essential difference between IAS 10 Events after The Reporting Period, and ISA 560 Subsequent Events, with regard to the definition of events occurring after the reporting date? (1)
2. For what purpose are procedures to identify events occurring after reporting date (subsequent events) carried out? (1)
3. Distinguish between an adjusting subsequent event and a non-adjusting subsequent event. (3)

4. Briefly describe the procedures the auditor should carry out to identify subsequent events. (3)
5. List five *specific* enquiries of management which the auditor might make when carrying out procedures to identify subsequent events. (3)
6. Even if a company declares a dividend *after* the reporting period, the dividend must be recognised as a liability at reporting date. True or False? Justify. (2)
7. What responsibility does the auditor have to perform procedures to identify subsequent events after the date of the audit report. (1)
8. Where the auditor concludes after signing his report that action should be taken to prevent future reliance on that report, what courses of action could be taken? (4)

**14.5**

**(29 marks 34 minutes)**

**Part A**

**(17 marks 20 minutes)**

You are the auditor of Rockett Imports (Pty) Ltd, a large company which imports motor vehicle accessories. Rockett Imports (Pty) Ltd does not sell its products direct but works through a large number of independent agent companies which earn commission on the sale of Rockett Imports (Pty) Ltd's products.

As part of your subsequent events review, you inspected the minutes of directors' meetings held after the financial year-end 29 February 2016 and came across the following entry:

"The report from Speedsystems CC was discussed by the meeting and it was unanimously agreed that the new application software for the calculation and recording of commissions designed by Speedsystems CC, would be adopted and that the CC would be engaged to implement it commencing on 1 July 2016."

"It was also decided that the amount of R472 917.00 relating to prior commissions would be ignored."

As you did not have any idea of what the R472 917.00 was about you raised the matter with Willie Nelson, the financial director who informed you as follows. Speedsystems CC had been engaged to design an entirely new system for agents' commissions. During their investigation into user requirements Speedsystems CC discovered that, in terms of their contracts, the existing application software had miscalculated commissions payable to the seven new agent companies who had entered into contracts with Rockett Imports (Pty) Ltd during the previous financial year. The miscalculation amounted to a total underpayment to the seven agents of R472 917.00.

He further informs you that the directors have accepted that the miscalculation has occurred but have decided to ignore it as no agent has raised any queries with regard to the commissions paid to them, and with the new software the same error will not occur.



On informing Willie Nelson that you will need to carry out further procedures, he responded by saying "Do whatever you want to but as far as we are concerned the matter is closed."

**YOU ARE REQUIRED TO:**

- a) indicate what further procedures you would carry out in respect of the R472 917.00 identified by Speedsystems CC. (11)
- b) explain the effect that this matter, which you regard as material, would have on your audit report assuming that the audit procedures conducted in (a) verified the findings of Speedsystems CC and that the directors will not heed the advice you give them. (6)

**Part B**

**(12 marks 14 minutes)**

Another audit client is Clevacomp (Pty) Ltd, an importer of computers and computer components. You are currently finalising the 31 December 2015 audit of the company's inventory and have the following outstanding matters, inter alia, to deal with:

1. The 22 January 2016 edition of the Business Day newspaper carried an article describing how the price of computer memory chips had increased dramatically due to a huge fire (in late December 2015) at the Japanese factory which manufactures 60% of the world supply of the high grade epoxy resins used in the manufacture of computer chips. As a direct result of this, Clevacomp (Pty) Ltd has written up the value of their imported memory chip inventory at year end by a material amount and has made full disclosure in the financial statements. Your audit procedures confirmed that the cost of memory chips has risen dramatically on world markets, and was not likely to reverse until at least 2017. (4)
2. In January 2015 Clevacomp (Pty) Ltd imported, (with sole distributing rights) a consignment of a unique software package at a cost of R5 million. At virtually the same time a local software house and direct competitor of Clevacomp (Pty) Ltd, launched a very similar package at a selling price 60% lower than the selling price of Clevacomp (Pty) Ltd's package and sales of the Clevacomp (Pty) Ltd software package virtually ceased. Clevacomp (Pty) Ltd immediately brought a civil action against the local software house to prevent them from selling their package, but was unsuccessful. The matter was taken on appeal but on 15 January 2016 the court once again ruled against Clevacomp (Pty) Ltd. In the 31 December 2015 financial statements, the directors had valued the inventory of the imported software package at R4.35m being the cost price of the packages on hand at that date. No mention was made of the court case. Despite the court decision, the directors are not willing to consider any amendments to the financial statements as they claim that their superior service and backup will recapture this particular market. (8)

**YOU ARE REQUIRED TO** state, giving reasons whether you would be satisfied with the directors' treatment of the two matters described above in the 31 December 2015 financial statements. Assume that the amounts involved are material.

You are the senior on the audit of Cream (Pty) Ltd and are currently engaged on the 29 February 2016 year-end audit. Whilst conducting procedures to identify subsequent events you came across the following:

1. A payment of R1 million made on the 3 March 2016 to Clive Clover a former director of Cream (Pty) Ltd. Clive Clover's services with Cream (Pty) Ltd had been terminated on the 30 November as a result of minor restructuring and the payment was in respect of compensation for loss of office. No mention of this payment has been made in the annual financial statements at 29 February 2016 although the restructuring was dealt with in the directors' report.

A directors' minute dated 21 March 2016 indicating that the company intends instituting proceedings against Clive Clover for the recovery of the R1m paid to him. It is alleged that prior to the termination of his services Clive Clover had breached his contract with Cream (Pty) Ltd by contractually agreeing to join the board of directors of a competitor of Cream (Pty) Ltd effective from 1 March 2016. Judge and Justice, Cream (Pty) Ltd's lawyers, are not prepared to comment at this stage on the likelihood of the action being successful. (6)

2. Correspondence from the liquidator of Butter (Pty) Ltd indicating that creditors of that company, which was declared insolvent on 10 March 2016, were unlikely to receive any more than twenty cents in the rand on their claims. At 29 February 2016 Butter (Pty) Ltd had owed Cream (Pty) Ltd R400 000. No allowance has been made for this loss at year-end in the accounting records of Cream (Pty) Ltd. (4)
3. Correspondence from Judge and Justice, Cream (Pty) Ltd's lawyers indicating that a number of claims against Cream (Pty) Ltd for personal damages had been received from the public. These had arisen from publicity surrounding an out of court settlement of R150 000 made prior to the year-end. Cream (Pty) Ltd had made this payment to a member of the public who had sued the company for personal damages having consumed contaminated yoghurt supplied by the company. You establish that the contamination was restricted to one small consignment of yoghurt and that the publicity had not affected subsequent sales. Judge and Justice are unable to give any indication of the possible liability arising from the claims. Although the directors admit that other members of the public could have been poisoned they consider that the matter should simply be ignored altogether or dealt with in the 2017 financial statements if the need arises. (6)
4. An article in the company magazine detailing the upcoming restructuring of the company's human resource section. (2)

**YOU ARE REQUIRED TO** state, giving reasons if any, the effect which each of the above matters will have on the 29 February 2016 financial statements. Assume all amounts are material.

In the portfolio of clients for which you are responsible at your audit firm, are a number of companies which have 31 December financial year-ends.

In carrying out the subsequent events review during the first week of February at these clients for the financial year ended 31 December 2015, you identified the following *unrelated* matters:

1. During October a new truck valued at R580 000 belonging to one of your clients, Roadcarry (Pty) Ltd had been hijacked whilst on a delivery. The truck which was insured has not been seen since. The financial director wrote the vehicle off at 31 December, recognised the small loss that was anticipated when taking into account the expected payout from the insurance company and raised the insurance company as a debtor. You were satisfied with this treatment. However late in January the insurance company notified Roadcarry (Pty) Ltd that they would not be paying out any amount in respect of the hijacked vehicle as their investigation had suggested that the driver of the hijacked vehicle had been involved. The driver who was an employee of Roadcarry (Pty) Ltd resigned from the company shortly after the incident. The company had referred the matter to its lawyers who have indicated that in terms of a strict interpretation of the insurance policy, the insurance company may be within its rights, but they recommended that the matter be taken to court. Roadcarry (Pty) Ltd has agreed to this. (5)
2. During the first week of February 2016 your client B M Car Manufacturers Ltd issued a notice in the press recalling all the units sold of a model which was launched during September 2015. A defect in the rear axles of this model had been brought about by a robot malfunction in the assembly of the vehicle of which the company had been unaware until late in January 2016. Modifications to the rear axels of all vehicles of this model will need to be carried out. (5)
3. One of your clients, Ausum Trucks Ltd, had during the year made a long-term investment of surplus funds in an investment company Financebond Ltd. Your audit procedures indicated the investment as being secure at 31 December. The directors had concurred with this. Late in January 2016 it was announced in the press that a major fraud (which had been in progress over a number of years) at Financebond Ltd had been exposed and that the company had been suspended from the JSE. Confirmation of this had been obtained from the company but no further details other than that the company is likely to be placed in liquidation, are available. (5)
4. Another of your clients, Sport Fibre (Pty) Ltd, supplies imported resin and glassfibre to manufacturers of canoes, sailboards, yachts and other glass fibre products. At year-end, large inventory of both resin and glassfibre was on hand. On 1 February 2016 certain trading restrictions on resins and glassfibre were lifted causing the cost of these products to drop considerably. (5)

**YOU ARE REQUIRED TO:**

- a) list the procedures commonly performed by auditors to *identify* subsequent events. (5)

- b) discuss each of the situations above indicating how each matter should be dealt with (if at all) in the financial statements of the various companies at 31 December 2015.(20)

#### 14.8

(25 marks 30 minutes)

You are the partner in charge of the audit of Swetts (Pty) Ltd. The company sells a large range of sports equipment under the trading name of Swettshops. You recently attended the annual general meeting of the company, at which the financial statements for the year were accepted and your firm's appointment for the following year was confirmed. You are now shocked to read in the financial press, that an investigation has revealed that large consignments of fake famous brand sportswear and shoes (such as Nike and Fila) have been brought into South Africa illegally during the previous year and are being sold (knowingly) by various sports outlets as the genuine product. Swettshops is alleged to be an offender.

After reading this article, you immediately re-examined the audit work papers, particularly the risk assessment procedures for the 31 March 2016 audit and were satisfied that the audit had been competently done. No reference to, or suspicion of, the purchase/sale of fake branded sportswear could be found. However, in the light of the information, you decided to return to Swetts (Pty) Ltd to resolve your concerns.

You contacted the financial director of Swetts (Pty) Ltd to discuss the article and to inform him that you wished to carry out further procedures. He responded as follows:

"I'm not denying it or admitting it. We knew about the investigation and have taken steps to protect ourselves. Anyway the audit is over and I don't really see what it has to do with you. There is no need for you to carry out further procedures – we'll worry about how we operate the business."

#### YOU ARE REQUIRED TO:

- a) comment, briefly, on the auditors responsibility in respect of fraudulent acts at a client.(3)
- b) explain how it is possible that an audit which has been "competently performed" may not reveal material fraud. (8)
- c) comment on whether you have any duty in respect of this matter in view of the fact that the annual financial statements have been accepted at the annual general meeting. (5)
- d) discuss whether this matter constitutes a reportable irregularity as contemplated by Sec 45 of the Auditing Profession Act 2005. (9)

#### 14.9

(19 marks 23 minutes)

You are the senior in charge of the audit of Superfood (Pty) Ltd, a company which operates a number of supermarkets. The financial statements reflect a pretax profit of nearly R14 million for the year. You have completed most of the audit work and are assisting the audit manager with the final evaluation so that the appropriate audit report can be drawn up. Your

firm's policy is to consider contingent liability disclosure as part of the final evaluation and he has asked you to deal with Note 15 which is shown below.

**Note 15 – Contingent liability**

The company has been sued by two customers who suffered serious injuries whilst shopping in one of the company's stores. A rack containing tinned goods collapsed on one of the customers resulting in a severe spinal injury. The second customer was permanently blinded in one eye when a piece of glass entered her eye, from a bottle broken in the collapse of a rack. The total amount for which the company is being sued is R5 million. It is unclear when the matter will be settled or what amount may be awarded as damages. For various reasons it is uncertain whether any damages awarded in this case will be covered wholly or partially by the company's insurance if the complainants are successful.

**YOU ARE REQUIRED TO:**

- a) state the assertions which relate to "presentation and disclosure". (5)
- b) outline what information should be provided when disclosing a contingent liability. (3)
- c) indicate whether in this case it would not be better to make a provision for R5 million in the financial statements at year end in view of the fact that the accident happened prior to year end. Justify your answer. (3)
- d) describe the audit procedures you would conduct in respect of the assertions relating to the presentation and disclosure of this contingent liability. (6)
- e) comment on whether this particular matter could not simply be ignored for financial reporting purposes. (2)

**14.10**

**(28 marks 33 minutes)**

- 1. What does the phrase "the financial statements are presented on the going concern basis" mean? (2)
- 2. What is the auditor's responsibility (with regard to the basis of preparation) where management has used the going concern assumption in the preparation of the financial statements? (2)
- 3. At what stage of the audit does the auditor consider the going concern ability of the client? Explain. (4)
- 4. When evaluating the adoption of the going concern basis presentation, would the auditor consider both "aggravating" factors and "mitigating" factors? Explain. (2)
- 5. If a material uncertainty exists relating to the company's ability to continue as a going concern, can the going concern basis for the preparation of the AFS be adopted? Explain. (3)
- 6. Contrast factual insolvency and commercial insolvency. (2)

7. List twelve conditions or events which may cast doubt about the going concern assumption relating to a company. Seven of the twelve should be conditions of a financial nature. (6)
8. List eight procedures which the auditor may carry out when evaluating the going concern ability of a company. (4)
9. Where a company is required to disclose a going concern problem in its notes, what information should the note contain? (3)

**14.11**

**(15 marks 18 minutes)**

1. In terms of ISA 570 - Going Concern, the adoption of the going concern assumption in the preparation of the annual financial statements means .....? (2)
2. What are the objectives of the auditor when conducting audit procedures relating to the going concern assumption? (2)
3. Is going concern an assertion? Justify. (2)
4. If the auditor issues an unmodified report on the annual financial statements, can a user take this as a guarantee that the company will remain a going concern for the foreseeable future? Justify. (2)
5. Para 10 of ISA 570 states that “the auditor shall, when performing risk assessment procedures as required by ISA 315 (Revised), consider whether there are events or conditions that may cast significant doubt on the entity’s ability to continue as a going concern”. Is the risk assessment stage of the audit the only stage during the audit that the auditor needs to consider the going concern ability of the company? Justify. (3)
6. If management (the directors) have already performed an assessment of their company’s going concern ability, is it necessary for the auditor to perform an assessment of going concern? Justify. (2)
7. What is a mitigating factor? (1)
8. If the financial statements are prepared on the going concern basis and the auditor is satisfied that this basis is *inappropriate*, what type of audit opinion should the auditor give? (1)

**14.12**

**(35 marks 42 minutes)**

You are the senior in charge of the audit of Skinham (Pty) Ltd, a company which treats skins and hides using labour intensive processes to produce leather which in turn is supplied to the shoe industry. Skinham (Pty) Ltd's raw material (skins and hides) is supplied to them by Slice and Slaughter Ltd. The skins and hides, both treated and untreated, are kept in controlled



warehouses as they must be protected from the elements. Once treated, most of the different leathers produced must be used for manufacture within about six months. After this, slight shrinkage occurs making the leathers difficult to work with.

The draft statement of financial position of Skinham (Pty) Ltd at 31 March 2016, was as follows :

		2016	2015
<b><i>Equity and long-term liabilities</i></b>			
Share capital		150 000	150 000
Retained earnings		<u>1 482 031</u>	<u>4 703 400</u>
Shareholders equity		1 632 031	4 853 400
Long-term liabilities	1.	<u>7 642 200</u>	<u>7 642 200</u>
		<u>9 274 231</u>	<u>12 495 600</u>
<b><i>Non-current assets</i></b>			
Property, Plant & Equipment	2.	9 133 600	9 591 100
Unlisted Investments	3.	81 500	81 500
<b><i>Net current assets</i></b>		59 131	2 823 000
Current assets		7 903 255	4 802 700
Inventory	4.	4 616 132	2 208 800
Debtors	5.	3 287 123	2 417 300
Bank		-	176 600
Current Liabilities		7 844 124	1 979 700
Creditors		<u>2 813 200</u>	<u>1 979 700</u>
Bank Overdraft	6.	<u>5 030 924</u>	-
		<u>9 274 231</u>	<u>12 495 600</u>

***Note 1***

The long-term liability is an unsecured loan from the Industrial Development Corporation, repayable in full on 1 April 2019. Interest is paid at 10% per annum in arrears. The interest which was payable on 1 April 2016, has not been accrued in the draft financial statements and has, as yet, not been paid.

***Note 2***

Property, plant and equipment is fairly valued and an adequate allowance for depreciation/impairment for the financial year-end 31 March 2016 has been made in the draft financial statements.

***Note 3***

The unlisted investment represents the cost price of a minority holding (10%) in Baggs (Pty) Ltd, a company which manufactures leather accessories. Recently an offer of R500 000 was made for these shares as part of an attempted purchase of Baggs (Pty) Ltd by a large conglomerate. Although the price was fair, other minorities did not wish to sell and the purchase bid fell through.

#### **Notes 4 and 5**

No allowances for bad debts or inventory obsolescence have been made in the draft statement of financial position. In prior years, both allowances have been set at 10% of the balance on hand at year-end and this has proved reasonably accurate. The number of days inventory on hand and the debtors collection period have increased sharply at 31 March 2016, compared to prior years. Inventory on hand at year-end consists of roughly 40% raw material and 60% treated leathers.

#### **Note 6**

The overdraft limit is R5 000 000 and is partially secured by the directors in their private capacities. The shoe industry is currently under serious threat due to the importation of shoes from Taiwan and Singapore, at a landed cost which makes locally manufactured shoes too expensive in the market place. All of Skinham (Pty) Ltd's customers are experiencing liquidity problems, with the exception of Doochi (Pty) Ltd, a company which manufactures a very expensive range of shoes for a sector of the market which is unaffected by cheap imports. The leather which Skinham (Pty) Ltd supplies to Doochi (Pty) Ltd is extremely expensive to produce, due to the complex tanning process and the fact that only certain hides are used, such as snake and crocodile. Doochi (Pty) Ltd is very demanding in respect of the quality of leather supplied. As a result of these circumstances, Skinham (Pty) Ltd and Doochi (Pty) Ltd have entered into a contract whereby Skinham (Pty) Ltd has agreed to supply at least minimum quantities of specified leathers to Doochi (Pty) Ltd each month and in return, Doochi (Pty) Ltd has agreed to pay for their purchases within 15 days of invoice.

A problem which Slice and Slaughter Ltd (suppliers of skins and hides to Skinham (Pty) Ltd) has had for a number of years, but which has intensified significantly during the current year, is the campaign by environmental groups against the use of skins and hides from non-domestic animals in the manufacture of shoes, handbags and accessories. Due to this development, the poor conditions in the shoe business and the fact that since the financial year end date the company has continued to incur losses, the directors of Skinham (Pty) Ltd have decided to diversify their business to include the manufacture of leather balls for a variety of sports, e.g. soccer and rugby. Shortly after the financial year-end the company was awarded, somewhat unexpectedly, a contract with a leading sports goods wholesaler, to supply soccer balls. To fill the order, Skinham (Pty) Ltd will need to invest in new cutting and stitching machines without delay.

**YOU ARE REQUIRED TO** comment on the appropriateness of presenting the financial statements of Skinham (Pty) Ltd at 31 March 2016 on the going concern basis, based on the information presented above.

**14.13**

**(30 marks 36 minutes)**

You are in charge of the audit of ShoeShuffle (Pty) Ltd a South African company which manufactures various types of footwear. The company has a 30 April year-end.

Ongoing reporting in the business press about the difficulties facing the shoe industry has prompted you to plan a comprehensive evaluation of the going concern ability of ShoeShuffle (Pty) Ltd, to be carried out in May. The senior trainee on the audit has provided you with the following:



***Draft Abridged Statement of financial position at 30 April 2016***

		R ‘000
<b>ASSETS</b>		
<b>Non-current assets</b>		
Property, plant and equipment	Note 2	9 436
Investment	Note 3	8 236
		1 200
<b>Current assets</b>		
Inventory		8 650
Accounts Receivable		4 875
Bank	Note 4	3 666
		109
<b>Total assets</b>		<u>18 086</u>
<b>EQUITY AND LIABILITIES</b>		
<b>Capital and reserves</b>		
Share capital		8 024
Retained earnings		7 500
		520
<b>Non-current liabilities</b>		
Long-term loans	Note 1	2 700
<b>Current liabilities</b>		
Accounts payable		7 362
Current portion of long-term loans	Note 5	5 362
		2 000
<b>Total equity and liabilities</b>		<u>18 086</u>

Note 1. The loan of R2.7m provided by Industrial Finance Inc is repayable in full in July 2018. Interest of ten percent per annum is payable in arrear. The interest accrual at year-end has been included in accounts payable.

Note 2. Property, Plant and Equipment is fairly valued provided ShoeShuffle (Pty) Ltd continues as a going concern (Interim audit work carried out in March 2016 supports this conclusion).

Note 3. The investment of R1.2m represents the cost of a 25% share in Its Shoetime (Pty) Ltd, a company which about a year ago opened a chain of retail shoe shops selling shoes at discounted prices. Due to negative public perceptions about “discount” shoes, these outlets have performed poorly and three (of the original ten) have closed.

Note 4. The company has an overdraft limit of R1million secured by a notarial bond over the company’s property.

Note 5. This R2 million is to be repaid on 1 August 2016. It represents four loans of R500 000 which were made to the company by the four major shareholders in the

company (they own 80% of the shares between them). Interest of 12% per annum is payable in arrears on these loans. All four of these shareholders are executive directors of the company. The interest accrual has been included in accounts payable.

***Other financial data/comparative information***

	<b>2016</b>	<b>2015</b>
	R'000	R'000
Turnover (sales are made only on credit)	14 058	16 323
Accounts Receivable (net of allowance)	3 666	2 907
Allowance for doubtful debts	10%	10%
Inventory (net of allowances)	4 875	3 490
Allowances for slow moving/damaged inventory	5.73%	8%
Profit for the year before taxation	287	1003

***Further information***

1. Most of the sectors within the shoe industry which the company supplies e.g. sports shoes, mens and womens formal, are very competitive.
2. The government sector e.g. military boots, gumboots, police footwear is also competitive and there is a complex tendering system which must be followed to obtain this business (see point 5 below).
3. Significant competition comes from cheap imports from China, Taiwan and India as well as local manufacturers. This competition has been the direct cause of the drop in turnover. To counter this, ShoeShuffle (Pty) Ltd has relaxed its credit limits. This has partially been successful but many of the company's customers are facing even stiffer competition and the resultant liquidity problems, as the large hyperstores carry more and more imported shoes.
4. At 30 April 2016 orders placed by value are only 60% of orders placed at 30 April 2015. The company has maintained its normal production due mainly to a threat of strike action by the factory employees if working hours were to be reduced.
5. In the minutes of directors' meetings it was noted that the directors have received notification from the Government Health Department that from August 2016 all suppliers of footwear to the department will have to satisfy certain black economic empowerment requirements if they wish to submit tenders to supply the department. Tenders which run for 12 months must be submitted by 1 August each year for supply commencing 1 November. The directors noted in the minute that in their estimation, it would take approximately 12 months for ShoeShuffle (Pty) Ltd to meet the tender requirements.

The notification from the Health Department also stated that from August 2016 the department would not accept tenders from non-South African (foreign) companies. Foreign companies currently supply 40% of this substantial market. ShoeShuffle (Pty) Ltd has supplied the Health Department with coloured gumboots for many years. It is one of the three government departments which the company supplies, and the sale of

gumboots, accounts for about thirty three percent of the company's R4.5 million sales to the government annually.

6. Our attendance at the year-end inventory count revealed that the quantity of finished goods on hand had increased substantially compared to the prior year, whilst raw material and work-in-progress had remained reasonably constant. No other audit work on inventory has been carried out.

**YOU ARE REQUIRED TO** evaluate whether the presentation of the financial statements of ShoeShuffle (Pty) Ltd at 30 April on the going concern basis is appropriate, based on the information given above. You are not required to present a conclusion.

**14.14**

**(24 marks 29 minutes)**

You are a manager in the audit firm of Preston and Threadbare. During late February 2016 you are evaluating the audit file for the 31 December 2015 audit of Milectrix (Pty) Ltd, a company which manufactures electronic components. Sixty percent of the shares in the company are owned by Rowlec (Pty) Ltd, a large industrial company. Milectrix (Pty) Ltd has returned poor trading results for a number of years and has had to borrow extensively from the bank and Rowlec (Pty) Ltd to meet its financial obligations.

This is due mainly to the establishment of a number of factories by Chinese companies in semi-rural areas in a number of provinces in South Africa. These provinces have provided incentives for foreign investors, and in doing so, have given them a competitive edge which has severely affected trading results of Milectrix (Pty) Ltd and similar local companies.

Your senior has included the following note on the going concern evaluation workpaper:

"As you will notice from the financial statements at 31 December 2015, the company's liabilities exceed its assets fairly valued. I have carried out a going concern evaluation and conclude that the company can only continue to operate as a going concern if Rowlec (Pty) Ltd continues to support Milectrix (Pty) Ltd by providing the finance necessary for the company to pay its debts. The financial controller of Milectrix (Pty) Ltd has informed me that Rowlec (Pty) Ltd will continue to provide the necessary finance to the company. He has also indicated that the government is not in favour of the provinces acting independently in giving investment incentives to foreign countries and it will be clamping down on this. Once this is achieved he believes companies such as Milectrix (Pty) Ltd will be able to compete effectively again.

Please refer to workpaper Statmin 2 where you will find a copy of a directors' minute dated 31 January 2016 which reads as follows:

It was resolved that the company would accept Rowlec (Pty) Ltd's offer to subordinate its loan account with the company until the government abolishes certain investment incentives in the provinces currently offering these incentives. The directors hereby acknowledge with pleasure, this show of confidence in the future of Milectrix (Pty) Ltd."

Based upon the opinion of the financial controller and directors' minute, I have drafted an unmodified audit report.

**YOU ARE REQUIRED TO:**

- a) discuss the financial position of Milectrix (Pty) Ltd in the context of Sec 22 of the Companies Act 2008. (4)
- b) state, giving reasons, any additional audit procedures which should be carried out by the audit firm arising out of the note on going concern included in the workpapers which you are evaluating. (20)



# **CHAPTER 15**

## **REPORTS**



Select the appropriate answer to the following :

1. The title of the audit report (Independent Auditor's Report) includes the word "Independent" to
  - 1.1 signify that the audit is an assurance engagement
  - 1.2 enhance the credibility of the report by emphasising the independence of the auditor
  - 1.3 distinguish it from the report of the internal auditors contained in the financial statements
  - 1.4 limit the auditor's liability should the audit report prove to be inappropriate.
2. The annual audit report for a listed company will be addressed to
  - 2.1 the audit committee
  - 2.2 the shareholders
  - 2.3 the chairman of the board
  - 2.4 the chief audit executive.
3. The audit report does **not** provide an opinion on
  - 3.1 the fair presentation of the financial position of the company
  - 3.2 the fair presentation of the cash flows of the company
  - 3.3 the effectiveness of the company's internal control
  - 3.4 the fair presentation of the company's financial performance.
4. When signing off the audit report, the terms "registered auditor" and "chartered accountant (SA)" must be included. True or false? Justify.
5. The auditor may need to modify his audit **opinion** because
  - 5.1 there is a disclosure in the financial statements which must be brought to the attention of users due to its importance
  - 5.2 the budget for the audit was exceeded
  - 5.3 there are uncorrected misstatements that are material to fair presentation
  - 5.4 none of the above.
6. Which of the following will result in a disclaimer of opinion in the audit report?
  - 6.1 the selected accounting policies result in pervasive misstatement because they are inappropriate
  - 6.2 the selected accounting policies have been appropriately selected but result in pervasive misstatement because they have not been applied in terms of the applicable standard.
  - 6.3 significant limitations have been placed on the auditor by the client's management
  - 6.4 none of the above.
7. Which of the following will result in an adverse opinion in the audit report?
  - 7.1 a disclosure which has a material affect on fair presentation, has been omitted from the financial statements
  - 7.2 the auditor wishes to draw the attention of users to a very important matter which is disclosed in the notes



- 7.3 the selected accounting policies result in pervasive misstatement because they are inappropriate
  - 7.4 the auditor is unable to obtain sufficient appropriate audit evidence due to circumstances beyond his control.
8. Which of the following combinations is possible in the same audit report on the financial statements as a whole?
- 8.1 an adverse opinion and a disclaimer of opinion
  - 8.2 an “except for” qualification based on disagreement and a disclaimer of opinion
  - 8.3 an “except for” qualification based on disagreement and an adverse opinion
  - 8.4 two “except for” qualifications, one based on a limitation of the auditor’s scope and the other on a disagreement.
9. Where an “emphasis of matter” paragraph is included in the audit report, it will commence with the following wording
- 9.1 in our opinion, the following matter requires emphasis.....
  - 9.2 without qualifying our opinion above, .....
  - 9.3 as explained in the auditor’s responsibility paragraph above, .....
  - 9.4 the following matter forms part of our audit opinion .....
10. With regard to ***other information*** in documents containing audited financial statements, e.g. a group report
- 10.1 the auditor has no responsibility
  - 10.2 the auditor has a responsibility to conduct audit procedures appropriate to determine whether the other information is fairly presented
  - 10.3 the auditor has a duty to test the other information to confirm that the information is factually correct
  - 10.4 the auditor has a duty to read the other information with the intention of identifying material inconsistencies between the other information and the financial statements.

## 15.2

(20 marks 24 minutes)

- 1. When reporting on a set of financial statements, what are the objectives of the auditor?(2)
- 2. What are general purpose financial statements? (1)
- 3. Fred Dedd the designated auditor on the audit of Pottholes (Pty) Ltd has been requested by the financial director of the company, not to provide a written audit report for the current year-end audit, but rather to present an oral auditor’s report at the company’s upcoming AGM. The financial director believes that this will give shareholders a much better understanding of the audit report as they will be able to ask Fred Dedd probing questions. Should Fred Dedd agree to this? Justify your answer. (3)
- 4. In terms of ISA 700, in forming his opinion, the auditor is required to evaluate whether the financial statements are prepared, in all material respects, in accordance with the applicable financial reporting framework, including consideration of the qualitative aspects of the entity’s accounting practices. List 5 other matters which the auditor should evaluate before forming the audit opinion. (5)

5. List the information which should be included in the introductory paragraph of the audit report. (3)
6. Which of the following statements is false? Justify your answer.
  - 6.1 a disclaimer of an opinion and an adverse opinion are the result of pervasive matters.
  - 6.2 an emphasis of matter can be given instead of an adverse opinion but not instead of a disclaimer of opinion.
  - 6.3 the audit report must be signed by the designated auditor. (2)
7. What are the characteristics of a misstatement which has a pervasive effect on the financial statements? (2)
8. What information should be included when signing off the audit report? (2)

### 15.3

(20 marks 24 minutes)

Excluding the paragraph dealing with “Other reports required by the Companies Act” the unmodified audit report consists of four clearly identifiable paragraphs. However, in some instances the unmodified audit report may be expanded.

#### YOU ARE REQUIRED TO:

- a) identify the four clearly identifiable paragraphs in the unmodified audit report and describe briefly what will be contained in each. (10)
- b) explain the circumstances under which the unmodified audit report will be expanded. (5)
- c) identify and describe briefly any additional paragraphs which may arise as a result of expanding the audit report. (5)

### 15.4

(12 marks 14 minutes)

<i>Circumstance</i>	<i>Nature</i>	<i>Material/pervasive</i>	<i>Opinion</i>
1. No cash sales records		Material and Pervasive	
2. Deferred tax policy inappropriately applied			Except for
3. Inventory stated at replacement cost		Material and Pervasive	
4. Going concern dependent on award of contract; adequate disclosure made		Material	
5. Misclassification of liabilities			Except for

6. Finance leases accounted for as operating leases			Adverse
7. Insufficient evidence relating to capitalization of intangible asset development costs			Except for
8. Non-disclosure of subsequent event		Material	

**YOU ARE REQUIRED TO** complete the chart given above. Consider each circumstance separately.

**15.5**

**(16 marks 19 minutes)**

You are the partner in charge of the audit of Cordon (Pty) Limited, a large manufacturing company, and are evaluating the audit working papers for the audit year end 31 March 2016 with a view to concluding on your audit opinion. All matters other than those mentioned below, have been satisfactorily resolved.

***Matter 1 - Inventory***

The company has valued its inventory at replacement cost. In discussion with the directors, who are adamant that the value remain unchanged, they have explained that they intend moving to “fair value” accounting and that by valuing at anticipated replacement prices, the statement of financial position will reflect the real value of inventory. The effect of this decision has been to increase the value of inventory and the profit for the year ended 31 March 2016 by R1 750 000. There is no effect on the taxation figure which is correctly calculated and disclosed.

***Matter 2 - Related party transactions***

It has been established through scrutiny of the minutes and other documents, that the following related party transactions have not been disclosed in the annual financial statements:

1. Purchase of manufacturing equipment costing R2 million from Billben CC, a close corporation in which Bill Benson, the chief executive officer of Cordon (Pty) Ltd has a 50% member's interest.
2. A supply and maintenance contract with George Grove for Cordon (Pty) Ltd's computer equipment. George Grove is married to Marie Grove, the company's IT director.

**YOU ARE REQUIRED** to draft the audit report of Cordon (Pty) Limited for the financial year-end 31 March 2016 assuming that both matters 1 and 2 remain unresolved. You are not required to write out the paragraphs dealing with the directors' or auditor's responsibilities or Other reports required by the Companies Act.

**15.6****(18 marks 22 minutes)**

You are the designated auditor of Destinations (Pty) Ltd. The Memorandum of Incorporation requires that the annual financial statements are audited. The company prepares its financial statements in terms of the IFRS for SMEs. The following matters were unresolved at the time you are preparing your audit report for the financial year-end 29 February 2016:

1. The company has failed to keep minutes of directors meetings as required by Sec 24 of the Companies Act 2008. Fortunately you have been able to satisfy yourself about information which should have been entered in the minutes by the application of alternative procedures.
2. One of the company's major debtors Time Travel (Pty) Ltd was, on 7 March 2016, placed in liquidation and the liquidator has indicated that unsecured creditors, including Destinations (Pty) Ltd, are unlikely to receive any payment. This will mean a material loss of R337 222 for the company but because the loss of the amount owed does not threaten the going concern ability of Destinations (Pty) Ltd, the directors refuse to deal with this matter in the financial statements at 29 February 2016.

**YOU ARE REQUIRED TO** draft the audit report you consider appropriate for the financial year-end 29 February 2016. Ignore any taxation implications. You are not required to include the paragraph which deals with the auditor's responsibility, but you should include the paragraph dealing with the directors' responsibility. There were no material inconsistencies between the directors report and the audited financial statements.

**15.7****(25 marks 30 minutes)**

You are the auditor of H-Two-Oh (Pty) Ltd, a chemical manufacturer based in Cape Town. Over the previous eighteen months, the company's monthly reporting system has revealed a steady decline in profits due mainly to the entry by foreign companies into the local market. In response to the decline, the directors took a decision halfway through the financial year currently under audit (31 December 2015), to invest in new plant and equipment capable of recycling chemical waste as this was regarded as the only way in which the company could continue to operate. The company's borrowing powers were extended to their limits to raise the necessary finance for the expansion.

The final audit for the financial year-end commenced in January, and at this stage, the company appeared to be geared for a return to profitable trading; the new plant had been commissioned and the first shipload of chemical waste for recycling had been ordered from the Far East, and was in fact on the water. A number of contracts for the supply of products from the recycling had been signed with various customers.

However, shortly before the completion of the year-end audit, a controversy which had been building for some months, erupted in the media concerning the importation of waste products for recycling. This resulted in the government placing an indefinite ban on such imports. Expert opinion believes that the ban will not be lifted in future years due to the growing influence of environmentalists in the government and business communities.

The consequences of the ban for H-Two-Oh (Pty) Ltd were felt immediately as the container ship transporting the chemical waste from the Far East was turned back as it would not have been allowed to dock in South Africa.

The directors of H-Two-Oh (Pty) Ltd have ignored this matter for the 31 December 2015 financial statements on the grounds that it occurred after reporting date and that there is no point in alarming the shareholders. They can offer no plausible explanation as to how the company will continue to operate profitably.

**YOU ARE REQUIRED TO:**

- a) discuss the effect which the above information would have on your audit report for the financial year-end 31 December 2015. (10)
- b) draft the appropriate audit report for the financial year end 31 December 2015 assuming that the directors are not prepared to make any changes to the financial statements. (15)

You are not required to include the paragraphs dealing with the directors' responsibility, the auditor's responsibility or Other reports required by the Companies Act 2008.

**15.8**

**(15 marks 18 minutes)**

You are the designated auditor of Specfix (Pty) Ltd. The company prepares its financial statements in terms of IFRS. During January 2016 the company was engaged by Railton Ltd to replace the bearings on an expensive piece of machinery. To carry out the replacement it was necessary to lift the equipment using a giant overhead crane. Whilst doing this, the machine was dropped and extensively damaged.

On investigating the matter, you determine the following:

- \* Railton Ltd has instituted legal proceedings against Specfix (Pty) Ltd for damages. The action for damages includes both the repairs to the equipment, and the substantial loss of profits expected to be suffered by Railton Ltd resulting from the disruption caused to Railton Ltd's production process.
- \* Because the accident was allegedly caused by the negligent actions of Specfix (Pty) Ltd's employees, its insurance company are refusing to settle the claim.
- \* Legal opinions obtained by Specfix (Pty) Ltd all indicate that the action brought by Railton Ltd will probably succeed, but the amount of the damages that will be awarded to Railton Ltd cannot be estimated with any reliability.
- \* On the facts available, the matter would appear to be material but not pervasive relative to the operating results and financial position of your client.
- \* The directors of Specfix (Pty) Ltd refuse to make any disclosure of the pending lawsuit in the company's financial statements for the year ended 31 March 2016. In their opinion because no amount for damages can be established, it is impossible to judge whether the matter is material to fair presentation and thus it can be ignored.

**YOU ARE REQUIRED TO** draft a suitable audit report for inclusion in the annual financial statements of Specfix (Pty) Ltd for the financial year ended 31 March 2016, assuming the directors will not change their position. Exclude the paragraphs dealing with the auditor's responsibility and the directors' responsibility. There were no other unresolved matters at the conclusion of the audit. You are also satisfied that there were no material inconsistencies between the directors' report and the audited financial statements.

**15.9**

**(30 marks 36 minutes)**

The following audit report was drafted by a trainee on the audit of Litetech (Pty) Ltd, a company which manufactures lighting systems. The trainee was asked to draft the report at the conclusion of the audit for the financial year end 30 June 2016 as part of "on-the-job" training and as part of your training, you have been asked to evaluate his report. The shareholders of Litetech (Pty) Ltd included a clause in the company's Memorandum of Incorporation which requires that the company's annual financial statements are externally audited.

***Independent Report***

To the board of directors.

We have evaluated the accompanying financial statements of Litetech (Pty) Ltd for fairness based on our annual audit carried out in terms of the Memorandum of Incorporation of the company.

Management is responsible for the preparation of the financial statements and for the prevention of fraud.

The auditor's responsibility is to perform the audit and in doing so, to detect any fraud which may have a material effect on the financial statements not having been prevented by the directors.

We report on the following aspects of the audit:

1. An expert was engaged by our firm to assist in the valuation of work-in-progress. Due to the complexity of some of the company's lighting systems, the risk of misstatement in work-in-progress warranted this.
2. The company is currently being sued by a former employee who suffered personal injury at work whilst testing electric current flow during quality control procedures.
3. With regard to the detection of fraud, we detected a small wage fraud relating to unauthorized overtime. We reported this to management who subsequently dismissed the perpetrators.

In our opinion, except for the matters raised in 1 to 3 above, there are no outstanding issues arising from the audit which was conducted in terms of the International Standards on Auditing and the International Financial Reporting Standards.

***Emphasis of matter***

There are no matters which require emphasis.

Mayweather and Mosely  
30 June 2016  
Packia Place  
Pretoria

**YOU ARE REQUIRED TO** detail the errors/deficiencies in the audit report presented to you for evaluation (give explanations where necessary). You are not required to redraft the report.

**15.10**

**(22 marks 26 minutes)**

You are the auditor of Habitat (Pty) Ltd a residential housing development company. One of the tracts of land (already divided into plots) belonging to the company, borders on an informal settlement which sprung up during the current financial year (year end 31 March 2016). No plots have been sold in this particular development and all interest by prospective customers has ceased. In addition to this development, Habitat (Pty) Ltd has other developments which are progressing well. The company is reasonably liquid and has recorded an after tax profit of R500 000 for the current year. At the current financial year-end total shareholder's funds amounted to R2 500 000.

The directors have chosen to include the plots in the development adjoining the informal settlement in the financial statements at the cost of the land purchased for cash in 2008 (R2 000 000) plus development costs, e.g. internal roads, gutters, water connections etc, paid to date (R3 000 000). This represents 30% of the current assets of the company.

As you were concerned about the price at which the plots could actually be sold, you contacted an independent and reputable estate agent (with the permission of Habitat (Pty) Ltd) who informed you as follows:

"Your question as to the potential selling price of these plots cannot be answered with any certainty. It is possible that in the foreseeable future not one single sale will take place whilst on the other hand the squatters may be moved or the government could appropriate the land on favourable terms. Informal settlements are a sensitive issue, anything can happen! I can't really offer an opinion on whether the value of the property should be written down."

A second estate agent whom you approached held a very similar opinion.

**YOU ARE REQUIRED TO** write the reports which you would consider appropriate assuming that

- a) the directors include these plots in the financial statements at R5 000 000 and make full disclosure relating to the informal settlement which has sprung up. (8)
- b) the directors include these plots in the financial statements at R5 000 000 but refuse to make any disclosures pertaining to the informal settlement. (6)

You must justify your choice of reports. (8)



You are not required to include the paragraphs dealing with the directors' or auditor's responsibilities or the paragraph dealing with Other reports required by the Companies Act in either report (a) or (b). You are also not required to repeat the title, address, introductory paragraph or signing off in report (b).

**15.11**

**(15 marks 18 minutes)**

You are the auditor of Mainline Ltd, a public company (but not listed) in long distance road transport. You have completed the financial year end 29 February 2016 audit and are conducting your final evaluation before drafting your audit report. The only matters under consideration are the following:

A significant proportion of Mainline Ltd's business is the transport of hazardous chemicals from the Durban harbour to chemical plants in Gauteng. Every attempt is made by the company to restrict the dangers of handling and transporting these chemicals due to the perceived threats to other road users. However, as a result of these dangers, government has intervened and there is a possibility that transportation of these chemicals by road will be prohibited and the chemicals will have to be transported by rail. This could have a far reaching effect on Mainline Ltd's business and although the directors did not want to disclose this matter in the notes to the financial statements, the audit committee insisted upon it and appropriate disclosure was made.

Included with the annual financial statements on pages 36 to 40, are a number of schedules containing additional information about the company. These schedules, which are not audited, are not sufficiently differentiated from the financial statements.

**YOU ARE REQUIRED TO** draft the audit report for Mainline Ltd's annual financial statements for the financial year end 29 February 2016. You are not required to include the paragraphs dealing with the directors' responsibility for the financial statements, or the auditor's responsibility.

**15.12**

**(20 marks 24 minutes)**

You are the manager on the audit of Missiles (Pty) Ltd, a large armaments manufacturing company. The company has a public interest score of well over 350. Whilst the company has appointed various board committees it does not have an audit committee and has not appointed a company secretary.

During the audit of the financial year end 31 March 2016 the financial director of Missiles (Pty) Ltd refused you and your team access to material parts of the sales and accounts receivable records, on the grounds that during the year the company had signed contracts to manufacture and supply sensitive defence equipment and is not prepared to divulge any information about these contracts. You were also denied access to the statutory registers. Other than being able to obtain a small amount of corroborating evidence you were unable, by the use of alternative audit procedures, to satisfy yourself as to the validity of these contracts, or the assertions relating to the company's sales/accounts receivable. You informed the financial director that the denial of access was contrary to the Companies Act 2008 and that



qualification of the audit opinion was inevitable. His response was that “you must do what you must do, the confidentiality of certain of our customers comes first.”

**YOU ARE REQUIRED TO:**

- (a) state, giving brief reasons, with which of the duties in terms of Sec 44 of the Auditing Profession Act 2005 you, and your audit team, would not be able to comply in this situation. (5)
- (b) draft the audit report which you would issue for the financial year-end 31 March 2016, assuming that the company will not allow you or your firm access as indicated by the financial director. You are not required to include the paragraph dealing with the directors’ responsibility. (15)

**15.13**

**(32 marks 38 minutes)**

You are the auditor of Workz (Pty) Ltd, a medium sized engineering firm which exports to various countries around the world. One of the company’s major creditors is Precision (Pty) Ltd from whom drilling components are purchased for export into Africa. This arrangement suits Precision (Pty) Ltd as they cannot obtain the necessary permits to export the components themselves.

Due solely to the collapse of certain markets in Eastern Europe and Africa, Workz (Pty) Ltd has found itself in severe financial difficulties to the extent that at the end of the current financial year (31 March 2016), the liabilities of the company exceed its assets fairly valued.

The directors of Workz (Pty) Ltd believe that the company will return to profitable trading once the economies of their trading partners in Eastern Europe and Africa are restructured. Precision (Pty) Ltd have agreed to subordinate (backrank) the amount owed to it by Workz (Pty) Ltd until Workz (Pty) Ltd is able to re-establish its Eastern European and African markets. As a result of this subordination agreement, the directors of Workz (Pty) Ltd have prepared the financial statements on the going concern basis.

**YOU ARE REQUIRED TO:**

- a) draft the audit report which you consider would be appropriate, assuming that you are satisfied with the subordination agreement as well as the disclosures the directors have made about the going concern problem, **but** that you believe that the restructuring of the Eastern European and African economies is too uncertain to make any predictions about the re-establishment of the company’s markets in those countries. Do not include the paragraph dealing with the auditor’s responsibility in your report. (16)
- b) draft the audit report which you consider would be appropriate, assuming that you are satisfied with the subordination agreement, as well as the disclosures the directors have made about the going concern problem and that you believe that there is a realistic chance that the economies of the Eastern European and African countries will be restored within a reasonable period. Do not include the title, introduction or the paragraphs dealing with the responsibilities of the directors and the auditor, and other reports required by the Companies Act, or the signing off of the report. (8)

- c) draft the audit report which you consider would be appropriate, assuming that you are satisfied with the subordination agreement, and that the directors are prepared to disclose the existence of the subordination agreement **but** are not prepared to disclose anything relating to the collapse of their Eastern European and African markets. Do not include the title, introduction or the paragraphs dealing with the responsibilities of the directors and the auditor, and other reports required by the Companies Act, or the signing off of the report. (8)

15.14

(21 marks 25 minutes)

You are the auditor of Bluevision (Pty) Ltd an importer of television sets, playstations etc. Following up on certain suspicious findings which came to light at the annual inventory count, you established that the company was involved in a scheme with a related party in Taiwan. The scheme was to reduce import tariffs payable by Bluevision (Pty) Ltd by understating the value of goods imported by Bluevision (Pty) Ltd from the Taiwanese company.

On satisfying yourself that the scheme was an unlawful act, you sent a report to the IRBA “without delay” as required by Sec 45 of the Auditing Profession Act 2005. Two days after sending the report you met with the board of directors of Bluevision (Pty) Ltd. At the meeting, having fully discussed the matter with them, the managing director acknowledged that he had knowingly entered into the scheme but had done so in an attempt to keep the company’s prices down as “the home entertainment sector is involved in a tough price war.”

The question of the audit report which you would give was then discussed and hearing what you had to say, the directors agreed that the company would as a matter of urgency, make a full declaration to the SARS and make full adjustment and disclosure in the year-end financial statements.

However, one of the directors who had said nothing during the discussion, asked what the situation would be relating to your audit report if the company stopped the scheme but ignored what had happened up to your discovery of the scheme.

**YOU ARE REQUIRED TO:**

- a) draft the **audit report** assuming that you are able to inform the IRBA in your second report to it, that a reportable irregularity did exist **but** that it is no longer taking place and adequate steps have been taken to pay all outstanding tariffs and penalties to SARS. You may assume that the directors have made full disclosure in, as well as all necessary adjustments to, the financial statements. You are not required to include the paragraphs dealing with the directors’ responsibility or the auditor’s responsibility. (13)
- b) **discuss** the audit report you would give assuming that the directors agreed to discontinue the scheme but refused to make any disclosures in, or adjustments to, the financial statements. (8)

15.15

(20 marks 24 minutes)

You have recently carried out the audit of Blockz (Pty) Ltd, a cement brick and block manufacturer. By the time the concluding stage of the audit had been reached, all audit differences (material misstatements) had been resolved with the exception of the following matter:

Whilst scrutinizing correspondence between Blockz (Pty) Ltd and its insurance company you came across a letter referring to a very expensive computerised block compactor which had been severely damaged after someone had disabled the power surge control unit, something which does not usually occur accidentally. The letter confirmed that Blockz (Pty) Ltd was insured against this type of accident provided that it was not the result of sabotage (a deliberate attempt to damage the machine). The letter also stated that the insurance company would be investigating the matter fully as "there appear to be some inconsistencies in the report on the event and because Blockz (Pty) Ltd had been experiencing severe labour unrest at the time". You had checked the accounting records and draft financial statements and could find no reference at all to the damage done to the machine. You raised this matter with Billy Bragg, the financial manager who responded as follows:

"You haven't found any adjusting entries or disclosures because we haven't made any, there is no need. I agree that in theory the machine has been temporarily impaired and its recoverable amount at reporting date was its scrap value of R50 000, but we have chosen to reflect the machine at its depreciated historic cost of R1.7 million because we are comprehensively insured. There is no permanent impairment of the asset, no loss to the company. What point is there in writing down the machine only to write it up again in a few months time when the machine is restored to use? The insurance company will bear the full cost... they can't prove sabotage."

You have established that the impairment of the asset was equal to approx 7.5% of the net profit after tax reflected in the draft financial statements.

**YOU ARE REQUIRED TO** draft the audit report of Blockz (Pty) Ltd for the financial year ended 31 March 2016, assuming that no changes will be made to the draft financial statements. You must include a working which justifies your choice of report.

Note: You are **not** required to include the paragraphs dealing with the auditor's responsibility, the directors' responsibility, or the paragraph dealing with the "other reports required by the Companies Act." Justification (5)

15.16

(20 marks 24 minutes)

State whether each of the following statements is **true** or **false**. Justify your choice.

1. An individual who qualifies as an accounting officer of a CC may conduct an independent review of a private company's annual financial statements provided the company's public interest score is in the range 100 to 349.
2. When conducting an independent review engagement on a set of annual financial statements a registered auditor is not required to comply with the International Standards on Auditing.

3. When conducting an independent audit the auditor is required to formulate a strategy for the audit, but for an independent review a strategy for the review is not specifically required.
4. A registered auditor conducting an independent review must set planning, performance and final materiality limits for the review engagement.
5. A registered auditor conducting an independent review does not need to obtain a detailed understanding of the client's internal controls.
6. An independent review engagement does not normally include risk assessment procedures.
7. A registered auditor conducting an independent review does not need to make specific inquiries concerning the existence and identity of related parties.
8. A practitioner conducting an independent review does not have to concern himself with reportable irregularities at the client.
9. An audit report gives rise to an audit opinion and a review engagement gives rise to a review opinion.
10. Because an independent review is not as detailed as an audit, only reasonable assurance that fair presentation has been achieved is given.

**15.17**

**(20 marks 24 minutes)**

You are a sole practitioner with a varied portfolio of clients to whom you offer audit, review, tax and accounting services. One of your tax clients, Ricoh (Pty) Ltd, which has a public interest score of 115 has engaged you to compile the annual financial statements for its bankers. In prior years this has been done by the company's bookkeeper, but she resigned recently. The company prepares its financial statements in terms of the IFRS for SMEs.

You have performed the engagement and are now preparing your report in respect of the compilation engagement.

**YOU ARE REQUIRED TO:**

- a) discuss the practitioners objectives in a compilation engagement. (2)
- b) describe briefly the fundamental principles of professional ethics with which a practitioner must comply in relation to compilation engagements. (6)
- c) draft the appropriate report for this compilation engagement. (10)
- d) comment on whether Ricoh (Pty) Ltd's financial statements compiled by you will have to be audited or reviewed and whether you will be eligible to carry out the audit or review. (2)

You are a partner in the accounting firm of Botha and Botha. It is a busy practice which offers a wide range of services, and as a result many assignments are undertaken which give rise to reports other than audit reports.

You are currently drafting two such reports for the following unrelated engagements:

1. In terms of the Companies Act 2008, Satcon (Pty) Ltd is required to have its annual financial statements independently reviewed. The review of the 31 March 2016 financial statements was successfully carried out other than for the following matter. Part of the company's inventory consists of imported cellular telephones valued at R2.8m. It appears that the telephones may be illegal in terms of the country's cellular network regulations and as a result, not saleable within South Africa. There is a possibility of exporting the telephones but this remains uncertain. A ruling on the legality of the telephones has been sought but is not expected for some time. The directors have valued the telephones at cost in the annual financial statements and have made no mention to the potential problem in the notes. The cost of these telephones is material but should they not be saleable, no threat is posed to the going concern ability of the company.
2. Once every six months, you report to the directors of Kwikchick (Pty) Ltd on the royalties payable to them by Featherfood (Pty) Ltd. Featherfood (Pty) Ltd manufactures and sells "Chicki Seed" products, a brand owned by Kwikchick (Pty) Ltd. In terms of clause 8 of the royalty agreement, Featherfood (Pty) Ltd pays a 10% royalty to Kwikchick (Pty) Ltd on sales of "Chicki Seed" products.

You have come to an agreement with the directors of Kwikchick (Pty) Ltd as to the procedures to be adopted by your firm for this engagement. In terms of the agreement, Featherfood (Pty) Ltd must give your firm access to its sales records. The procedures are as follows:

1. The value of sales reflected on all invoices for the period, is checked against the royalty schedule to confirm that the value of each invoice is accurately recorded.
2. Unit selling prices on invoices are checked at random to the master pricelist.
3. The casts and extensions on the invoices and royalty schedule are checked.
4. The sequence of sales invoices is tested and any missing invoices are noted.
5. The royalty calculation is recomputed.

The engagement for the six month period ended 31 March 2016, has been completed successfully except that a book of 100 Featherfood (Pty) Ltd invoices could not be found to substantiate the entries made in respect of these sales recorded on the royalty schedule.

**YOU ARE REQUIRED TO:**

- a) draft the report for the independent review of the annual financial statements of Satcon (Pty) Ltd at 31 March 2016. You are not required to include the paragraphs dealing with the directors' responsibility, independent reviewer's responsibility, or other reports required by the Companies Act. (12)
- b) draft the appropriate report for the Kwikchick (Pty) Ltd engagement. (10)

**15.19**

**(13 marks 16 minutes)**

You are the accounting officer of Fleetwood CC which operates in the sports goods retail sector. The CC has a public interest score of 77 for the current year. You are a chartered accountant and you have been in public practice for some years. You are not a member of Fleetwood CC. There are six members in the CC, each of whom holds a 15% interest whilst your wife, who is the seventh member, holds a 10% interest. The corporation does not have an association agreement. The minutes of a meeting of members held during the past year indicated, inter alia, the following:

*The meeting (3 members present in person) agreed by 3 votes to nil that the close corporation should immediately purchase a building which the CC has been offered. The building will become the company's distribution warehouse.*

**YOU ARE REQUIRED TO:**

- (a) discuss whether you can act as accounting officer of Fleetwood CC bearing in mind that your wife is a member. (3)
- (b) write the report of the accounting officer for the year ended 31 March 2016. (10)

**15.20**

**(16 marks 20 minutes)**

Ponzey (Pty) Ltd is an industrial wholesale company. As Ponzey (Pty) Ltd has a public interest score of around 85, it is required to have its annual financial statements independently reviewed. Your firm has conducted the review since the Companies Act 2008 became effective and you have just completed your review of the financial statements as at 31 March 2016.

The review did not go well. You found the financial personnel to be unco-operative and that internal controls had weakened considerably to the extent that the financial data produced by the system, was simply not sufficiently reliable for you to perform the procedures which were to have formed the main thrust of your review engagement. Accounting breakdowns had also resulted in a lack of suitable supporting documentation which you required to gain sufficient evidence to support what employees had told you in your discussions with them.

On raising the matter with Kent Magura, the recently appointed financial manager, he responded as follows "Just relax, don't take it so seriously, this is not an audit, it is just a review, and we are not too concerned about the problems you have raised, we will sort them out in due course."

**YOU ARE REQUIRED TO:**

- a) comment briefly on Kent Magura's response. (3)
- b) draft the report which would be appropriate for this engagement. You are not required to include the paragraphs dealing with the independent reviewer's responsibility or other reports required by the Companies Act. (13)



Images (Pty) Ltd is a company which imports photographic equipment. The company has a public interest score of 134 for the financial year end 30 April 2016, and has its financial statements independently compiled by a small firm of registered auditors who specialise in providing services as “independent accounting professionals”. Your firm had been the auditor of Images (Pty) Ltd but subsequent to the promulgation of the Companies Act 2008, had changed its professional relationship with Images (Pty) Ltd, to that of independent reviewer of the annual financial statements. The company’s financial statements are prepared in terms of IFRS for SMEs. You have just completed the review for the 30 April 2016 financial statements and have only the following matter to deal with:

The company holds a number of listed investments on a long term basis. In prior years, the company has presented these on a “fair value” basis but for the year end 30 April, have included them at the value at which they were presented at the end of the prior year 30 April 2015. Had the fair value of the investments at 30 April 2016 been used, an impairment of R327 206 would have to have been recognised. Keegan Naidoo the financial accountant, tells you that the directors feel that as the value of the company’s investments fluctuate, it is simply a pointless exercise to revalue them when the intention is to hold them in the long term. He also tells you that the independent accounting professional didn’t think that not revaluing them at reporting date was anything to worry about. When you informed Keegan Naidoo that you would have to modify your conclusion in the review report, he responded by saying that the board understood fully that you were required to fulfil your duties responsibly. A modification was not an issue for the board, particularly as the users of the reviewed annual financial statements were only going to be the fifteen shareholders and possibly the bank and SARS.

**YOU ARE REQUIRED TO :**

- a) explain the term “independent accounting professional” in the context of Images (Pty) Ltd. (5)
- b) comment on whether your firm could compile and perform the review of the annual financial statements of Images (Pty) Ltd in view of the fact that your firm had been the auditor of the company. (3)
- c) draft the report which would be appropriate for this engagement, based on the information given in the question. You are not required to write out the paragraphs dealing with the Independent Reviewer’s Responsibility or Other reports required by the Companies Act. (12)