Tutorial letter 102/0/2017

ADVANCED AUDITING

AUE4861/ZAU4861/NAU4861

Year Module

Department of Financial Governance

IMPORTANT INFORMATION:
This tutorial letter contains important information about your module.
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DUE DATE

TEST 1 ON TUTORIAL LETTER 102: 14 MARCH 2017

PERSONNEL AND CONTACT DETAILS

<table>
<thead>
<tr>
<th>Name</th>
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<td>012 429 4744</td>
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<td>Secretary</td>
<td></td>
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<td>Hettie Beylefeld</td>
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</tbody>
</table>

The Department of Financial Governance has a HELPDESK for postgraduate students. All queries, except those of a purely administrative nature, may be directed to the Helpdesk. You can contact the Helpdesk either by e-mail or telephonically between 08h00 to 16h00, Monday to Friday.

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<thead>
<tr>
<th>E-mail</th>
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PRESCRIBED METHOD OF STUDY

1. By this time, you should be familiar with the relevant chapters in your prescribed textbook as well as the International Standards on Auditing covered by the study units. Only refer to the prescribed material if any principles are contained in the questions, with which you are not familiar, when working through this tutorial letter.

2. Read the standards and interpretation(s) that are covered in these study units.

3. Answer the questions in the study units and make sure you understand the principles contained in the questions.

4. Consider whether you have achieved the specific outcomes of the study units.

5. After completion of all the study units, attempt answering the self-assessment questions to test whether you have mastered the contents of this tutorial letter.
# Suggested Working Programme

<table>
<thead>
<tr>
<th>MONDAY</th>
<th>TUESDAY</th>
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<th>THURSDAY</th>
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<tr>
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<td>10</td>
<td>11</td>
<td>12</td>
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<td>14+15</td>
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<tr>
<td>AUE4861 Read tutorial letter 101</td>
<td>The audit process and pre-engagement activities</td>
<td>Pre-engagement activities</td>
<td>Planning an audit (risk assessment, planning activities and materiality)</td>
<td>Planning an audit (risk assessment, planning activities and materiality)</td>
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| 16     | 17      | 18        | 19       | 20     | 21+22   |
| Planning an audit (obtaining an understanding of the control environment) | Planning an audit (obtaining an understanding of the control environment) | Planning an audit (obtaining an understanding of the control environment) | Do self-assessment questions | Do self-assessment questions | Do self-assessment questions |

| 23     | 24      | 25        | 26       | 27     | 28+29   |
| Do self-assessment questions | Do self-assessment questions | | | | |
HOW THE TOPICS OF THIS TUTORIAL LETTER RELATE TO THE AUDIT PROCESS

STAGES OF THE AUDIT PROCESS

Pre-engagement activities
(TL 102)

Planning
(TL 102)

Establish overall audit strategy (TL 102)

Develop an audit plan (TL 102)

Obtain audit evidence (the auditor's response to assessed risk)

Perform tests of controls (TL 104)

Perform substantive procedures (TL 104)

Evaluation, conclusion and reporting
(TL 105)
INTRODUCTION

The diagram on page 5 sets out the different stages of the audit process. The audit process can be divided into four stages, namely the pre-engagement phase (1), the planning phase (2), the obtaining of audit evidence phase (3) and the evaluation and concluding phase (4). The planning phase (second phase) includes obtaining an understanding of the entity and its environment, the assessment of risks and establishing the overall audit strategy and audit plan. The obtaining of audit evidence phase (third phase) is all about the auditor's response to the risks that have been assessed in the planning phase and requires from the auditor to perform tests of controls and substantive audit procedures. The last phase in the audit process requires that the auditor evaluate the evidence that has been gathered to make the necessary recommendations and to issue the most appropriate audit opinion.

This diagram will be included in all the tutorial letters to demonstrate to you where the topics covered by the different tutorial letters, fit into the audit process. The topics relevant to this tutorial letter are shaded in the diagram.

While studying the diagram, you will notice that the Code of Professional Conduct (CPC), By–Laws, Auditing Profession Act (APA), rules regarding improper conduct, King III and Companies Act are depicted across all the stages of the audit process. This is because they are not only applicable to a specific stage of the audit process, but relevant to the whole audit process. The auditor should therefore comply with ethics, principles and laws, from the time of assessing whether or not to accept the client until the issuance of the audit report.

OBJECTIVES

After the completion of this tutorial letter, you should be able to:

- identify and explain the details of each stage of the audit process.

PRESCRIBED STUDY MATERIAL

INTRODUCTION

The first phase of the audit process is to perform pre-engagement activities. The auditor has certain responsibilities in agreeing the terms of an audit engagement.

The terms preliminary engagement activities and pre-engagement activities are used interchangeably.

Pre-engagement activities take place before the auditor accepts or declines an audit engagement. These activities are performed when the auditor has to decide whether to accept a new client or to continue with the relationship with an existing client.

OBJECTIVES

After the completion of this tutorial letter, you should be able to:

- discuss the pre-engagement activities that you would have to perform before accepting a prospective client or an existing client; and
- evaluate the audit work performed when accepting new clients by referring to ISQC1, ISA 220, ISA 300, and the CPC.

PRESCRIBED STUDY MATERIAL

Framework : International framework for assurance engagements (par 17-19)
ISA 210 : Agreeing the terms of audit engagements
ISA 220 : Quality control for an audit of financial statements
ISA 300 : Planning an audit of financial statements
ISA 600 : Special considerations – audits of group financial statements (including the work of component auditors)
ISA 610 : Using the work of internal auditors
ISA 620 : Using the work of an auditor’s expert
ISQC 1 : Quality control for firms that perform audits and reviews of financial statements, and other assurance and related services engagements

Also refer to Auditing notes for South African Students, 10th edition. Chapter 6, 6/9 to 6/13.
SECTION A – ADDITIONAL INFORMATION

Overview

At the beginning of the current audit engagement the auditor shall undertake the following activities (ISA300 par 6):

(a) performing procedures required by ISA 220 regarding the continuance of the client relationship and the specific audit engagement;
(b) evaluating compliance with relevant ethical requirements, including independence in accordance with ISA 220; and
(c) establishing an understanding of the terms of the engagement, as required by ISA 210.

IMPORTANT PRINCIPLE

Before an audit firm can accept or continue with a client relationship the firm has to consider (ISA 220 par 12 and A8 and ISQC 1 par 26):

1. the integrity of the principal owners, key management and those charged with governance of the entity;
2. whether the engagement team is competent to perform the audit engagement and has the necessary capabilities, including time and resources to do so;
3. whether the firm and engagement team can comply with the relevant ethical requirements; and
4. significant matters that have arisen during the current or previous audit engagement, and their implications for continuing the relationship.

Let’s have an in-depth look at each of the above four considerations

1. The integrity of the principal owners, key management and those charged with governance of the entity

When considering the integrity of the client the engagement partner may consider the following (ISQC1 par A19):

- the identity and business reputation of the client’s principle owners, key management, and those charged with governance;
- the nature of the client’s operations, including its business practices;
- information concerning the attitude of the client towards matters such as:
  - an aggressive interpretation of accounting standards and the internal control environment; and
  - a reputation for maintaining poor relationships with its auditors;
- the client’s attitude towards paying the audit fee (will they be able to pay the audit fee and/or are they only concerned with keeping the fee as low as possible);
- any indications that the client will impose a limitation on the audit;
- indications that the client might be involved in any criminal activities;
- the reasons for the proposed appointment of the firm and non-reappointment of the previous firm (reason/s for the change of auditors); and
- the identity and business reputation of related parties.
2. Competence, capabilities and resources of the engagement team

When considering the competence, capabilities of the engagement team, the engagement partner may consider the following (ISA 220 par A11 and ISQC1 par A18):

- the audit team’s experience with audit engagements of a similar nature and complexity;
- the professional standards and applicable legal and regulatory requirements that must be adhered to and whether the firm personnel have experience with these requirements, or the ability to gain the necessary skills and knowledge;
- the availability of sufficient personnel at the firm who has the necessary competence and capabilities;
- the technical expertise within the team or access to other auditors or experts that do have the relevant expertise (ISA600, ISA610 and ISA620);
- knowledge of the relevant industry in which the client operates;
- the audit team’s ability to apply professional judgement;
- the ability to comply with the firm’s quality control policies and procedures as per ISQC1;
- the availability of personnel to perform quality control reviews; and
- the ability of the engagement team to complete the engagement within the reporting deadline.

3. The relevant ethical requirements (ISA 200, par 14)

The firm and the engagement team are required to be independent in order to comply with the ethical requirements prior to accepting a new client or when continuing to provide statutory audit services to an existing client.

Please refer to the CPC for the different types of threats to independence. Please note that the CPC is only applicable to chartered accountants, and that it might be that not all the members of the audit team are chartered accountants. However, all the members of the audit team are required to be independent in terms of the International Standards on Auditing. As a result, the CPC will be used as guidance to identify any independence threats of the audit team members, including those who are not chartered accountants.

Section 210 of the CPC, deals with ethical considerations of a Professional appointment. This section also entails procedures that need to be followed when contacting the previous auditors.

**EXAMPLE: ETHICAL REQUIREMENTS**

The scenario states that the engagement partner assigned to the audit of ABC Ltd is married to the CEO of ABC Ltd. The CEO of ABC Ltd receives a bonus based on profits.

Required: Discuss ethical concerns prior to accepting ABC Ltd as a statutory client.

If your answer is only one of the following it would be incomplete:

- There is a threat to independence and therefore the engagement partner should not be part of the audit of ABC Ltd.

  OR

- There is a familiarity threat and therefore the engagement partner should not be part of the audit of ABC Ltd.

We recommend that you present your answer in the following manner:

- There is a self-interest threat, as the audit partner has a financial interest in ABC Ltd as she is married to the CEO.
Ethical requirements

- There is a **familiarity threat**, as the audit partner is married to the CEO.
- There is an **intimidation threat**, as the audit team might be reluctant to ask challenging question in fear of upsetting the audit partner’s spouse.
- Based on the above, the threat to independence is seen as significant.
- It will not be appropriate for the audit partner to be involved in the audit of ABC Ltd.

**EXAMINATION TECHNIQUE**

The threats in the above answer are explained by linking each threat to the information in the scenario, whereas in the top part of the answer the threats were not applied to the information in the scenario. Applying of the theory to the information in the scenario is very important if you want to score the marks.

4. **Other significant matters**

When considering other significant matters the engagement partner may consider the following:
- any changes that occurred during the year for existing clients;
- information obtained from communication with the predecessor auditor (ISA 300 par 13(b));
- whether there is a legal vacancy to appoint the auditors (Sec 91 of the Companies Act); and
- any professional and legal responsibilities that might arise (Sec 45 and 46 of the Auditing Profession Act).

**Establishment of the terms of the engagement**

After the auditor has considered the four aspects above, the terms of the audit must be agreed upon. The auditor may only accept a new client or continue an audit engagement if the terms of the audit has been agreed upon.

ISA 210 par 9 to 10 states that the agreed terms of the audit engagement shall be recorded in an audit engagement letter and shall include:

1. the objective and scope of the audit of the financial statements;
2. the responsibilities of the auditor;
3. the responsibilities of management;
4. the identification of the applicable financial reporting framework for the preparation of the financial statements; and
5. reference to the expected form and content of any reports to be issued by the auditor and a statement that there may be circumstances in which a report may differ from its expected form and content.

Refer to ISA 210, par 9 to 12 for the agreement on audit engagement terms and ISA 210 Appendix 1 for an example of an audit engagement letter.
SECTION B – QUESTION ON PRE-ENGAGEMENT ACTIVITIES

QUESTION 1

YOU HAVE 15 MINUTES TO READ THIS QUESTION

You are an audit trainee at CTZ Auditors (‘CTZ’) and part of the external audit team of Sports Electronics (Pty) Ltd (‘SET’). CTZ has two partners and 15 professional staff members, and its offices are located in Sunnyside, Pretoria. CTZ was appointed as auditor of SET in September 2014. Management has requested that the audit for the financial year ended 30 September 2014 (‘FY2014’) be completed as soon as possible after the year end, as the company’s bankers urgently require the financial statements in order to assess an application for finance received from SET.

SET is a rapidly growing company in the information technology (IT) sector and a manufacturer of wearable connected devices for sport, fitness and wellness. The company was formed three years ago by five friends who met at university. Being sport fanatics, they identified a gap in the market for affordable, reliable and fashionable devices for sportsmen and sportswomen that track motion and activity such as distance travelled, calories burned and active time of exercise. The company operates from leased premises in Midrand, which house the manufacturing operations, the warehouse and the administrative offices.

SET has since incorporation been funded by the shareholders from savings and personal borrowings, but as a result of the rapid growth of its operations, the shareholders urgently need capital to fund its operations and to stimulate future growth. SET has exhausted all its overdraft facilities, and the bank has indicated that additional facilities will only be considered if the company receives a clean audit report. The directors also intend growing the business as fast as possible and to list the company in two years’ time in order to unlock value for its shareholders. The directors see themselves as ‘go-getters’ and very dynamic, and persons to whom failure of the business is not an option. They are determined to maximise the value of the business at all costs.

As all the shareholders are directors and SET’s annual financial statements were in the past neither audited nor independently reviewed. However, in view of their need for additional finance they now require audited financial statements, and have resolved to be audited from FY2014 onwards. This was why CTZ was appointed as the company’s external auditors.

Except for the financial director, all the directors have an engineering background, and have limited financial and regulatory knowledge. They have in the past relied heavily on CTZ to provide them with accounting services, as CTZ assisted with setting up the small accounting function, and with the preparation of the financial statements in accordance with International Financial Reporting Standards for the last two years. The directors have stated that they also want CTZ to assist them with the listing of SET in two years’ time.

The audit is currently in progress, and the following work paper is available:

A101 – Understanding the entity and its environment
1. **Nature of the business**

SET's activities comprise the manufacture and sale of wearable connected devices for sport, fitness and wellness. The company has a small research and development department that focuses on developing new products for the market, together with software updates for its existing products.

SET's only tracking device, called SEMS, was developed by the five entrepreneurs in the garage of one of their parents, and once the prototype was stable and tested, manufacturing was outsourced to a company in China. In order to gain more control over the production process, manufacturing operations were moved in October 2013 to the present Midrand premises. The product proved to be very popular as it is durable, fashionable and very affordable in comparison to similar overseas products.

SEMS uses a three-axis accelerometer to sense the user's movement, which measures steps taken, distance cycled or swum, etc., and then combines it with user data to calculate calories burned and the distance of the activity, as well as its duration and intensity. It also measures sleep quality by tracking periods of restlessness, how long it takes for the wearer of the device to fall asleep and the duration of actual sleep. SEMS has wireless capabilities, which allow the user to upload the data tracked to a smartphone application (‘app’).

SET offers a free website service, called ‘MyFitness’, that is available with or without the SEMS tracker and that can be used for recording and viewing data. Users can log their food intake, activities, weight, blood pressure, heart rate and glucose levels and then monitor them over time. Users can also set daily and weekly goals for themselves. This data can also be synchronised between MyFitness and the app. MyFitness is hosted on SET’s IT platform.

For a subscription fee of R250 per annum, the user can access additional functionality on MyFitness and the app, such as altitude analysis, lap times and the ability to post data directly to their Facebook or Twitter profile. This is very popular amongst sportsmen and sportswomen, serving to stimulate friendly rivalry and competition amongst them.

2. **Directors and corporate governance**

The directors are all equal shareholders (20% each) in the company. The directors subscribe to the principles of sound corporate governance and corporate citizenship.

3. **Overview of operations**

The manufacture of the tracking devices is a relatively simple process and involves – sourcing the internal components from a supplier in China (computing boards, GPS tracking units, batteries, etc.);
- sourcing external components from a local supplier (plastic and rubber casings); and
- assembling the tracker units, installing the software and packaging of the devices at the factory in Midrand.

Once the tracker devices are packaged they are stored in the warehouse.
Sales are made mainly to South African retailers or directly to South African customers via the website and agents at major sporting events.

An identification number is assigned to each SEMS tracking device upon installation, and the device is then activated by sales staff on a sales website provided by SET.

4. Business processing and IT

The company makes use of standard enterprise resource planning (ERP) software. The software is used for accounting and to manage the production process.

CTZ’s IT specialist reviewed the general control environment at SET and highlighted various issues with regard to the server that hosts the websites, including the following:

- The server can be accessed by most employees as it also houses other applications used by SET (such as the ERP software);
- There is a lack of backups, which was recently highlighted when unauthorised access by a disgruntled customer caused the server to crash. Valuable customer information and device activation information were consequently lost; and
- The database of the device activation details loaded by sales staff is not password protected.

The IT systems, database and website hosting are all located at the Midrand premises. The maintenance and operation of the database and software systems are outsourced to a local IT service provider.

5. Financial performance

The company incurred a pre-tax loss of R10 500 000 in FY2014 that was mainly attributable to start-up costs and sales that had not yet reached optimum levels. The directors are, however, confident that the company will be profitable in FY2015.

6. Developments during FY2014

The following important developments that had a significant impact on the business occurred late in FY2014:

6.1 Contract for consignment sales

SET entered into an agreement with Warehouse for Sportsmen (‘WFS’), a leading sports department store in South Africa, for the retail distribution of the SEMS tracking devices. The agreement stipulates that WFS stores may sell the devices. Inventory would be supplied to the WFS stores on a consignment basis.
6.2 Privacy and security concerns regarding the MyFitness website

In June 2014 the MyFitness website was criticised for its default user activity-sharing setting. All users have the option of keeping their physical activity information private, but some users were unaware that the information was public by default. SET responded to the criticism by changing the default setting to private and requesting that search engines remove indexed user profile pages from their databases.

REQUIRED

YOU NOW HAVE 23 MINUTES TO ANSWER THIS QUESTION

Part (a) Discuss the factors that CTZ should have considered before accepting the engagement as external auditor of SET

1. INDEPENDENCE AND OBJECTIVITY

Providing accounting and financial statement preparation assistance

1.1 This creates a self-review and (possible advocacy) threat to independence. (1)

1.2 Consideration should be given to how significant the threat is, namely the nature of the services provided, and management’s involvement in taking responsibility for the financial statements and accounting records. (1)

1.3 The threat is significant and should the audit be accepted, these services should rather not be provided. (1)

1.4 Alternatively CTZ should consider whether there are safeguards that can be implemented to ensure the auditors’ independence, for example that the audit team should not be involved in the accounting records or preparation of the financial statements/second review partner should review work (any valid safeguard to be considered) (1)
Assisting the client in future with listing (corporate finance services)

1.5 The provision of corporate finance services, e.g. structuring arrangements and transactional services for listing, could directly affect the amounts in the financial statements and create a self-review/self-interest or possible advocacy threat for independence.

1.6 Considerations on how significant this threat is, will depend on factors such as the degree of subjectivity involved, the nature of services, etc.

1.7 Possible safeguards could include using professionals who are not members of the audit team. (any valid safeguard)

1.8 Management is under pressure for a clean audit report and this may result in an intimidation threat for the auditor.

2. MANAGEMENT’S INTEGRITY AND BUSINESS RISK

2.1 Management’s integrity could be suspect as they appear to have little regard to compliance and control issues – they seem to want to maximise the value of the business at all cost. (valid e.g. of non-compliance)

Management are also go-getters and intend listing the company – could be an indicator of poor control environment.

2.2 The business risk also appears to be very high as –

(a) The control environment is weak given the lack of accounting experience and staff; and

(b) The financial constraints of the company and possible going concern problems.

2.3 The integrity and reliability of the financial statements are also questionable due to management’s incentive to manipulate them in order to achieve a clean audit.

2.4 A positive factor might be the directors’ commitment to sound corporate governance procedures OR there is evidence that there are corporate governance issues and therefore a weak control environment.

3. AUDIT CONSIDERATIONS

3.1 Does CTZ have enough staff to audit a client that wants to list and expand operations (only two partners, 15 staff members)? The question is thus whether it has professional staff independent from the audit staff to provide advice on the listing.

Considering the tight audit deadline (the engagement was only accepted in September) will there be enough resources to complete in time considering the size of the firm.

3.2 Does CTZ have staff with the relevant experience and expertise, given the complex accounting issues (R&D costs capitalised, forex transactions, etc.) and are there enough staff to audit all locations

3.3 Does CTZ want to do the audit in future once the company lists or meets the score for a statutory audit (currently it is a voluntarily audit only) given the fact that it will be disqualified as auditors if accounting and financial services are continued to be provided (it should thus consider not undertaking other services).
3.4 The risk of legal liability given the fact that the bank will rely on the financial statements for purposes of granting additional funding.

3.5 Will the client be able to pay CTZ’s our audit fee given its financial position?

3.6 The client was neither audited nor reviewed in the prior years, will the additional time required to audit in the current financial year be recoverable?

4. ENGAGEMENT CONSIDERATIONS

4.1 Establish whether the preconditions for the audit are present, such as whether the financial framework is acceptable.

4.2 Is the client is prepared to sign the standard engagement letter to acknowledge that it understands its responsibilities with regards to the audit?

4.3 Consider whether the appointment of the auditors has been effected in terms of the Companies Act.

5. OTHER VALID CONSIDERATIONS

Available 25
Maximum 14
Communication skills – clarity of expression 1

MARKERS’ COMMENTS

- Note that 0.3 minutes reading time per mark is allowed. As such, only five minutes reading time should be allowed for this question. However, since the question is an adapted example from the ITC January 2015 exam, the scenario is long and more reading time is given. When doing practice questions keep the 0.3 minutes per mark standard in mind and work on your reading skills if necessary. Time management is very important on CTA level.

- Note how the answer is structured under the subheadings of independence and objectivity, management’s integrity and business risk, audit considerations and engagement considerations. This corresponds with the four considerations explained in Section A of this study unit.

- From the above, it is clear that good exam technique when answering a pre-engagement question is to use ISA 220 par A8 (from ISA 220 par 12) as framework. This will ensure that you take all four pre-engagement considerations into account.

- Don’t forget to apply the theory (i.e. ISA 220 par A8) to the information supplied in the scenario.

- Corporate governance and companies act considerations were excluded from the question as it will only be covered in a later tutorial letter; However, keep in mind that these topics will form part of a typical pre-engagement question during the exams. Corporate governance and companies act issues usually relate to the integrity of the principle owners, key management and those charged with governance of the entity considerations.
INTRODUCTION
Planning plays a vital role when conducting an audit. Planning an audit of the financial statements is the second phase of the audit process. Planning an audit involves establishing the overall audit strategy and developing an audit plan (ISA 300 par 2).

For ease of discussion, the basic concepts that will be discussed are as follow:
1. obtaining an understanding of the entity and its environment;
2. assessing risks of material misstatement at the overall financial statement level;
3. assessing risks of material misstatement at the assertion level;
4. planning activities; and
5. materiality in planning and performing an audit.

OBJECTIVES
After the completion of this tutorial letter, you should be able to:
- explain how the auditor may gain an understanding of an entity and its environment;
- identify and assess the risks of material misstatements through understanding the entity and its environment;
- identify the risk indicator from the scenario and describe the audit risks/risks of material misstatement;
- know the difference between risks at overall financial statement level and risks at assertion level;
- provide responses to the identified risks of material misstatements at the overall financial statement level and assertion level;
- know the difference between audit strategy and an audit plan;
- discuss the details dealt with in the audit plan and audit strategy;
- calculate planning materiality and apply planning materiality to a given scenario; and
- identify weaknesses in the calculation of materiality presented to you in the scenario.
1. **Obtaining an understanding of the entity and it’s environment**

During the planning phase the auditor shall obtain an understanding of the entity and its environment including the entity’s internal controls. Obtaining this understanding enables the auditor to identify and assess the risks of material misstatement whether due to fraud or error, at the overall financial statement level and at the assertion level. This risk assessment will then provide the auditor with a basis for designing and implementing the responses to the assessed risks of material misstatement (ISA 315 par 3). In identifying and assessing the risks of material misstatement the auditor shall perform risk assessment procedures.

The auditor shall obtain an understanding of the aspects as set out in ISA 315 par 11 to 24. It is important for the auditor to obtain an understanding of the entity and its environment (ISA 315 par 11) as well as of the entity’s relevant internal controls (ISA 315 par 12 to 24). It is a matter of the auditor’s professional judgement whether a control, individually and/or in combination with others would be relevant to the audit. For a detailed discussion on the auditors understanding of the entity’s internal control please refer to Study unit 4.

The risk assessment procedures shall include the following (ISA 315, par 5 – 10):

(a) analytical procedures;

(b) inquiries; and

(c) inspection and observation.
It is important to understand the different types of risks that an auditor is faced with. Please refer to the glossary of terms included in the SAICA Handbook, Volume 2A(1), Auditing for a definition of the following terms:

1. Audit risk;
2. Business risk;
3. Control risk;
4. Detection risk;
5. Inherent risk;
6. Risks of material misstatement; and
7. Significant risk.

Risks of material misstatement only entails inherent and control risk, whereas audit risk on the other hand includes inherent risk, control risk (which is risk of material misstatement) and detection risk.

Therefore if you are required to describe the risks of material misstatement you will not discuss detection risk.

Business risk is broader than the risks of material misstatement of the financial statements, although it includes the latter.

2. Assessment of risks of material misstatement at the overall financial statement level.

Risks of material misstatement at the overall financial statement level refer to risks that relate pervasively to the financial statements as a whole and potentially affect many assertions (ISA 315 par A124).

The following table provides examples of conditions and events that may indicate the existence of audit risk at the overall financial statement level. The examples provided cover a broad range of conditions and events; however, not all conditions and events are relevant to every audit engagement and the list of examples provided below is not necessarily a comprehensive list. Refer to ISA 315, Appendix 2 for the list of these examples.

<table>
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<th>Risk indicator</th>
<th>Description of risk</th>
<th>Component of audit risk</th>
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<tbody>
<tr>
<td>1.</td>
<td>Operations in regions or countries with strict regulations/different regulations to SA.</td>
<td>The AFS may be materially misstated as the entity might not comply properly with the relevant laws and regulations possibly resulting in material misstatements of unrecorded liabilities, expenses, etc. For instance JSE regulations, Environmental Laws, Labours Laws, etc.</td>
<td>Inherent risk</td>
</tr>
<tr>
<td>2.</td>
<td>Liquidity issues. Operating losses. Loss of significant customers or suppliers. Constraints on availability of capital and credit. Changes or loss of key personnel. Pending significant litigation.</td>
<td>The AFS may be materially misstated as the going concern assumption might not be properly accounted for and/or disclosed. The AFS may be materially misstated by engaging in fraudulent financial reporting to hide a going concern threat.</td>
<td>Inherent risk</td>
</tr>
<tr>
<td>No</td>
<td>Risk indicator</td>
<td>Description of risk</td>
<td>Component of audit risk</td>
</tr>
<tr>
<td>----</td>
<td>--------------------------------------------------------------------------------</td>
<td>-----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------</td>
<td>--------------------------------</td>
</tr>
<tr>
<td>3.</td>
<td>Changes in the industry and management does not want to comply.</td>
<td>The AFS may be fraudulently materially misstated as the <em>entity might not comply with the changes to the laws</em> Companies Act, King III etc., in the industry within which it operates indicating lack of integrity by management.</td>
<td>Control risk</td>
</tr>
<tr>
<td>4.</td>
<td>Expanding into new locations/decentralisation of the entity.</td>
<td>The AFS may be materially misstated as the <em>control environment</em> in other locations might not be operating effectively resulting in fraudulent activities or errors.</td>
<td>Control risk</td>
</tr>
<tr>
<td>5.</td>
<td>Lack of personnel with appropriate accounting and financial reporting skills.</td>
<td>The AFS may be materially misstated as there might be <em>errors occurring in the preparation of financial records.</em></td>
<td>Control risk</td>
</tr>
<tr>
<td>6.</td>
<td>New client.</td>
<td>• The AFS may be materially misstated as material misstatements and errors <em>could go undetected</em> as we are not familiar with the client.</td>
<td>Detection risk</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• The AFS may be fraudulently materially misstated by management due to the fact that the new auditors have limited knowledge of the entity.</td>
<td>Inherent risk</td>
</tr>
<tr>
<td>7.</td>
<td>Management’s integrity questionable.</td>
<td>The AFS may be materially misstated as the <em>control environment might be compromised by management who lacks integrity.</em></td>
<td>Control risk/Inherent risk</td>
</tr>
<tr>
<td>8.</td>
<td>Use of work of third party (component auditor (ISA 600)/internal auditor (ISA 610)/expert (ISA620).)</td>
<td>The AFS may be materially misstated as the <em>third party might not be competent and appropriately qualified</em> in performing the work required for audit evidence.</td>
<td>Inherent risk</td>
</tr>
<tr>
<td>9.</td>
<td>Management receives bonuses driven by profits.</td>
<td>The AFS may be materially misstated as directors might <em>engage in fraudulent financial reporting</em>, i.e. overstated of revenue, understatement of expenses to maximise bonuses.</td>
<td>Inherent risk</td>
</tr>
<tr>
<td>10.</td>
<td>Financials to be used to obtain financing from the bank.</td>
<td>The AFS may be materially misstated as directors might <em>engage in fraudulent financial reporting</em>, i.e. overstated of assets and profits and under-statement of liabilities and expenses to ensure that financing will be obtained.</td>
<td>Inherent risk</td>
</tr>
<tr>
<td>11.</td>
<td>Tight deadline.</td>
<td>• The AFS may be materially misstated as management <em>might not have sufficient time to properly account and disclose post balance sheet events</em> (Subsequent events).</td>
<td>Inherent risk</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• There is a risk that the <em>auditor might not have sufficient time to obtain the audit evidence</em> resulting in material misstatement going undetected.</td>
<td>Detection risk</td>
</tr>
<tr>
<td>No</td>
<td>Risk indicator</td>
<td>Description of risk</td>
<td>Component of audit risk</td>
</tr>
<tr>
<td>----</td>
<td>--------------------------------------------------------------------------------</td>
<td>----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------</td>
<td>----------------------------------------</td>
</tr>
<tr>
<td>12.</td>
<td>Listed on the JSE Ltd.</td>
<td>The AFS might be materially misstated as the company <strong>might not comply with JSE regulations resulting in the delisting of the company and affecting the going concern of the company.</strong></td>
<td>Inherent risk</td>
</tr>
<tr>
<td>13.</td>
<td>Change of the accounting software.</td>
<td>The AFS may be materially misstated as the financial data might not be properly transferred from the old accounting system to the new accounting system.</td>
<td>Control risk/Inherent risk</td>
</tr>
<tr>
<td>14.</td>
<td>History of errors or significant adjustment at year end.</td>
<td>The AFS may be materially misstated as the current financial statements <strong>might include material misstatements.</strong></td>
<td>Inherent risk</td>
</tr>
<tr>
<td>15.</td>
<td>Managers are the owners of the entity.</td>
<td>The AFS may be materially misstated as directors <strong>might engage in fraudulent financial reporting to present the performance and position of the entity in a more favourable light.</strong></td>
<td>Inherent risk</td>
</tr>
<tr>
<td>16.</td>
<td>Entity required to produce group financial statements / Different accounting policies in a group / Different accounting systems/ reporting dates.</td>
<td>The AFS may be materially misstated as <strong>errors might occur during consolidation as it involves an intricate process possibly resulting in material misstatements.</strong> The AFS may be materially misstated as <strong>related party transactions might not be eliminated on consolidation.</strong> The AFS may be materially misstated as the <strong>consolidation might not be properly done in terms of IAS 27.</strong></td>
<td>Inherent risk</td>
</tr>
<tr>
<td>17.</td>
<td>Obtaining control of another company.</td>
<td>The AFS may be materially misstated as the requirements of <strong>IFRS 3/IFRS 10 might not be properly.</strong></td>
<td>Inherent risk</td>
</tr>
</tbody>
</table>

**EXAMINATION TECHNIQUE**

No marks are allocated for the risk indicators, unless you are required to list the risk indicators. Marks are awarded for **describing the risk as per the “description of risk column”** in the table above. The risk indicator will be mentioned in the scenario of a question to enable you to discuss or describe the required risk.

Remember to apply the risks which you identified to the information provided in a given scenario otherwise no marks can be awarded to you.

3. **Assessment of risks of material misstatement at the assertion level**

Assertions are representations made by management that are embodied in the financial statements, and are used by the auditor to consider the different types of potential misstatements that could possibly occur (ISA 315 par 4(a)). ISA 315 par A124 sets out the assertions used by the auditor to consider the different types of potential misstatements that could occur. These assertions fall into the following three categories:

- assertions about classes of transactions and events for the period under audit;
- assertions about account balances at the period end; and
- assertions about presentation and disclosure.
To demonstrate conditions and events which may affect risks at the assertion level, we will use the following example. (Note that these conditions and events can be found in ISA 315, Appendix 2.)

**EXAMPLE**

You are a first year trainee accountant of ABC Ltd (ABC). The audit senior on the job has provided you with the following information which you will require in the audit of ABC.

Revenue comprises sales to local and foreign customers. Foreign customers are invoiced in their respective currencies. During the year, ABC entered into a forward exchange contract (FEC) for the goods ABC sold to one of their once off foreign customers to protect itself against foreign currency fluctuations. The normal credit terms are 30 days. ABC provides for credit losses at 2% of the trade receivables balance. Management of ABC receives a bonus based on profit for the year. At year end, trade receivables were factored to provide ABC with the cash flow that was required.

**REQUIRED:**

(a) Identify the significant account balance(s) and/or class(es) of transactions in the above scenario of ABC Ltd.

(b) Describe the risks of material misstatement of the identified account balance(s) and/or class(es) of transactions.

(c) Indicate which assertions are affected.

**SUGGESTED SOLUTION**

1. (a) Significant class of transactions: **Revenue**.

   (b) and (c) Risks of material misstatement at the assertion level

<table>
<thead>
<tr>
<th>Conditions or events affecting risks at assertion level</th>
<th>Risk indicator</th>
<th>Risk (b)</th>
<th>Assertion (c)</th>
</tr>
</thead>
</table>
| Appendix 2 (ISA 315)  
Complexity of the underlying transaction  
Susceptibility of the account to misstatement | Foreign customers are invoiced in foreign currencies.  
Management receives a bonus based on profit for the year. | There is a risk that revenue from foreign customers might not be translated at the correct exchange rate.  
There is a risk that revenue might be recognised in the incorrect period in order to inflate the revenue figure for bigger bonuses.  
There is a risk that management might record fictitious sales in order to inflate the revenue figure for bigger bonuses. | Accuracy  
Cut-off  
Occurrence |
2. (a) 1. Significant account balance: *Trade receivables.*
2. Significant class of transactions: *Allowance for credit losses.*

(b) and (c) Risks of material misstatement at the assertion level.

<table>
<thead>
<tr>
<th>Conditions or events affecting risks at assertion level</th>
<th>Risk indicator</th>
<th>Risk (b)</th>
<th>Assertion (c)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Appendix 2 (ISA 315)</td>
<td></td>
<td>There is a risk that trade receivables might not be translated at the correct closing rate at year end.</td>
<td>Valuation and allocation</td>
</tr>
<tr>
<td>Susceptibility of the account to misstatement</td>
<td>Foreign customers are invoiced in their foreign currencies.</td>
<td>There is a risk that trade receivables might not be accurately accounted for resulting in misstatement of trade receivables account.</td>
<td>Valuation and allocation</td>
</tr>
<tr>
<td>Completion of unusual and complex transaction.</td>
<td>Once-off FEC for goods sold to foreign customers.</td>
<td></td>
<td></td>
</tr>
<tr>
<td>And/Or</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Complexity of the underlying transaction making up the account balance.</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>And/Or</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Transaction not subject to routine processing.</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Susceptibility of account to misstatement.</td>
<td>Management receive bonuses based on net profit for the year.</td>
<td>There is a risk that fictitious debtors could be recorded in the financial records in order to inflate the revenue figure for bigger bonuses.</td>
<td>Existence</td>
</tr>
<tr>
<td>Degree of judgment involved.</td>
<td>Allowance for credit losses.</td>
<td>There is a risk that the allowance for credit losses is understated to inflate the trade receivables account and reflect ABC’s financial position in a better light.</td>
<td>Valuation and allocation of Trade receivables and Accuracy and completeness of allowance for credit losses</td>
</tr>
<tr>
<td>Completion of unusual transaction</td>
<td>Trade receivables are factored.</td>
<td>There is a risk that the trade receivables account does not belong to ABC Ltd since debtors have been factored.</td>
<td>Rights and obligations</td>
</tr>
</tbody>
</table>

Please note:

1. The first two columns are not required. They are included in the suggested solution to demonstrate to you how conditions or events can affect risks at the assertion level.
2. The assertions at risk for the relevant class of transactions (statement of comprehensive income line item) revenue, in this instance are **accuracy, cut-off** and **occurrence**.

3. Completeness and classification are not at risk relating to revenue at ABC Ltd, hence they are not addressed in the suggested solution.

4. The completeness assertion has not been addressed for the trade receivables account as it is not at risk for ABC Ltd.

**EXAM TECHNIQUE**

1. Present your answer using assertions even when not required to do so. This will enable you to generate points and would demonstrate to the marker that you are able to make the link between the risk and the applicable assertion.

2. Use ISA 315 par A124 when answering a question on risks at the assertion level. This will enable you to address the correct assertion that is at risk for a class of transaction, account balance and/or disclosure.

3. When you are required to describe the risk at the assertion level, use the information in the scenario. For instance, if you were to write “there is a risk that trade receivables might be valued incorrectly”, your answer would be incomplete as you did not link it to the information in the scenario. You would have to link your answer to forex valuation and the impact of the provision for credit losses when addressing the valuation assertion.

4. When you are required to describe the risks at the assertion level, do not confuse the required for an audit procedures question. The audit procedures will be covered in TL 104.

**4. Planning activities**

As per ISA 300 par 7 the auditor shall establish an overall audit strategy that sets the scope, timing and direction of the audit, and that guides the development of the audit plan.

**4.1 Overall audit strategy**

In establishing the overall audit strategy, the auditor shall:

(a) identify characteristics of the engagement that define its **scope**;

   For instance:
   1. The financial reporting framework (IFRS, SA GAAP, GRAP, etc.).
   2. Industry-specific reporting requirements (compliance with JSE regulations), Government regulations (Environmental, labour, etc.) etc.
   3. Number of locations for expected audit coverage.
   (For more examples on the characteristics of the engagement refer to ISA 300 Appendix)

(b) ascertain the reporting objectives of the engagement to plan the **timing** of the audit and nature of communication required;
For instance:
1. Entity’s reporting timetable for interim financial results and year end financial results.
2. Meetings with management and those charged with governance.
3. Communicating with auditors of components regarding the time deadlines.
(For more examples on the reporting objectives, timing of the audit and nature of communications refer to ISA 300 Appendix)

(c) consider significant factors in directing the engagement team;

The significant factors will include for instance the following:
1. Materiality.
2. Areas with higher risk of material misstatement.
3. Volume of transactions.
(For more examples on the significant factors refer to ISA 300 Appendix)

(d) Consider the results of the preliminary engagement activities and, where applicable, whether knowledge gained on other engagements performed by the engagement partner for the entity is relevant; and

(e) ascertain the nature, timing and extent of resources necessary to perform the engagement.

The nature, timing and extent of resources will include the following:
1. The selection of the engagement team.
2. The engagement budget.
(Refer to ISA 300 Appendix)

As discussed above refer to ISA 300 par 8 and A8 to A11 as well as the Appendix for considerations in establishing the overall audit strategy. (The Appendix has a detailed list of considerations in establishing the overall audit strategy.)

The auditor shall design and implement overall responses to address the assessed risks of material misstatement at the overall financial statement level (ISA 330 par 5).

A high risk of material misstatement at the overall financial statement level will have the following impact on the overall audit strategy (ISA 330 par A1 to A3):
- follow a substantive approach or a combined approach (if there are deficiencies in the control environment);
- perform more tests of detail and less analytical procedures;
- incorporate an element of unpredictability in testing;
- exercise professional scepticism;
- consider the use of an expert;
- perform procedures closer to year end;
- put less reliance on management representations;
- extend sample sizes;
- engage more experienced staff; and
- lower materiality.

4.2 Audit plan

The completion of the overall audit strategy guides the development of the audit plan.
The audit plan is more detailed than the overall audit strategy and include a description of (ISA 300 par 9):

(a) the nature, timing and extent of planned risk assessment procedures as determined under ISA 315;
(b) the nature, timing and extent of planned further audit procedures at the assertion level as determined under ISA 330: and
(c) other planned audit procedures that are required to be carried out so that the engagement complies with the ISAs.

The auditor’s assessment of the identified risks at the assertion level provides a basis for considering the appropriate audit approach (combined audit approach or a substantive audit approach) for designing and performing further audit procedures (ISA 330 par A4).

The auditor can decide to follow either of the following approaches:

a combined audit approach which entails tests of controls and substantive procedures.
This is normally when the auditor intends to rely on the operating effectiveness of controls or substantive procedures alone cannot provide sufficient appropriate audit evidence at the assertion level (ISA 330, par 8);

OR

A substantive approach which entails both tests of detail and substantive analytical procedures.

Irrespective of the assessed risks of material misstatement, the auditor shall design and perform substantive procedures to each material class of transactions, account balance and disclosure (ISA 330, par 18 and A4).

The nature of audit procedures refers to its purpose (that is, test of controls or substantive procedures) and its type (inspection, observation, inquiry, confirmation, recalculation, reperformance, or analytical procedures).

The timing of audit procedures refers to when it would be performed.

IMPORTANT PRINCIPLE

Risks at the overall financial statement level will be addressed by the overall audit strategy (ISA 330, par 5 and A3). The risks at the assertion level will be addressed by the audit approach (ISA 330, par 6 and A4 to A8).

IMPORTANT PRINCIPLES

Nature (ISA 330 par A5): The nature of audit procedures refers to its purpose (that is, test of controls or substantive procedures) and its type (inspection, observation, inquiry, confirmation, recalculation, reperformance, or analytical procedures).

Timing (ISA 330 par A6): The timing of audit procedures refers to when it would be performed.
The auditor can perform the procedures as follow:
- before year end (interim); or
- at and after year end; or
- early verification just prior to year end with roll forward procedures at year end; or
- both at interim and after year end.
(The auditor has to incorporate an element of unpredictability in the timing of performing certain audit procedures.)

<table>
<thead>
<tr>
<th>Extent (ISA 330 par A7):</th>
<th>The extent of audit procedures refers to the quantity to be performed.</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>This entails the quantity of tests of control, tests of detail and/or analytical procedures the auditor will perform.</td>
</tr>
<tr>
<td></td>
<td>For instance, if you have a strong control environment you will perform more tests of controls, with less tests of detail and more analytical procedures (and visa versa).</td>
</tr>
</tbody>
</table>

(Refer to ISA 330, par A4 to A19 for detailed response to the assessed risks at the assertion level.)

5. **Materiality in planning and performing an audit**

Materiality in planning and performing an audit is determined when developing the overall audit strategy.

Study ISA 320 in detail to understand the effect that the determination of materiality in planning and performing the audit, will have on conducting and concluding the audit. Know the difference between planning materiality and performance materiality (Refer to ISA 320 par 10 to 11). Please note that performance materiality is lower than planning materiality. This enables the auditor to minimise the risk of expressing an incorrect audit opinion.

There is an inverse relationship between materiality and inherent risk i.e.:
- if inherent risk is assessed as high, a low materiality will be set to compensate for the high inherent risk; or
- if inherent risk is assessed as low, a high materiality will be set because there is a smaller chance that a material misstatement would occur.

**EXAMPLE**

Gross profit = R5 000 000

This audit firm applies the following percentages to gross profit in the materiality calculation:
- high inherent risk 0,5%
- medium inherent risk 1%
- low inherent risk 2%
<table>
<thead>
<tr>
<th>Inherent risk</th>
<th>Set materiality</th>
<th>Result</th>
</tr>
</thead>
</table>
| High (0,5%)   | R25,000 (low)  | • Increased sample sizes  
• Can tolerate less errors in sample tested  
• Most conservative |
| Medium (1%)   | R50,000 (medium) | • Sample sizes smaller than above  
• Can tolerate a bit more errors in samples tested  
• More conservative |
| Low (2%)      | R100,000 (high) | • Smallest sample sizes  
• Can tolerate more errors (we do not expect a lot of errors)  
• Less conservative |

When answering a question relating to calculating materiality in planning an audit, table the following steps:

1. Determine which figures to use:
   • budgeted figures;
   • unaudited figures of current year (i.e. management accounts); or
   • prior year audited figures.

2. Consider the indicators and perform the calculations:
   • Turnover $\frac{1}{2} - 1\%$
   • Gross profit $1 - 2\%$
   • Net income $5 - 10\%$
   • Total assets $1 - 2\%$
   • Equity $2 - 5\%$

You can use the above percentages as a guide on which to base the materiality calculation. If you are given percentages in a scenario, you should use the given percentages.

Remember to consider the nature of the business. For an entity that is capital intensive you are likely to use total assets for your materiality calculation. The materiality calculation bases will differ from audit firm to audit firm.

3. Determine the materiality

Remember there is an inverse relationship between materiality and inherent risk. Marks will be awarded for the reasoning given for your chosen materiality even if your calculations are incorrect.
SECTION B – QUESTIONS ON PLANNING AN AUDIT: RISK ASSESSMENT, PLANNING ACTIVITIES AND MATERIALITY

QUESTION 1

YOU HAVE 9 MINUTES TO READ THIS QUESTION

You are a first-year trainee accountant at Andre Gauta Ephraim Incorporated (AGE), a medium-sized firm. You are one of six audit team members to audit the DanChrome Group.

In preparation for the audit of DanChrome Group, your audit senior presented you with the following information on the DanChrome Group.

DANCHROME GROUP BUSINESS BACKGROUND

DanChrome Ltd (DanChrome) was established in 1976 in South Africa. Its core business is the mining and smelting of chrome ore. Chrome ore is converted to ferrochrome through intense metallurgical processing. DanChrome is one of the largest integrated ferrochrome producers in the world with an annual capacity of one million tons. DanChrome produces three grades of ferrochrome, namely charge chrome, intermediate chrome and low carbon ferrochrome, each used in different areas of the stainless steel smelting process.

DanChrome’s mining operations are situated in Meyerton. The head office is situated in the central business district of Johannesburg. The DanChrome Group employs a workforce of 16 300 employees.

In April 2010 AGE was awarded a tender to audit DanChrome and its newly acquired subsidiary company, SamCoal (Pty) Ltd (SamCoal) for the year ended 31 August 2010. The appointment of AGE will be evaluated annually at DanChrome’s annual general meeting as stated in the revised memorandum of incorporation of the company. The appointment of AGE as the auditors of DanChrome came about as a result of the previous auditors filing a notice of resignation. They resigned because they considered themselves as not having adequate resources to service DanChrome due to the company’s growth. When the previous auditors were contacted by AGE, they confirmed that they had enjoyed the long association with DanChrome and also stated that DanChrome has a good reputation in the industry.

DanChrome acquired a 55% shareholding in SamCoal on 11 September 2009. At the time, the year end for SamCoal was 31 March. To ensure consistency in group reporting, the financial year end of SamCoal was changed to 31 August. The core business of SamCoal is the mining of coal. SamCoal has three coal mining sites in various areas of the Mpumalanga province and a newly established mining site in the Limpopo province. Each coal mining site has accounting staff responsible for capturing financial data. The head office of SamCoal is situated in Middelburg.

During mid-March 2010, Denzil Phillips, the audit partner on the audit, was approached by Sipho Platinum Mines Ltd, an 80% shareholder of DanChrome, to negotiate the sale of their shares in DanChrome. The sale was completed successfully in May 2010. This resulted in the delisting of DanChrome from the JSE Ltd. The new shareholding of DanChrome is as follows:
In May 2010, the DanChrome Group was affected by the South African Transport Union’s strike that lasted for a month. Employees of DanChrome Group also went on a strike in July 2010 over salary increases. This strike lasted for two weeks. The DanChrome Group was not able to export ferrochrome and coal to overseas customers during this period. These customers represent 80% of the group’s customer base. As a result, the group recorded a loss for the 2010 financial year, for the first time in years.

On 30 June 2010 the service contract of both the chief executive officer (CEO) and the managing director (MD) of DanChrome Group came to an end. The majority shareholders decided at a general meeting not to renew their contracts. Both the CEO and MD had been employed by DanChrome for more than 10 years. It has been reported in the business press that they are the main people who can be credited for the financial success of DanChrome over the years. The search is on for two candidates with the required skills, knowledge and experience to fill the vacant positions. In the meantime, the financial director is acting as both the CEO and MD.

To ensure that the DanChrome Group is well managed, a significant part of the remuneration of directors is incentive-based. The director’s remuneration is determined by the audit committee.

A week before the DanChrome Group’s financial year end, the audit partner became aware of the following article in the financial press:

**SAMCOAL MINES ON CULTURAL HERITAGE SITE**

The Department of Water Affairs and Forestry has raised concerns about the illegal mining operations performed by SamCoal on the cultural heritage site in the Limpopo province, near the Zimbabwean border. The site is home to more than 470 bird species, as well as more than 50 different species of endangered plant life. According to the Department, SamCoal has already destroyed five square kilometres of the indigenous forest in order for them to perform their mining activities. A spokesperson for the Department of Minerals and Energy stated that SamCoal owns the mining rights to a portion of land situated close to the site. The Department of Water Affairs and Forestry has filed a lawsuit against SamCoal for the damage they have caused to the cultural heritage site.

James Taylor, Limpopo

On 5 September 2010, the attorneys of the DanChrome Group indicated that the court is likely to rule in favour of the Department of Water Affairs and Forestry. The estimated cost set to restore the site amounts to approximately R10 000 000.

The acting CEO has informed AGE that the new holding company requires the audited financial statements of the DanChrome Group within two weeks after the year end. The shareholders require this information as soon as possible to determine if the group might need to be steered in a different direction.
FINANCIAL DATA OF DANCHROME

The AGE audit management team has reviewed the draft financial statements to identify significant accounts and your audit senior has brought the following to your attention:

Revenue
Revenue has decreased significantly as compared to prior years, due to the strikes that occurred during the current financial year. DanChrome’s revenue comprises mainly the sale of ferrochrome to international customers.

Trade receivables
At 31 August 2010, DanChrome had a trade receivables balance of R9.8 million. European customers comprised 67% of this balance, while Americans made up 13% and South African customers made up the balance. Both the Europeans and the Americans are invoiced in their respective currencies. When a sale is made to international customers, DanChrome enters into forward exchange contracts to protect itself against foreign currency fluctuations.

Provision for rehabilitation
DanChrome’s provision for rehabilitation amounts to R63 000 000 at 31 August 2010. According to the Department of Minerals and Energy, DanChrome is required to rehabilitate the land in Meyerton once the useful life of the chrome ore mine comes to an end. To assist with obtaining audit evidence that is appropriate and sufficient, AGE has decided to engage an environmental specialist to audit the provision. The environmental specialist works in the department of sustainability reporting at AGE.

Goodwill
Goodwill of R10 000 000 was raised on acquisition of SamCoal. Goodwill was not assessed for impairment at year end. As per discussions with the acting CEO, he indicated that goodwill will be carried at cost given the company’s performance.

Patent
Also included in the intangible assets is a patent with a carrying value of R55 000 000. The patent relates to “Optimised Mine Ventilation on Demand” technology purchased from Swiss Technologies. The patent is carried at cost and its useful life is 20 years. The contract with Swiss Technologies is for 15 years.

REQUIRED

<table>
<thead>
<tr>
<th>YOU NOW HAVE 41 MINUTES TO ANSWER THIS QUESTION</th>
</tr>
</thead>
</table>

<table>
<thead>
<tr>
<th>(a) With regard to the opening paragraph and the DanChrome Group business background information:</th>
<th>Marks</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Describe the risks of material misstatement at the overall financial statement level of the DanChrome Group.</td>
<td>17</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>(b) With regard to the financial data of DanChrome:</th>
<th>Marks</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Describe the risks of material misstatement at the assertion level of DanChrome for each of the items listed.</td>
<td>10</td>
</tr>
</tbody>
</table>
SUGGESTED SOLUTION

(a) 1. Risk of material misstatement at the overall financial statement level of the DanChrome Group

(i) To be included in the financial statements of DanChrome Group are 18 months results of SamCoal (year end change).
   • Errors might occur during consolidation, resulting in material misstatements.
   • Accounting for revenue and expenditure in SamCoal will prove to be problematic due to cut-off.

(ii) SamCoal’s business is decentralised.
   • There is a risk that controls might not be functioning properly and consistently as they ought to be at all the coal mining sites which may result in errors in the financial statements.

(iii) Directors might be involved in fraudulent financial reporting:
   • to improve the net asset value or profit, as directors have a 15% shareholding in DanChrome;
   • to overstate results as a significant part of the directors’ remuneration is incentive based;
   • to hide the loss that DanChrome Group has incurred in the current financial year;
   • to meet investors’ expectations as their integrity is questionable (involved in illegal mining).

(iv) Director’s remuneration is determined by the audit committee.
   • There is a risk that non-compliance with King III may indicate a lack of management integrity, which increases the risk of fraudulent financial reporting.

(v) There is a risk that the going concern principle might not be appropriate and may not be appropriately addressed in the financial statements as a result of the following:
   • the contracts of the key personnel, (CEO and MD) were not renewed and their positions are still vacant;
   • the company reported a financial loss for the first time in years;
   • DanChrome Group could have lost the majority of its clients during the period it was not able to export ferrochrome and coal, resulting in existing clients rather purchasing from its competitors;
   • the fact that SamCoal is being sued for the destruction of the cultural heritage site indicates a contravention of the law which might result in a reportable irregularity; and
   • DanChrome group could incur more losses due to a bad reputation.

(vi) There is a tight audit deadline.
   • There is a risk that financial statements might be materially misstated and/ or incomplete as little time is available to prepare financial statements.
   • There is a risk that post balance sheet events might not be identified and properly accounted for by management of DanChrome group.
(vii) DanChrome Group sells products to overseas customers.

- There is a risk that the DanChrome Group might not comply with all the relevant laws and regulations in this regard resulting in DanChrome Group being prevented from operating in foreign countries resulting in loss of business. 

(1)

(viii) Due to the loss of key personnel (MD and CEO) there might be a break-down in the control environment which might result in errors in the financial statements.

(1)

(ix) DanChrome operates within a group.

- There is a risk that consolidation workings might not be accounted for properly. 

(1)

- There is a risk that the acquisition of SamCoal might not be accounted for properly in terms of IFRS 3 resulting in material misstatement in accounting for assets, liabilities, income and expenses. 

(1)

- There is a risk that intercompany transactions might not be at arm’s length, for instance in accounting for taxation and unrealised profits.

(1)

(x) The DanChrome Group operates in strictly regulated industry, therefore there is a risk that all relevant laws and regulations, including the Companies Act for the sale of shares, might not be complied with appropriately.

(1)

Total 21

Maximum 17

(b) 1. Risk of material misstatement at the assertion level of DanChrome (Pty) Ltd for the identified classes of transactions and account balances

(i) Revenue

- Revenue might be overstated due to the fact that the company’s financial performance is not as good compared to the prior years and the directors might want to project better results (accuracy; cut-off).

(1)

- There is a risk of fictitious sales being recorded as a result of the company performing worse than in previous years and the directors might want to reflect better results (occurrence).

(1)

- There is risk that foreign sales might not be translated at the correct exchange rate (accuracy).

(1)

- Revenue might not be accounted for at fair value of the consideration received (accuracy).

(1)

(ii) Trade receivables

- There is a risk that foreign receivables might not be translated at the correct exchange rate at year end (valuation).

(1)

- There is a risk that the profit/loss on the hedge could be calculated incorrectly/not correctly offset against the value of trade receivables at year end in terms of IAS 39 (valuation).

(1)

- There is a risk that the hedge might not be properly monitored resulting in incorrect valuation.

(1)

- There is a risk that fictitious debtors could be raised in order to inflate the financial results as the company is performing worse than in previous years (valuation/rights and obligations and existence).

(1)
(iii) Provision for rehabilitation
- There is a risk that the provision might not be valued correctly as we have to rely on the work of the expert (valuation). (1)
- There is a risk that the provision might not be accounted for correctly if it doesn’t meet the requirements of a provision in terms of IAS 37 (existence/valuation/rights and obligations and completeness). (1)
- There is a risk that the provision might be understated in order to improve the financial results of the company (valuation). (1)

Goodwill
- There is a risk that goodwill might not be accounted for properly at acquisition in terms of IFRS 3 (existence/rights and obligations/valuation/completeness). (1)
- There is a risk that goodwill is carried at the incorrect amount at year end as it was not tested for impairment (valuation). (1)

(iv) Patent
- There is a risk that the amortisation could be based on an inappropriate amortisation method (valuation). (1)
- There is a risk that the useful life used to depreciate the patent is incorrect, as the years used to write off the patent are more than the years of the contract (valuation). (1)
- There is a risk that the patent might not meet the requirements of an intangible asset in terms of IAS 38 (existence). (1)

MARKERS' COMMENTS

Part (a)
- Most students did not properly link the risk at the assertion level to the scenario given. Instead, students used assertions and vaguely formulated a risk, as in this case, “There is a risk that revenue might not be accurately accounted”. Please refer to the solution to see how risk at the assertion level should have been described.

General

Time management is a significant problem for many students.
**Planning Materiality calculation**

<table>
<thead>
<tr>
<th>Client: ABC (Pty) Ltd</th>
<th>Prepared by: CTA Student</th>
<th>Date: 2/04/2014</th>
</tr>
</thead>
<tbody>
<tr>
<td>Year ended: 31 March 2014</td>
<td>Reviewed by:</td>
<td></td>
</tr>
</tbody>
</table>

**Objective**

To calculate planning and performance materiality

**Extract of the financial information**

<table>
<thead>
<tr>
<th></th>
<th>Year ended 31 March 2014</th>
<th>Year ended 31 March 2013</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>R'000 Forecast</td>
<td>R'000 Audited</td>
</tr>
<tr>
<td>Revenue</td>
<td>32 000</td>
<td>23 000</td>
</tr>
<tr>
<td>Gross profit</td>
<td>12 700</td>
<td>10 300</td>
</tr>
<tr>
<td>Net profit (loss)</td>
<td>(3 500)</td>
<td>1 500</td>
</tr>
<tr>
<td>Total assets</td>
<td>35 000</td>
<td>32 500</td>
</tr>
</tbody>
</table>

**Background information on ABC (Pty) Ltd**

ABC (Pty) Ltd is a truck manufacturing company. ABC anticipates a net loss as a result of significant foreign currency losses. During 2014 the Rand has been performing weaker against foreign currencies. The company’s customers include farmers and construction companies. The customer portfolio of ABC increased by 10% in comparison to last year. The actual 2014 financial results are not available as management is still finalising the closing journal entries.

**Audit work performed**

**Materiality calculation for the 2014 audit**

1. Use the 2013 audited results as they are the most accurate in comparison to the 2014 forecast and the 2014 actual results are not available.

2. Materiality is calculated using the net loss as it reflects the financial results of ABC.

3. **Calculation** – The following guidelines are used to calculate materiality:
   - Revenue 2%
   - GP 3%
   - NP (loss) 2.5%
   - Total assets 1%

4. Inherent risk is assessed as high therefore (1 500 000 net profit x 2.5%) = R37 500 is an appropriate planning materiality figure of ABC.
REQUIRED

YOU NOW HAVE 12 MINUTES TO ANSWER THIS QUESTION

By providing reasons and calculations where applicable, criticise working paper A100 on the planning and performance materiality calculation.

SUGGESTED SOLUTION

1. The prior year audit results are not an appropriate base for the calculation of the 2014 planning materiality as it does not take the 10% increase in the customer portfolio into account. (1)

2. The 2014 forecast results will be most appropriate to use as management is still closing the journal entries on the 2013 actual results. (1)

3. In terms of ISA 320 par A4 the profit before tax from continuing operations is often used for profit-orientated entries. In this case a net loss has been forecasted. (1)

4. It is not appropriate to use a net loss as a basis. (1)

5. The materiality calculation must be based on stable figures. Net loss incurred is not a stable figure (due to the foreign currency losses incurred). (1)

6. Revenue, gross profit and total assets represent stable figures instead. Revenue and gross profit would be considered for the materiality calculation as ABC’s existence is dependent on the revenue it generates. Total assets would also be considered as ABC is a manufacturing company and thus considered to be asset intensive. (1)

7. Materiality should be calculated as follows:

\[
\begin{align*}
\text{Revenue} & \quad (32\ 000\ 000 \times 2\%) = 640\ 000 \quad \text{(1)} \\
\text{Gross profit} & \quad (12\ 700\ 000 \times 3\%) = 381\ 000 \quad \text{(1)} \\
\text{Total assets} & \quad (35\ 000\ 000 \times 1\%) = 350\ 000 \quad \text{(1)}
\end{align*}
\]

Max 2

8. Since inherent risk is assessed as high, materiality will be set as low. (1)

9. Therefore materiality for ABC (Pty) Ltd for 2014 will be set at R350 000 (total assets). (1)

10. The working paper does not indicate the performance materiality figure. The performance materiality figure would be more conservative i.e. lower than the planning materiality figure. (1)

11. Since the forecast figures are used in calculating planning materiality, performance materiality will also need to be determined. This will be the auditor’s safety margin in order to express an appropriate audit opinion. (1)

Available 12

Maximum 8
## INTRODUCTION

Obtaining an understanding of the control environment forms part of the planning phase of the audit process. Through understanding the entity and its environment, including control, the auditor identifies and assesses the risks of material misstatement in the financial statements.

For ease of discussion, the basic concepts that will be addressed are as follow:

1. internal control and business cycles; and
2. general and application controls.

## OBJECTIVES

After the completion of this tutorial letter, you should be able to:

- apply your knowledge of the various business cycles;
- apply your knowledge of internal control and its components;
- design systems of internal control;
- describe why it is necessary to obtain an understanding of the accounting and internal control systems during the planning phase of the audit;
- evaluate the effectiveness of an internal control system, identify weaknesses and/or consequences and advise on possible improvements to the system;
- evaluate findings and report weaknesses;
- consider and evaluate the risks related to a client’s accounting processing system;
- define the audit objectives (assertions) related to transactions;
- identify a significant deficiency in internal control;
- describe the impact of controls on the audit approach;
- discuss the various methods of information processing and be able to differentiate between the different computerised systems environments; and
- evaluate the general control environment as well as a specific computer system’s application controls.
PRESCRIBED STUDY MATERIAL

<table>
<thead>
<tr>
<th>Standard</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>ISA 265</td>
<td>Communicating deficiencies in internal control</td>
</tr>
<tr>
<td>ISA 315</td>
<td>Identifying and assessing the risks of material misstatement through understanding the entity and its environment</td>
</tr>
<tr>
<td>(Revised)</td>
<td></td>
</tr>
<tr>
<td>ISA 402</td>
<td>Audit consideration relating to an entity using a service organisation</td>
</tr>
<tr>
<td>ISAE 3402</td>
<td>Assurance reports on control at a service organisation</td>
</tr>
</tbody>
</table>

Also refer to the following chapters in Auditing notes for South African Students, 10th edition. Chapter 5 p 5/1 to 5/28, Chapter 7 p 7/1 to 7/21, Chapter 8 and Chapters 10 to 14.

COMMENT

It is very important that you meticulously study the theory in Auditing Notes regarding business cycles (Chapters 10 to 14). This will build the foundation that you need to answer questions relating to risks in manual and computerised information system (CIS) environments.

It is not sufficient to only work through this tutorial letter. The information contained in the relevant chapters in Auditing Notes is not duplicated in this tutorial letter and should be studied from Auditing Notes. You will miss crucial information if you do not study the relevant chapters from Auditing Notes.

You need to be well familiar with the basic knowledge of business cycles before attempting any questions. You must be able to apply the basic principles of auditing to both manual and computerised business environments.

Due to its integrated nature, computer auditing should not be seen in isolation. It can be combined and integrated with almost all of the other auditing topics and tutorial letters. You should therefore expect integrated computer auditing questions in almost every test during the year and the final examination.

You don’t need to be an information technology (IT) expert. The basic concepts covered in this tutorial letter and in the relevant chapters of Auditing Notes is sufficient for you to answer computer related questions.
SECTION A – ADDITIONAL INFORMATION

1. Internal control and business cycles

**IMPORTANT PRINCIPLE**

What is internal control?

ISA 315 par 4 stipulates that internal controls is -

- the process designed, implemented and maintained;
- by those charged with governance, management and other personnel; and
- to provide reasonable assurance about the achievement of an entity’s objectives with regard to:
  - reliability of financial reporting;
  - effectiveness and efficiency of operations; and
  - compliance with applicable laws and regulations.

ISA 315 par 12 stipulates that the auditor has to obtain an understanding of the internal controls that are relevant to the audit. Internal control is designed and implemented to address identified business risks that threaten the achievement of any of the above objectives. When the auditor obtains an understanding of internal control, he/she has to (ISA 315 par 13):

- **evaluate the design of those controls.** Does a control (individually or in combination with others) **effectively** prevent, detect and correct material misstatements?

- **determine whether these controls have been implemented.** It is no use having brilliant controls in theory if they are not implemented and used effectively by the entity. Inquiry from the entity’s personnel alone is not sufficient. Other procedures (e.g. observation, inspection, etc.) have to be performed in addition.

**COMMENT**

Internal control, according to ISA 315 par 14 to 24, consists of the following components:

- the control environment;
- the entity’s risk assessment process;
- the information system (including the related business processes relevant to financial reporting and communication);
- control activities relevant to the audit; and
- monitoring of controls.

Study these components from ISA 315. Also make use of ISA 315 Appendix 1 for further guidance on these components. Flag Appendix 1 of ISA 315, as it explains these components in detail and gives valuable examples to guide you in a test or the exam.
When the auditor obtains an understanding of the entity’s control activities, ISA 315 par 21 stipulates that the auditor must ALSO obtain an understanding of how the entity responds to risks arising from IT, as the use of IT affects the way that control activities are implemented. From an audit perspective, controls over IT systems are effective when they maintain the integrity of information and the security of the data and include effective general and application controls. (ISA 315 par A103 to A105).

**COMMENT**

As you can see, controls in an IT system (including general and application controls) form part of the entity’s total system of internal control.

As it is expected of the auditor to obtain an understanding of the entity’s internal control (as per ISA 315 par 12) and how the entity responds to risks arising from IT (ISA 315 par 21), it is expected of the auditor to also obtain an understanding of controls in an IT system (including general and application controls).

These controls (general and application) can be manual and/or automated controls. For both manual and automated controls you have to know the theory on business cycles as discussed in chapters 10 to 14 of Auditing Notes. Note how the same general and application controls are applied over and over again to the various business cycles in Chapters 10 to 14.

It is important for you to familiarise yourself with ISA 315 par A60 to A66. These paragraphs deal with the characteristics of manual and automated elements of internal control.

In a fully manual system it may be easy to trace a transaction’s path from initiation to its inclusion in the financial statements by following the flow of documentation. However, in computerised system environments, it may be more difficult to trace transaction flows through systems as these may not be visible. In some cases it may be impossible to obtain an understanding of the flow of transactions without the aid of sophisticated computer programs which map out the flow of data as it moves through the live processing phases of a computer system.

Business cycles can be described as the process of grouping together similar types of transactions or transaction processing systems.

In general organisations group their accounting transactions according to the following five common business cycles:

- the revenue and receipts cycle;
- the acquisition and payments cycle;
- the inventory and production cycle;
- the payroll and personnel cycle; and
- the finance and investment cycle.

**Significant risks and significant deficiencies in internal control**

ISA 315 par 27 requires the auditor to determine whether any of the risks identified are in his/her judgment, a significant risk.
# IMPORTANT PRINCIPLES

## What is a significant risk?

<table>
<thead>
<tr>
<th>ISA 315 par 4 definition (e)</th>
</tr>
</thead>
<tbody>
<tr>
<td>“An identified and assessed risk of material misstatement that, in the auditor’s judgment, requires special audit consideration.”</td>
</tr>
</tbody>
</table>

## What should the auditor consider when deciding if a risk is significant?

<table>
<thead>
<tr>
<th>ISA 315 par 28</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Is the risk a risk of fraud?</td>
</tr>
<tr>
<td>• Is the risk related to recent significant economic, accounting or other developments and, therefore, does it require specific attention?</td>
</tr>
<tr>
<td>• Is (are) the transaction(s) complex?</td>
</tr>
<tr>
<td>• Does the risk involve significant transactions with related parties?</td>
</tr>
<tr>
<td>• What is the degree of subjectivity in the measurement of financial information related to the risk?</td>
</tr>
<tr>
<td>• Does the risk involve significant transactions that are outside the normal course of business for the entity/ or appear unusual?</td>
</tr>
</tbody>
</table>

## Why do significant risks often relate to significant non-routine transactions or judgmental matters?

<table>
<thead>
<tr>
<th>ISA 315 par A132</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Non-routine transactions:</td>
</tr>
<tr>
<td>- are unusual (due to size or nature) and</td>
</tr>
<tr>
<td>- occur infrequently.</td>
</tr>
<tr>
<td>• Judgmental matters:</td>
</tr>
<tr>
<td>- May have significant measurement uncertainty (e.g. development of accounting estimates).</td>
</tr>
</tbody>
</table>

## Risks of material misstatement may be greater for...

<table>
<thead>
<tr>
<th>ISA 315 par A133–A134</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Significant non-routine transactions arising from the following matters:</td>
</tr>
<tr>
<td>- greater management intervention to specify the accounting treatment;</td>
</tr>
<tr>
<td>- greater manual intervention for data collection and processing;</td>
</tr>
<tr>
<td>- complex calculations or accounting principles; and</td>
</tr>
<tr>
<td>- the nature of the non-routine transaction.</td>
</tr>
<tr>
<td>• Significant judgmental matters that require the development of accounting estimates, arising from the following matters:</td>
</tr>
<tr>
<td>- accounting principles for accounting estimates or revenue recognition may be subject to differing interpretation; and</td>
</tr>
<tr>
<td>- required judgment may be subjective or complex, or require assumptions about the effects of future events, e.g. judgment about fair value.</td>
</tr>
</tbody>
</table>

## How should the auditor respond to a significant risk?

<table>
<thead>
<tr>
<th>ISA 330 par 15</th>
</tr>
</thead>
<tbody>
<tr>
<td>If the auditor wants to place reliance on a control(s) over a risk he/she has identified as a significant risk, the auditor shall test the control(s) in the current period.</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>ISA 330 par 21</th>
</tr>
</thead>
<tbody>
<tr>
<td>If the auditor determines that an assessed risk of material misstatement at the assertion level is a significant risk, he/she has to perform substantive procedures that are responsive to that risk.</td>
</tr>
</tbody>
</table>

If the approach is to only perform substantive procedures for that significant risk, it should include tests of details.
| What happens when the significant risk relates to a risk of material misstatement due to fraud? | ISA 240 par 27  
The auditor shall obtain an understanding of the entity’s related controls, including control activities, relevant to such risks. It is important for the auditor to obtain an understanding of the controls that management has designed, implemented and maintained to prevent and detect fraud (par A32). |
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>What if management have not appropriately responded to significant risks of material misstatement by implementing controls over significant risks?</td>
<td>This is an indicator of a significant deficiency in internal control.</td>
</tr>
</tbody>
</table>
| What is a significant deficiency in internal control? | ISA 265 par 6  
A deficiency or combination of deficiencies in internal control that, in the auditor's professional judgment, is of sufficient importance to merit the attention of those charged with governance. |
| What are possible indicators of significant deficiencies in internal control? | ISA 265 par A7 (a few examples)  
- Evidence of ineffective aspects of the control environment. Good examples are when management commits fraud (material or not) that is not/was not prevented by the entity’s internal control and if management fails to implement appropriate remedial action on significant deficiencies that have been communicated to them (by us) in the past.  
- Evidence that management does not oversee the preparation of financial statements.  
- Absence of controls over significant risks.  
- Absence of a risk management process.  
- Restatement of previously issued financial statements (as a result of a material misstatement due to fraud or error). |
| How should the auditor respond to a significant deficiency in internal control? | ISA 265 par 9 to 11 and A15  
The auditor must communicate (in writing) the significant deficiencies in internal control identified during the course of the audit to those charged with governance on a timely basis (par 9). Refer to par 10 and 11 for detail on the reporting of a significant deficiency in internal control. The level of detail of the communication, will depend on (par A15):  
- the nature of the entity (e.g. public interest entity vs. non-public interest entity);  
- the size and complexity of the entity;  
- the nature of the significant deficiency;  
- the entity’s governance composition; and  
- legal or regulatory requirements. |
| Who are “those charged with governance”? | ISA 260 par 10  
This is the person(s) or organisation(s) with responsibility for overseeing the strategic direction of the entity and obligations related to the accountability of the entity (including overseeing of the financial reporting process). |
Internal control related questions are typically examined in the following ways (in tests and examinations):

**REQUIRED: weaknesses, risks and recommendations**

- A question can either only require one of the above (e.g. only the weaknesses), or it can require a combination of two (e.g. weaknesses and risks), or even weaknesses, risks and recommendations.

- If more than one of the above are required, present your answer in a *tabular format* (even if the question does not specifically require it). This will assist you in presenting your answer in a structured manner and it will make it easier for the marker.

For example:
Identify the weaknesses, potential risks/consequences of the weaknesses as well as your suggestions for improvement thereof relating to the revenue and receipts cycle.

Structure your answer in the form of a table, as illustrated below:

<table>
<thead>
<tr>
<th>Weakness</th>
<th>Potential risk/Consequences</th>
<th>Suggested improvement (recommendation)</th>
</tr>
</thead>
</table>

- When you are required to identify weaknesses in an internal control system, it is important to remember to:
  - not only address those internal controls that are *performed incorrectly* (as indicated in the given scenario);
  - but also to address the *key internal controls* that should be performed but *are not mentioned* in the scenario.

Please note: These should still be relevant to what is given in the scenario.

---

**EXAMPLE**

The following question formed part of Unisa’s Exam of 2013. This question provides a good indication of how this section of the tutorial letter could possibly be tested.

You are a second year trainee accountant at Amanda, Mirriam & Gert Incorporated (AMG), a firm of Registered Auditors. AMG is a medium sized audit firm in South Africa with offices in Cape Town, Durban, Mangaung and Pretoria.

You were allocated to the audit team busy with the audit of Cottonworth Holdings Limited (hereafter referred to as Cottonworth). AMG was recently reappointed at the annual general meeting of Cottonworth to be the external auditor of the company and group’s financial statements for the year ended 31 August 2013. AMG is also the external auditor of Cottonworth (Proprietary) Limited (hereafter referred to as CPL). The partner in charge of the audit was excited about the reappointment since Cottonworth and CPL represent at least 80% of revenue earned by AMG.
You held several discussions with the Chief Information Officer (CIO), the Information Technology (IT) manager and other staff members in the IT department at Cottonworth. The following is an email you sent to the senior trainee accountant on the audit:

From: unisa.student@amg.co.za
Sent: Friday, 16 August 2013, 2:32 PM
To: Helen.Peterson@amg.co.za
Subject: General- and application controls at Cottonworth

Dear Helen,

I just wanted to bring a few things to your attention.

The IT control environment:

I had a meeting with the current CIO, Don Futherton, on Monday 5 August 2013. He provided me with a breakdown of salaries for all Cottonworth employees even though I didn't request it. This made me feel a bit uncomfortable as he made a joke that he likes the feeling of having sensitive company information at the push of a button and the power to use it as he sees fit. I got the idea that he is very friendly and helpful, but maybe not the most ethical person.

Don showed me the hard copy of the Cottonworth code of ethical behaviour. He informed me that there is currently only one copy of this document and that employees are welcome to come and read it in his office when they have ethical concerns. He mentioned that this was not specifically communicated but that he believes employees will speak up if they have issues.

Don informed me that a database administrator, Mark Jacobs, was appointed during January 2013. Don explained that IT management take the word of new employees when it comes to their experience and qualifications as employees need to prove themselves anyway. IT management don't believe in strict rules governing their recruitment practices. After Don and Mark became friends on Facebook, Don saw the following comment on Mark's Facebook profile made during January 2013:

"Guys, you would not believe my luck. I got a job at Cottonworth and they pay me a HUGE salary. Since I am not nearly qualified or experienced for the job, I had to improvise a bit in the interview. They are such IDIOTS ;-) I also have access to change my own salary and I have so much time at work to surf the internet and watch movies. What a pleasure to work for Cottonworth". Don explained that due to time constraints a disciplinary hearing will be held early in 2014 and that Mark will continue to work as a database administrator until such time.

..
I had a discussion with Mark on Tuesday 13 August 2013. He believes that his apparent “lack of competence” in the tasks allocated to him as database administrator were not communicated to him by management or his supervisors at any stage during the year and that it was never clearly explained to him what his role or specific tasks would be.

**General controls over the continuity of operations:**

I had a meeting with the IT manager, Will Smithers, on Wednesday 14 August 2013. Will is responsible for all general controls over the continuity of operations at Cottonworth.

Will explained to me that Cottonworth faced tremendous challenges during the current financial year. One of the biggest challenges faced was the fire that broke out at the head office during August 2013. Luckily no injuries were suffered by any of the employees. However, numerous personal computers (PCs) and servers were completely damaged in the fire. The week after the fire was apparently quite interesting (in Will’s own words).

The disaster recovery document was lost in the fire and everyone was a bit confused as to their roles and responsibilities after the incident. Will explain that there was never a good opportunity to test the recovery plan prior to the fire. Unfortunately the extent of data loss has not yet fully been determined as the back-up server was also partially damaged in the fire. According to Will, on-site back-ups are made weekly and on a monthly basis all data is backed-up to an off-site server.

**Change in salary information:**

After taking note of the Facebook comment made by Mark Jacobs about the fact that he has access to make changes to his own salary, I did some investigations and it seems that his salary on the master file is substantially higher than the salary documented in his employment contract (signed in January 2013).

I don’t want to sound like “Trainee of the year”, but I read the relevant ISAs (International Standards on Auditing) over the weekend and came to the following conclusions:

I don’t believe the incident can be classified as fraud. It was committed by an ordinary employee and not by the management of Cottonworth and was only an isolated incident.
I also don’t believe it is a significant risk or a significant deficiency in internal control. I saw on the prior year audit file that we tested payroll related access controls in detail and I don’t see why we should test them again this year.

I don’t think it is necessary to discuss this with management as I think I should have a chat with Mark and inform him that we are aware of his activities. I used to work at a club as a bouncer during my student days and I know how to handle these types of situations.

I know what you might be thinking, I am only a trainee accountant and already I am showing partner qualities, but that is just how I am. A born leader... (Just joking!).

Regards,
Unisa Student

---

**REQUIRED**

Evaluate the reasoning and conclusions of the second year trainee accountant with reference to the change in salary information mentioned in the email to Helen Peterson.

**Note:** Detailed reporting requirements of significant risks and significant deficiencies in internal controls are not required.

<table>
<thead>
<tr>
<th>Communication skills: Logic, structure and layout</th>
<th>Marks</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>1</td>
</tr>
</tbody>
</table>

**SUGGESTED SOLUTION:**

Evaluate the reasoning and conclusions of the second year trainee accountant with reference to the change in salary information mentioned in the email to Helen Peterson.

**Fraud:**

1. The statement made by the trainee accountant that the incident cannot be classified as fraud is **incorrect**. (1)

2. In terms of the definition of fraud set out in ISA 240, the incident does **constitute fraud**. (1)

3. The incident:
   (a) Was an intentional act by an employee (which is included in the definition of fraud) as **Mark Jacobs intentionally made changes to his salary information**. (1)
   (b) Involved the use of deception to obtain an unjust or illegal advantage as **making unauthorised changes to salary detail gave Mark an unjust and illegal advantage**. (1)
4. The statement made by the trainee accountant that he believes the incident to be an isolated incident is **not correct.** *(1)*

5. If there is an indication of fraud (as per ISA 240 paragraph 35), the auditor shall **evaluate the implications of the misstatement in relation to other aspects of the audit** and the auditor should recognize that fraud is unlikely to be an isolated incident. *(1)*

**Significant risk:**

6. The statement made by the trainee accountant that the incident is not a significant risk is **incorrect.** *(1)*

7. In terms of ISA 315 par 28 the auditor shall, in exercising judgment as to which risks are significant risks, **consider whether the risk is a risk of fraud** *(1)*

8. In terms of ISA 240 par 27 the auditor shall treat the assessed risk of material misstatement **due to fraud as a significant risk.** *(1)*

9. The statement made that payroll related access controls were tested in detail in the prior year and that he does not believe it should be tested in the current year is **incorrect.** *(1)*

10. In terms of ISA 330 par 15, should the auditor want to place reliance on controls over a risk that has been identified as a significant risk, the auditor shall **test those controls in the current period.** *(1)*

11. ISA 240 par 27 also states that the auditor shall obtain an understanding of the entity’s related controls, including **control activities, relevant to significant risks.** *(1)*

**Significant deficiency in internal control:**

12. The statement made by the trainee accountant that there is no significant deficiency in internal control is **incorrect.** *(1)*

13. As the incident might not be an isolated incident and the extent of the fraud might be difficult to ascertain, the deficiency in the controls relating to access to payroll files could possibly **lead to material misstatements in the financial statements** of Cottonworth for the year ending 31 August 2013. *(1)*

14. The **access controls over payroll related data do not operate effectively** as Mark was able to change his own salary. *(1)*

15. In terms of ISA 265 par 6 this would **constitute a deficiency in internal control** as the controls were not able to **prevent, detect or correct misstatements** in the financial statements on a timely basis *(1)*

16. As per ISA 265 par A6, in considering whether a deficiency in internal control can be classified as a significant deficiency in internal control, the auditor should consider whether the related **asset or liability is susceptible to fraud,** which in this case salaries are. *(1)*
17. In terms of ISA 265 par A7, misstatements that are detected by the auditor’s procedures and were not prevented, or detected and corrected by the entity’s internal controls, are indicators of significant deficiencies in internal controls.

18. The deficiencies in the access controls over payroll data would therefore constitute a significant deficiency in internal control.

19. The comment made by the trainee accountant that it is not necessary to discuss this with management is incorrect.

20. As per ISA 265 par 9, the auditor should respond to a significant deficiency in internal control by communicating it in writing to those charged with governance on a timely basis.

The following control activities can be found in any good internal control system. They apply to all the business cycles. When you are answering a question relating to internal control, always keep the control activities in mind and apply them to the given scenario.

Control activities (ISA 315 par A96):
- authorisation;
- information processing;
- performance reviews;
- physical controls; and
- segregation of duties.

Always remember that you should mainly address the control activities that are most relevant to the given scenario.

What is the difference between identifying a weakness, describing the risk and making a recommendation.

- **Weakness** → When identifying a weakness, you merely state:
  - whether an existing control is being performed incorrectly, and/or
  - if an internal control (relevant to the scenario) is not being performed at all.

- **Risk** → You might be asked to describe the risks in a given scenario. The risk is the potential consequence of the weaknesses mentioned above. This is normally what management and we as auditors are concerned about, as the risk usually relates to the impact on the financial statements and/or the financial/reputational impact on the client’s business.
### EXAMPLE

<table>
<thead>
<tr>
<th>Weakness</th>
<th>Risk/Consequence</th>
</tr>
</thead>
</table>
| There is poor segregation of duties since Mr X performs all of the following functions (list the functions):  
  -  
  -  
  - Internal control not being performed at all. | Possible fraud or other irregularities could go undetected which could have a negative financial impact on the entity.  
  = Potential consequence. |
| No tests of creditworthiness are carried out on clients before the order is processed.  
  = Internal control not being performed at all. | Sales could be made to clients who are not creditworthy. This could have severe financial implications for the entity.  
  = Potential consequence. |
| The product catalogue is only updated quarterly.  
  = Existing control being performed incorrectly. | The product catalogue that a client is using might be out of date which could lead to sales being made at incorrect prices. This could lead to financial losses for the company.  
  = Potential consequence. |
| There is no independent review of the work performed by Mr X.  
  = Internal control not being performed at all. | As Mr X is not independently reviewed, he could commit fraud and/or errors (made by him) could go undetected. This could have a negative financial impact on the entity.  
  = Potential consequence. |

### Recommendations

If you are required to make recommendations (suggestions for improvements), make sure that you do not formulate your answer as weaknesses! The recommendations that you make should be practical and preferably cost effective (from a client’s perspective). If we take the weakness of: “no tests of creditworthiness carried out” (in the table with the example of weaknesses and risks above), what would appropriate recommendations be?

- A credit limit **should** be determined for each new client after proper background checks have been carried out.
- When the orders are received, the computer system or the sales clerk **should** check whether the credit limit has been exceeded and should then authorise the sale.
- If the credit limit has been reached, the credit manager or other senior official **should** authorise the sale.

A question can also require you to “evaluate the effectiveness of an internal control system”. Here you will have to address both negative (weaknesses) as well as positive aspects of the controls being performed. An evaluation means that you compare the negative and the positive of a certain matter and conclude thereon.
A question can require you to identify/list/describe the internal controls (both manual and automated) that should be present in a clients' internal control system, or that should be implemented to ensure certain control objectives are met. Don't confuse this with tests of controls. You should be comfortable with the various business cycles and the internal controls that should be performed in each cycle. You cannot describe controls that a client should have in place if you are not familiar with the controls in each cycle.

**EXAMPLE**

<table>
<thead>
<tr>
<th>Control →</th>
</tr>
</thead>
</table>

- A reconciliation between deposits captured and bank statements **should** be performed by the accounting department.
- This reconciliation **should** be reviewed by a senior official (manager).
- Any security breaches **must** be logged and followed up by management.

As you can see you are **not testing** the control, but merely stating what the control **should be**.

**General aspects**

Refer to all the self-assessment questions in this tutorial letter for past Unisa test and exam questions. These questions will provide you with guidance on how internal control related topics were tested and examined in the past. Please note that you have to determine exactly what a question requires you to do. Does the question only require you to look at a certain function of a transaction cycle? Does it require you to address only certain control objectives (assertions)? The golden rule is to limit your answer to what is required from you!

Determine from whose point of view the question is asked (i.e. the external auditor, internal auditor or management). This would influence the way in which you have to formulate your answer.

**2. General and application controls**

As discussed in the previous section, controls in a CIS environment include both general and application controls. These controls can be both manual controls and controls designed and built into computer programs (automated controls).

**2.1 General controls**

In terms of ISA 315 par A104, general IT-controls are policies and procedures that relate to many applications and support the effective functioning of application controls. They apply to mainframe, mini-frame and end-user environments.

General controls comprise:

- (a) data centre and network operations;
- (b) system software acquisition, change and maintenance;
- (c) program change;
- (d) access security; and
- (e) application system acquisition, development and maintenance.
Refer to Auditing Notes page 8/7 to 8/25 for a discussion on the categories of general controls.

2.2 Application controls

As per ISA 315 par A105, application controls are manual or automated procedures that typically operate at a business process level and apply to the recording of transactions by individual applications. Application controls relate to specific tasks performed by computerised information systems and can be preventative or detective in nature. Their function is to provide reasonable assurance that the initiation, recording, processing and reporting of financial data are properly performed. Application controls are categorised as “input”, “processing”, “master file maintenance” and “output” controls. Application controls relate primarily to the occurrence, authorisation, accuracy and completeness of transactions within a specific application in an organisation. General controls, in turn, provide the standards and guidelines under which employees function in their work governing the functions of developing, maintaining and operating systems to process data.

Refer to Auditing Notes page 8/26 to 8/41 for a discussion on application controls.

**COMMENT**

Contained in Chapters 10 to 14 of Auditing Notes for South African students, are sections that discuss the computerisation of the particular business cycle. It is crucial for you to study this together with Chapter 8 of Auditing Notes.

**EXAMINATION TECHNIQUE**

The following table should always be used when planning your answer on an application control related question.

<table>
<thead>
<tr>
<th>Control Objective</th>
<th>Input</th>
<th>Processing</th>
<th>Output</th>
<th>Master file</th>
</tr>
</thead>
<tbody>
<tr>
<td>Occurrence and authorisation (validity)</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Accuracy</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Completeness</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

First of all determine which transaction cycle (or part of it) is being addressed in the scenario (e.g. payroll cycle). Secondly determine which function of the process in the transaction cycle is being addressed in the scenario. Does the scenario deal with the:

- input phase;
- processing phase;
- output phase; and/or
- master file maintenance phase?

For example, capturing employees’ clock card hours onto the payroll system would fall into the **input phase** of the payroll transaction cycle.

Thirdly determine which control objective(s) is/are being addressed. Does the question require you to address:

- occurrence;
- authorisation;
- accuracy; and/or
- completeness?
EXAMPLE

List the controls that the management of company X should implement to ensure the accuracy and completeness of the capturing of clocked hours on the clock cards.

Where do you start?

1. Determine the transaction cycle (or part of it):
   – Payroll and personnel cycle.

2. Determine the phase of the process:
   – Input phase (capturing of clocked hours).

3. Determine the control objectives:
   – Accuracy and completeness.

What should your table look like?

<table>
<thead>
<tr>
<th>Control objective</th>
<th>Input phase</th>
</tr>
</thead>
<tbody>
<tr>
<td>Accuracy</td>
<td></td>
</tr>
<tr>
<td>Completeness</td>
<td></td>
</tr>
</tbody>
</table>

You should only address the input phase of the payroll cycle and the accuracy and completeness control objectives.

- Most marks in the test or exam will normally be allocated to the input and processing phases. Master file change controls are VERY popular and for relatively high mark allocations.

- When dealing with sequentially pre-numbered documents (hard-copy or electronic), two control objectives are being addressed:
  – completeness: to identify missing documents/transactions; and
  – occurrence: to identify duplicate documents/transactions.

IMPORTANT PRINCIPLE

Access controls can be both general and application controls. Use the following as guidance:

Access Controls

- General Controls
  - Programmed (logical) controls
    - For example user ID and password to gain access to computer (e.g. Windows)

- Application Controls
  - Physical controls
    - For example servers kept in locked server rooms.
  - Access on the application level
    - For example user ID and password to gain access to the payroll application (e.g. VIP)
A weakness in general controls can influence many applications as it encompasses the overall controls over all IT activities.

### GENERAL CONTROLS

<table>
<thead>
<tr>
<th>Payroll Program</th>
<th>Application controls</th>
</tr>
</thead>
<tbody>
<tr>
<td>I</td>
<td>P</td>
</tr>
<tr>
<td>O &amp; A</td>
<td></td>
</tr>
<tr>
<td>A</td>
<td></td>
</tr>
<tr>
<td>C</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Inventory Program</th>
<th>Application controls</th>
</tr>
</thead>
<tbody>
<tr>
<td>I</td>
<td>P</td>
</tr>
<tr>
<td>O &amp; A</td>
<td></td>
</tr>
<tr>
<td>A</td>
<td></td>
</tr>
<tr>
<td>C</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Sales Program</th>
<th>Application controls</th>
</tr>
</thead>
<tbody>
<tr>
<td>I</td>
<td>P</td>
</tr>
<tr>
<td>O &amp; A</td>
<td></td>
</tr>
<tr>
<td>A</td>
<td></td>
</tr>
<tr>
<td>C</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Debtors’ Program</th>
<th>Application controls</th>
</tr>
</thead>
<tbody>
<tr>
<td>I</td>
<td>P</td>
</tr>
<tr>
<td>O &amp; A</td>
<td></td>
</tr>
<tr>
<td>A</td>
<td></td>
</tr>
<tr>
<td>C</td>
<td></td>
</tr>
</tbody>
</table>

**Abbreviations relating to above:**
- \( I \) = input
- \( P \) = processing
- \( O \) = output
- \( M \) = master file maintenance
- \( O & A \) = occurrence and authorisation (Validity)
- \( A \) = accuracy
- \( C \) = completeness

The illustration above indicates that general controls relate to all applications. If there is a weakness in the general controls, it could affect some or all of the applications.

The following general controls are very popular for tests and exams:

- **System development controls:**
  - You need to know the controls in detail (e.g. project authorisation, project management, approval, training, etc.).

- **Programme change controls:**
  - Know each of the controls and be able to apply it to a given scenario.

- **Access controls:**
  - Know the theory relating to access control as set out in Auditing Notes
  - It is not just passwords!!

- **Continuity of operations:**
  - Including disaster recovery plans, physical elements, back-ups, etc.
ISA 315 par A60 clearly indicates that an entity’s system of internal controls contains both manual and automated elements.

Internal controls in IT systems can be set out as follows:

**Internal controls in IT systems**

**Automated (programmed) controls**

These controls are embedded in computer programs.

Examples include:
- Access controls on the computer, e.g. user names and passwords.
- Programme checks, e.g. limit checks, range checks, size checks, etc.
- Exception reports generated by the computer, etc.

**Manual controls**

**Manual dependent**

These manual controls are performed with the use or assistance of a computer.

Examples include:
- A person using an exception report generated by the computer to follow-up on exceptions.
- A person authorizing reconciliations on the computer via a unique password.

**Manual independent**

These manual controls are performed without the use or assistance of a computer.

Examples include:
- Physical paper reconciliation being authorized by a person.
- A person following up on reconciling items without using a computer.
SECTION B – QUESTIONS ON PLANNING AN AUDIT: OBTAINING AN UNDERSTANDING OF THE CONTROL ENVIRONMENT

QUESTION 1

YOU HAVE 9 MINUTES TO READ THIS QUESTION

Background information

You are a third-year audit trainee at the audit firm TOE Incorporated (TOE). TOE has recently been appointed as the auditor of Top-Electric (Pty) Ltd (Top-Electric).

Top-Electric owns and operates 15 retail stores in South Africa that provide electrical equipment including televisions, DVD players, portable radios, irons, ovens, cordless phones, etc. to the general public. Since its inception in 2005, the company has established itself as the leading conglomerate in South Africa in electrical equipment, offering the public low and competitive prices. Through increased brand awareness and radical marketing strategies, Top-Electric continues to grow in popularity and size.

Top-Electric has succeeded in winning over the South African consumer by fulfilling its promise to provide the widest variety of electrical products at the lowest retail prices. Its continuous battle against inflation-based price escalation has given it the nickname “inflation rebel”.

The financial year end of Top-Electric is 31 March 2014 and the financial director indicated that he would like to have the final audit report on 20 April 2014 at the latest.

You have been assigned by the audit manager to review the controls that Top-Electric currently has in place over the ordering and receiving of goods and to comment on the draft report on significant deficiencies in internal controls. You have been provided with the following working papers and other documentation:

| AA – 1 | Information on the acquisition and payments cycle: Ordering of goods |
| BB – 1 | Information on the acquisition and payments cycle: Receiving of goods |
Information on the acquisition and payments cycle: Ordering of goods

**General**

- Top-Electric's retail stores purchase goods (electrical equipment) over the internet and then sell the goods to the general public.

- Each of the 15 retail stores is responsible for ordering and receiving its own goods. Standardised procedures (stipulated in the Standardised Procedures Manual), established by Top-Electric's management, and should be followed in this regard by the retail stores for consistency purposes.

- Discussions with management at each of the 15 retail stores revealed that only 7 of these retail stores' personnel were aware of the existence of such a manual.

- A predetermined mark-up percentage is added to the purchase price of an item to calculate the selling price to the public. This mark-up percentage is stipulated in the Standardised Procedures Manual.

- The mark-up percentages were last updated in 2011.

**Ordering of goods**

- Top-Electric's management believes that the internet is the best way to do business. They believe that the most competitive prices are obtained through thorough internet research and bulk purchases.

- Each retail store has its own ordering department with a number of order clerks. The number of order clerks depends on the size of the retail store. At this stage there are 16 order clerks at the largest store and 4 order clerks at the smallest store.

- Each order clerk is equipped with a personal computer with internet access. Their main task is to search on the internet for low and competitive prices with discounts on bulk purchases.

- As soon as an order clerk identifies a “bargain” on the internet, that clerk has the authority to immediately place an order with the relevant supplier.

- The order clerk has to obtain an order confirmation document from the supplier, which is then filed in an order file that is kept by each order clerk.

- A copy of this order confirmation is sent to the goods receiving department.
Information on the acquisition and payments cycle: Receiving of goods

Receiving of goods

- The goods receiving department receives a copy of the order confirmations from the ordering department.
- Each of the retail stores has its own goods receiving department and warehouse with a number (depending on the size of the retail store) of goods receiving clerks.
- Upon arrival of the supplier’s delivery vehicle, goods are offloaded into the goods receiving area.
- Any available goods receiving clerk then obtains the delivery note from the supplier’s truck driver and checks that the quantity of the received goods corresponds with the supplier’s delivery note.
- The goods are then transferred to the warehouse.
- Consistent problems with theft have been experienced at six of the retail stores which have led to major losses for Top-Electric. Management is under the impression that the problems are experienced owing to fraudulent activities by some of the company’s personnel. These cases of theft are still under investigation.

REQUIRED

YOU NOW HAVE 45 MINUTES TO ANSWER THIS QUESTION

<table>
<thead>
<tr>
<th>Mark</th>
<th>Question</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>20</td>
<td>1.</td>
<td>Identify the weaknesses and discuss the potential business risks of each weakness relating to the ordering of goods as evident from the background information and working paper AA – 1. Present your answer in a tabular format. Note: Do not include any weaknesses or business risks relating to the use of the internet as part of your answer.</td>
</tr>
<tr>
<td>10</td>
<td>2.</td>
<td>Recommend in detail improvements to the current receiving of goods function of the company as described on working paper BB – 1.</td>
</tr>
</tbody>
</table>

(Unisa: Test 2 2011 – adapted)
SUGGESTED SOLUTION:

1. Weaknesses as well as potential business risks of each weakness relating to the ordering of goods

<table>
<thead>
<tr>
<th>Weaknesses</th>
<th>Potential risks</th>
</tr>
</thead>
<tbody>
<tr>
<td>1.1 Only 7 of the 15 retail stores were aware of the Standardised Procedures Manual. (1)</td>
<td>• Owing to a lack of consistent procedures and controls, possible fraud or other irregularities could go undetected, which could have a negative financial impact on the entity. (1)</td>
</tr>
<tr>
<td>1.2 There appears to be a weak control environment (management at the retail stores seem to have a poor attitude towards and awareness of internal controls). (1)</td>
<td>= potential consequences</td>
</tr>
<tr>
<td>= Existing controls being performed incorrectly</td>
<td></td>
</tr>
<tr>
<td>1.3 The mark-up percentages were last updated in 2011. (1)</td>
<td>• Should the mark-up percentages not be up-dated at regular intervals, there is a potential risk that these percentages are outdated and sales could be made at incorrect prices. (1)</td>
</tr>
<tr>
<td>1.4 Only 7 of the 15 retail stores would be able to use the mark-up percentage as stipulated in the Standardised Procedures Manual. (1)</td>
<td>• The other 8 retail stores are therefore incorrectly pricing goods (not according to company policy). (1)</td>
</tr>
<tr>
<td>= Existing controls being performed incorrectly</td>
<td>• This could have severe financial implications for the entity. (1)</td>
</tr>
<tr>
<td>= potential consequences</td>
<td></td>
</tr>
<tr>
<td>1.5 The order clerks place orders without receiving an authorised requisition based on preset reorder levels or reorder quantities (inventory levels are not checked first). (1)</td>
<td>• Orders might be placed for incorrect or unnecessary goods, resulting in liquidity problems (as the company might purchase goods which they won’t be able to sell) and wastage. (1)</td>
</tr>
<tr>
<td>= Internal controls not being performed at all</td>
<td>• The ordering of unauthorised goods through fraudulent activity could result in major losses for the company. (1)</td>
</tr>
<tr>
<td>= potential consequences</td>
<td></td>
</tr>
<tr>
<td>1.6 Numerous orders could be placed by various order clerks for the same product. (1)</td>
<td>• This could result in large amounts of unnecessary goods, which could lead to liquidity problems (as the company might purchases goods which they want to be able to see) and wastage for the entity. (1)</td>
</tr>
<tr>
<td>= Internal controls not being performed at all</td>
<td>= potential consequences</td>
</tr>
<tr>
<td>1.7 When purchasing goods, an order clerk could perceive something to be a “bargain” when it is not. (1)</td>
<td>• This could lead the entity to pay unnecessarily high prices for goods and could have a negative financial impact. (1)</td>
</tr>
<tr>
<td>1.8 No formal/authorised price lists are available for the order clerks to use when purchasing goods from suppliers. (1)</td>
<td>= potential consequences</td>
</tr>
<tr>
<td>= Internal controls not being performed at all</td>
<td></td>
</tr>
<tr>
<td>1.9 Each order clerk has the authority to immediately place an order with the relevant supplier without prior approval of a supervisor or senior. (1)</td>
<td>• Order forms could be misused, e.g. for placing orders for private purchases. The company could suffer financially as goods that could have been sold to the general public are stolen. (1)</td>
</tr>
<tr>
<td>= Internal controls not being performed at all</td>
<td>= potential consequences</td>
</tr>
</tbody>
</table>

HJB
<table>
<thead>
<tr>
<th>Weaknesses</th>
<th>Potential risks</th>
</tr>
</thead>
<tbody>
<tr>
<td>1.10 There is no list of authorised suppliers to purchase goods from.</td>
<td>• Orders could be placed with unsuitable/unreliable suppliers leading to problems with (1)</td>
</tr>
<tr>
<td>= Internal controls not being performed at all</td>
<td>− unfulfilled orders</td>
</tr>
<tr>
<td></td>
<td>− orders not filled on time</td>
</tr>
<tr>
<td></td>
<td>− unreasonable high prices</td>
</tr>
<tr>
<td></td>
<td>− inferior quality products</td>
</tr>
<tr>
<td></td>
<td>− reputational damage for the entity (Max 2) which could lead to financial losses for the entity.</td>
</tr>
<tr>
<td></td>
<td>= potential consequences</td>
</tr>
<tr>
<td>1.11 There is no isolation of responsibilities, as the order clerks placing the orders do not sign the order confirmation documents. (1)</td>
<td>• Without proper isolation of responsibility, it will be difficult or impossible for management to pinpoint responsibility for orders placed and make it easier for order clerks to place orders for private purposes without being caught. This could lead to losses for the entity. (1)</td>
</tr>
<tr>
<td>= Internal controls not being performed at all</td>
<td>= potential consequences</td>
</tr>
<tr>
<td>1.12 No internal (sequentially numbered) order forms are used. (1)</td>
<td>• It will be impossible to perform a reconciliation of orders placed to order confirmations. This could expose the entity to certain liabilities as the entity will have no proof that an order was not placed. (1)</td>
</tr>
<tr>
<td>= Internal controls not being performed at all</td>
<td>= potential consequences</td>
</tr>
<tr>
<td>1.13 No one follows up on orders placed, e.g. there is no reconciliation of orders placed with order confirmation documents. (1)</td>
<td>• Without a proper follow-up of orders placed and a reconciliation of orders placed with order confirmations, orders might be unfulfilled, not filled on time, filled for the incorrect goods (including quantity) etc. This could negatively impact on the financial position or reputation of the entity. (1)</td>
</tr>
<tr>
<td>= Internal controls not being performed at all</td>
<td>• Should no one follow up on orders placed, orders might take weeks or months to reach the retail stores. As the goods are electrical equipment, some items might become outdated or obsolete in this period, which could lead to losses for the company if these items cannot be resold. (1)</td>
</tr>
<tr>
<td>= Potential consequences</td>
<td>= potential consequences</td>
</tr>
<tr>
<td>1.14 The order confirmation is kept with the order clerk and is not centrally filed. (1)</td>
<td>• Order confirmations could be misfiled or lost, making it impossible for the company to reconcile orders placed with goods received. (1)</td>
</tr>
<tr>
<td>= Existing controls being performed incorrectly</td>
<td>= potential consequences</td>
</tr>
</tbody>
</table>

2. **Recommended improvements to the current receiving of goods function**
   - All the retail stores’ goods receiving departments as well as warehouses should be physically secured and access controlled, e.g.: (1)
     - security cameras
     - locked warehouses
     - security guards (Max 2)
   - Delivery truck drivers should sign an access register (detailing the name of the supplier, date of delivery etc.) at the entrance gate upon arriving and leaving. (1)
It needs to be ensured that there is always a goods receiving clerk available to receive goods (possible time tables).

The goods receiving clerk taking receipt of the delivered goods should:
- ensure that the quality and nature/description of the goods received correspond with the supplier's delivery note; (1)
- ensure that the goods delivered are in good condition (e.g. no items are broken); (1)
- reject all incorrect deliveries (i.e. should not take receipt of incorrect goods) and make a note; (1)
- take receipt of goods, even though the quantity may be short delivered, but make a note of the actual quantity received on the delivery note; (1)
- ensure that the delivery truck driver signs both copies of the delivery note including all rejected items, short deliveries etc.; (1)
- sign both copies of the supplier's delivery notes as acknowledgement of verifying the quantity, quality and description of the goods received; (1)
- prepare a sequentially numbered goods received note and only enter the quantity and description of the items actually accepted; (1)
- sign the goods received note; (1)
- reconcile the delivery note/goods received note with the order confirmation document received from the order clerks (in terms of quantity and description of goods ordered vs goods actually received); (1)
- two people to receive each delivery/check each other/counter sign delivery note and goods received note; and (1)
- on transfer of the goods from the goods receiving area to the warehouse, the following procedure should be followed:
  - the goods receiving clerk should sign the goods out on the goods received note that accompanies the goods to the warehouse; (1)
  - on receipt of the goods at the warehouse the warehouse foreman should check the actual quantity of goods to the goods received note and sign it as proof of receipt. (1)

MARKERS’ COMMENTS

1. Weakness as well as potential business risks of each weakness relating to the ordering of goods

- Students generally struggled with identifying weaknesses:
  - Some students wrote very long paragraphs on what the weakness is, but never managed to actually identify the weakness. Be careful of over emphasising a specific point.
  - One word answers are not sufficient for describing the weakness.
  - Some students wrote things such as “Standard procedures manual” as the weakness. This is NOT a weakness! You need to specifically say that only 7 of the 15 retail stores are aware of this manual and that there appears to be a weak control environment due to this (management has a poor attitude towards internal control).
- The weaknesses did not always correspond to the risks described.
  - Students wrote sentences from the scenario without explaining what the weakness is. For example: “A predetermined mark-up percentage is added to the purchase price of an item”. No marks were given for this as this is again NOT a weakness. The weakness is that these percentages were last updated in 2008.
Students struggled to describe risks.
- No follow through is made in the discussion of the issues as to how these impact on the business, i.e. will lead to a financial loss for the entity.
- Many students only expanded further on the weakness in the risk column without addressing the potential consequence, i.e. risk.
- Some students described the risk perfectly, but did not manage to link it to the correct weakness. This did not earn any marks.

Weaknesses or business risks relating to the use of the internet were specifically not required as set out in the required section of the test. Many students wasted valuable time, without receiving marks, for discussing internet related weaknesses and risks, e.g. access controls etc.

2. **Recommended improvements to the current receiving of goods function**

- This part is basically pure theory on the acquisition and payments cycle.
- Minimal application to the scenario was required.
- Students however did not write nearly enough for 10 marks.
- Many students overspent on their allocated time for part 1 and therefore did not have sufficient time left for part 2.

**QUESTION 2**

YOU HAVE 20 MINUTES TO READ THIS QUESTION

**Background information**

You are a first-year trainee accountant at Motholo & Terblanche Incorporated (Motholo & Terblanche), a medium-sized audit firm in South Africa. Motholo & Terblanche operates from its only office situated in Johannesburg. There have been talks among the directors of the firm to open an office in Bloemfontein and East London once the clientele of Motholo & Terblanche increases.

You are currently involved in the 31 July 2015 year end audit of Billing4U Limited (Billing4U) and have been provided with the following information by your audit senior:

**Understanding of the Entity**

In September 2014, Motholo & Terblanche was appointed for a third term (a term is a five year period) as the statutory auditors of Billing4U. Billing4U was established in 1998 and it was listed on the AltX of the JSE in 2006. Billing4U deals exclusively with providing billing solutions to eight (8) metropolitan municipalities in South Africa. Billing4U bills the residents living in the relevant municipalities for services that include water, electricity and rates on behalf of the municipalities. Billing4U has provided this service to metropolitan municipalities since 2005.
During February 2015, Billing4U changed its software from Billfast X200 to Speedbill 9000 in order to streamline the accounts of the residents for the services provided by the municipalities.

In March 2015 thousands of households in the City of Johannesburg were disconnected from the services provided by the municipality. According to media reports, there were numerous complaints from residents. These complaints included inaccurate and hugely inflated bills. Complaints in other metropolitan municipalities were also reported but they are said to be insignificant compared to the complaints about the City of Johannesburg. The residents of the City of Johannesburg marched in protest to the Mayor’s office demanding that their municipal services be reconnected and for their bills to be corrected. The Mayor of the City of Johannesburg contacted the CEO of Billing4U, Julius Zille, to help deal with the residents’ crisis. Julius Zille knew about these issues after he has received numerous complaints from residents following the implementation of the new billing software system. However, he informed the Mayor that there was no crisis regarding the billing of the residents, as he believed the number of complaints is immaterial to the total number of residents in the City of Johannesburg.

The Mayor independently investigated the matter and found that there are problems within the billing system of Billing4U. The Mayor decided to terminate the contract with Billing4U when it reaches the end of its term on 31 March 2016. The Mayor lodged a lawsuit against Billing4U for the inconvenience caused to the residents of the City of Johannesburg. The lawsuit is set to cost Billing4U R210 million, and the legal team is confident that the ruling will be in favour of the Mayor. Billing4U does not have insurance to cover such lawsuits. The revenue received by Billing4U from the City of Johannesburg is the largest compared to revenue received from other metropolitan municipalities.
Decision and approval to purchase the Speedbill 9000 system

- During August 2014 the Information Technology (IT) director, Mrs Rosa, sent out a questionnaire to the staff members who would be performing billing functions to obtain an understanding of their specific needs and requirements in terms of the new billing system.

- Only Mr Johnson, the Information Technology (IT) manager, replied to this questionnaire. As he is mainly responsible for the effective functioning of the new system, Mrs Rosa decided that Mr Johnson spoke on behalf of all the staff members and she decided not to waste any more time on further queries regarding this matter.

- Mrs Rosa conducted an extensive feasibility study in September 2014. She did some market research and discussed the following matters with the international supplier of the Speedbill 9000 system:
  - all the specifications and requirements of this new billing system versus those of other billing systems (locally and abroad) on the market;
  - all relevant costs associated with this new system (purchase costs as well as implementation and maintenance costs);
  - whether there would be new updated versions of the Speedbill 9000 system in the future, as this is a standard package; and
  - whether the international supplier has a good reputation locally and abroad.

- The international supplier of the Speedbill 9000 system has several branches and offices abroad. However, the South African branch closed down in 2013.

- No problems were identified during the feasibility study conducted by Mrs Rosa.

- Mrs Rosa contacted one company abroad currently using the Speedbill 9000 system. The company indicated that it did not experience any problems, although this company did not provide billing services to municipalities with a customer base of more than 250 residents. Mrs Rosa was of the opinion that if it worked for a customer base of 250 residents, it would work for a customer base of 1.2 million residents as in the case of the City of Johannesburg.

- After a detailed cost–benefit analysis conducted by Mrs Rosa and the financial manager, Mr Kriel, it was decided that the Speedbill 9000 system would be purchased from the international supplier. The purchase was authorised by management as well as the steering committee appointed by management to run the Speedbill 9000 project.
Mrs Rosa was assigned to the conversion process by the steering committee and management. She was appointed as the only member of the “conversion project team”. She was mainly responsible for:

- deciding on an appropriate conversion method;
- setting deadline dates and cut-off points;
- setting time schedules for specific stages of the project;
- allocating specific tasks to appropriate staff members;
- giving clear guidance and support to these staff members as well as time schedules for completion of these tasks;
- regularly monitoring the progress of the process;
- identifying possible problems in the process; and
- reporting to the steering committee at regular intervals.

Mr Johnson was allocated to the training of staff members on the Speedbill 9000 system, as he trained himself in the use of the new system. Due to time constraints, he had brief discussions with the management of each department. He advised management that task descriptions would not have to be changed as each person would still be responsible for the same functions in general.

As part of the preparation for conversion, Mrs Rosa allocated the tedious task of preparing standing data files for the Speedbill 9000 system as well as the task of balancing files on the existing Billfast X200 system to Mr Kriel. She explained that in her opinion Mr Kriel was the financial manager and therefore would know much about making things balance.

After Mr Kriel had performed the above preparation tasks, the data transfer was authorised by management and the steering committee. Supervisors (senior management) were appointed to oversee the conversion. The external auditors, Motholo & Terblanche, also attended the conversion.

A power outage was experienced during the conversion process.

Testing and post-implementation review of the Speedbill 9000 system

It was decided that the system would not be tested after the conversion and that the first month of actual billing to residents would be the test run of the Speedbill 9000 system.

All Speedbill 9000 system flowcharts, system descriptions, operating manuals, etc. either were drawn up or were updated.

Back-ups were made of the new system and they were kept off-site.

A post-implementation review was scheduled for January 2016.
Background information

- Billing4U deals with all residents’ bill disputes, queries and complaints on behalf of its municipalities on a monthly basis. A separate module on the Speedbill 9000 system called “Disputes” is used specifically for this purpose. On average, approximately 1 500 disputes are received in aggregate for all the municipalities on a monthly basis.

Disputes by City of Johannesburg residents

- In the month following the implementation of the Speedbill 9000 system, thousands of disputes on bills were received from the City of Johannesburg residents. It was agreed by the City of Johannesburg and Billing4U that Billing4U would conduct a formal investigation, as the number of disputes were far in excess of the average number of monthly disputes.

- After a full investigation by Billing4U, the following matter was identified as the main cause for the disputes:
  - During the conversion process from the Billfast X200 system to the Speedbill 9000 billing system, a power outage occurred.
  - The power outage took place during the transfer of data files for the City of Johannesburg from the old to the new billing system.
  - As the generator had not been used in several months, it did not function on the day of the power outage.
  - A comparison between the files on the Billfast X200 system and the files on the Speedbill 9000 system for the City of Johannesburg was made as part of the investigation. It was estimated that data on approximately 98 000 residents of the City of Johannesburg were lost, incorrectly transferred or duplicated.

Lodging of formal disputes on bills

- The City of Johannesburg residents were given the option either to lodge a formal dispute personally at one of four Billing4U care centres in the Johannesburg area or to call the Billing4U call centre. Operating hours at the care centres and the call centre were from 08:00 to 18:00 from Monday to Saturday.

- Billing4U employed temporary clerks at each of the four Billing4U care centres, as well as at the call centre to capture the formally lodged disputes on the “Disputes” module. All temporary clerks signed employment contracts what were valid for a period of two months.
Each clerk was allocated a personal computer on which he/she captured the resident's unique account number, the nature of the dispute, etc. directly onto the computer via a keyboard. The date is an auto field.

After capturing the resident’s unique account number, the “Disputes” module automatically retrieves the resident’s details from the Speedbill 9000 master file and displays these on the screen. The system does not allow the clerks to delete or edit resident's master file details.

A reference number, allocated by the “Disputes” module, is given to a resident on receipt of a formal dispute. Reference numbers are allocated sequentially. These numbers are used by Billing4U to track the progress on the specific dispute. The following criteria have to be met in order to receive a reference number:
- The resident has to be a customer of one of the eight metropolitan municipalities.
- The resident has to lodge a formal dispute within 30 days of the invoice date.

The “Disputes” module only allowed the following types of disputes to be captured:
- incorrect stand and physical addresses;
- excessive billing amounts;
- deeds transfers not correctly updated on the Speedbill 9000 system;
- incorrect estimated meter readings;
- bills not received;
- receiving duplicate bills;
- incorrect detail given on bills; and
- services unduly disconnected.

**REQUIRED**

**YOU NOW HAVE 96 MINUTES TO ANSWER THIS QUESTION**

<table>
<thead>
<tr>
<th>Statement</th>
<th>Marks</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. With regards to working paper 2800-1, describe the weaknesses in the procedures followed by Billing4U which relate to the purchase of Speedbill 9000, as well as the conversion, testing and post-implementation review thereof.</td>
<td>25</td>
</tr>
<tr>
<td>2. With regards to working paper 2900-1, describe any additional computerised (programmed) application controls that you would expect to see in order to ensure the: (i) occurrence and authorisation; and (ii) completeness of the lodged disputes by the temporary clerks.</td>
<td>12</td>
</tr>
</tbody>
</table>

(Unisa 2011 Exam – adapted)
SUGGESTED SOLUTION

1. Weaknesses in the procedures followed by Billing4U Ltd, which relate to the purchase, conversion, testing and post-implementation of Speedbill 9000.

<table>
<thead>
<tr>
<th>Information from the scenario to which the weakness relates (DOES NOT COUNT MARKS)</th>
<th>Weaknesses</th>
</tr>
</thead>
<tbody>
<tr>
<td>Decision and approval to purchase the Speedbill 9000 system</td>
<td>Mrs Rosa only sent out the questionnaire to staff members who would be performing billing functions on the new system and therefore did not take the needs and requirements of the following parties into account: (1) – the IT staff members of Billing4U; – the internal auditors of Billing4U; or – the external auditors, Motholo &amp; Terblanche, Max (2) A questionnaire might not be sufficient to determine all user needs and requirements relating to the new system e.g. input, procedures, calculations, output, reports, audit trails, etc. Have all of these issues been dealt with in the questionnaire? (1)</td>
</tr>
<tr>
<td>Only Mr Johnson, the Information Technology (IT) manager replied to the questionnaire in terms of specific needs and requirements with regards to the new system. As he is mainly responsible for the effective functioning of the new system, Mrs Rosa decided that Mr Johnson spoke on behalf of all the staff members and she decided not to waste any more time on further queries regarding this matter.</td>
<td>Mrs Rosa decided that Mr Johnson (the IT manager) spoke on behalf of all staff members and therefore did not take the needs and requirements of any users who would be performing the actual billing functions on the Speedbill 9000 system into account. (1) Management of each user department did not authorise or approve the final specifications/needs/requirements of the Speedbill 9000 system. (1)</td>
</tr>
<tr>
<td>No problems were identified during the feasibility study conducted by Mrs Rosa. The international supplier of the Speedbill 9000 system has several branches and offices abroad. The South African branch closed down in 2009.</td>
<td>No alternative suppliers of similar systems were considered. (1) Mrs Rosa did not identify any issues from the matters investigated in the feasibility study, but she neglected to raise the issue that the supplier does not have a branch in South Africa: – this could have a serious impact on the assistance and support being offered by the supplier; or (1) – it could indicate that the software is not appropriate for the South African market. (1)</td>
</tr>
<tr>
<td>Mrs Rosa discussed certain matters with the international Supplier of the Speedbill 9000 system.</td>
<td>A system purchased abroad, might not cater for specific South African requirements (e.g. VAT and other specific tax requirements). (1) As it is a standard package, it might not be tailor-made for Billing4U’s requirements and might not be adaptable for changes. (1) A supplier can’t objectively evaluate itself. (1)</td>
</tr>
<tr>
<td>Information from the scenario to which the weakness relates (DOES NOT COUNT MARKS)</td>
<td>Weaknesses</td>
</tr>
<tr>
<td>---</td>
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</tr>
<tr>
<td>Mrs Rosa contacted one company abroad currently using the Speedbill 9000 system.</td>
<td>Mrs Rosa only contacted one company abroad that uses the Speedbill 9000 system and based her conclusion that the system would work for Billing4U on only this company’s experiences. (1) This company is abroad and therefore may not experience the same problems unique that are to a South African company. (1)</td>
</tr>
<tr>
<td>The company abroad, which Mrs Rosa contacted, identified no problems although it does not provide billing services to municipalities with a customer base of more than 250 residents. Mrs Rosa is of the opinion that “if it works for a customer base of 250 residents, it will work for a customer base of 1,2 million residents”</td>
<td>The company abroad using the Speedbill 9000 system only provides billing services to municipalities with a customer base of not more than 250 residents. This company is therefore not a good benchmark seeing that Billing4U’s biggest client has a customer base of approximately 1,2 million residents. (1) The processing speed and storage functions of the Speedbill 9000 system, might not be sufficient to cater for 1,2 million residents. (1)</td>
</tr>
<tr>
<td>The purchase was authorised by management as well as the steering committee appointed by management to run the Speedbill 9000 project.</td>
<td>Only management and the steering committee approved the purchase of the Speedbill 9000 system without the users, IT staff, internal auditors, etc. approving it after the results of the feasibility study and recommendations have been considered. (1) The board of directors did not authorise the purchase of the software, despite the system’s major operational and financial impact. (Bonus)</td>
</tr>
</tbody>
</table>

**Conversion from the Billfast X200 system to the Speedbill 9000 system**

- Management and the steering committee assigned Mrs Rosa to the conversion process. She was appointed as the only member of the “conversion project team”.
- She was mainly responsible for:
  - Deciding on an appropriate conversion method.
  - Setting deadline dates and cut-off points.
  - Setting time schedules for specific stages of the project.
  - Allocating specific tasks to appropriate staff members.
  - Giving clear guidance and support to these staff members as well as time schedules for completion of these tasks.
  - Regularly monitoring the progress of the process.
  - Identifying possible problems in the process.
  - Reporting to the steering committee at regular intervals.
- A project team (with appropriate IT and user staff members) was not formed by the steering committee as only Mrs Rosa was assigned to the conversion process (the only member of the “conversion project team”). (1) Mrs Rosa was solely responsible for all the tasks allocated to her by the steering committee and a lack of involvement/ownership by other people. She might not have:
  - The required knowledge or experience to perform all these tasks. (1)
  - Sufficient time to perform the tasks to the required standard. (1)
<table>
<thead>
<tr>
<th>Information from the scenario to which the weakness relates (DOES NOT COUNT MARKS)</th>
<th>Weaknesses</th>
</tr>
</thead>
<tbody>
<tr>
<td>• As part of the preparation for conversion, Mrs Rosa allocated the tedious task of preparing standing data files on the Speedbill 9000 system as well as the task of balancing files on the Billfast X200 system to Mr Kriel. She explained that in her opinion “Mr Kriel is the financial manager and therefore knows a lot about making things balance”.</td>
<td>• The task of preparing standing data files on the Speedbill 9000 system as well as the task of balancing files on the Billfast X200 system was allocated to Mr Kriel, the financial manager. He probably does not have the required skills, knowledge or expertise to perform these technical IT functions. (1)</td>
</tr>
<tr>
<td>• Mr Johnson was allocated to the training of staff members on the Speedbill 9000 system as he trained himself in the use of the new system.</td>
<td>• As Mr Johnson trained himself in the use of the new system, he might not be capable of providing sufficient training on the Speedbill 9000 system (he did not receive proper training himself). (1) • No formal programme was devised setting out the detail of all personnel to be trained, dates and times for the training etc. (1) • User procedure manuals were not used for the training as only quick discussions were held. (1)</td>
</tr>
<tr>
<td>• Due to time constraints, he had brief discussions with the management of each department.</td>
<td>• Brief discussions with management of each department are not adequate training as all staff members were not individually trained regarding their specific tasks and functions. (1) • Time constraints indicate poor planning and/or monitoring of the process from purchase until final implementation. (1)</td>
</tr>
<tr>
<td>• Mr Johnson advised management that job descriptions would not have to be changed as each person would still be responsible for the same tasks.</td>
<td>• Clearly defined and updated job descriptions were not used as part of the training exercise. (1)</td>
</tr>
<tr>
<td>• A power outage occurred during the conversion process.</td>
<td>• As a power outage occurred during the conversion process, the premises of Billing4U were clearly not adequately prepared in terms of disaster recovery procedures etc. (1) • There were no data recovery procedures. (1)</td>
</tr>
</tbody>
</table>
| • It was decided that the system would not be tested after the conversion and that the first month of actual billing to residents would be the test run of the Speedbill 9000 system. | • It seems as though the following controls over preparation and entry of data were not performed as the system was not tested: (1) − A comparison between the files on the Billfast X200 system and the files on the Speedbill 9000 system. − All discrepancies identified investigated. − Record counts, control totals or hash totals used in the reconciliation of the old to the new system. − Exception reports on problems identified obtained and investigated. − User approval for data converted (in terms of each user department). − Obtaining direct confirmation from the municipalities of information reflecting on the new system. Max (4)
2. The computerised (programmed) application controls you would expect to see to ensure the following:

(i) The occurrence and authorisation (validity) of the capturing of lodged disputes by the temporary clerks.

<table>
<thead>
<tr>
<th>Information from the scenario to which the application control relates (DOES NOT COUNT MARKS)</th>
<th>Computerised application control over input – occurrence and authorisation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Occurrence and authorisation</td>
<td>Computerised access controls</td>
</tr>
<tr>
<td>• Billing4U employed temporary clerks at each of the four care centres as well as at the call centre to capture the formally lodged disputes on the “Disputes” module.</td>
<td>• Temporary access should be given to the temporary clerks, which should be valid for a period of 2 months (after this period it should be automatically disabled). (1)</td>
</tr>
<tr>
<td>• Employment contracts valid for a period of 2 months were signed by all temporary clerks.</td>
<td>• A temporary user Identification (ID) number and password should be allocated to the clerks on only the Speedbill 9000 “Disputes” module. (1)</td>
</tr>
<tr>
<td>• Operating hours at the care centres and the call centre were from 08:00 to 18:00 from Monday to Saturday.</td>
<td>• Restricted access in terms of user profiles/access tables at both “Disputes” programme level as well as Speedbill 9000 system level should be in place. A CRUD matrix (create, read only, update and/or delete) could be used for this purpose. (1)</td>
</tr>
<tr>
<td>• The system does not allow the clerks to delete resident’s details derived from the master file.</td>
<td>• The module should check that the chosen password conforms with best practices. (1)</td>
</tr>
<tr>
<td>• Each clerk was allocated a personal computer on which the clerk did capturing via a keyboard.</td>
<td>• Clerks should only be allowed access to the system during operating hours from 08:00 to 18:00, Monday to Saturday. (1)</td>
</tr>
<tr>
<td></td>
<td>• The personal computer (PC) on which the clerk does the capturing should shut down when an access violation takes place (e.g. incorrect user ID or password is entered three times). (1)</td>
</tr>
<tr>
<td>Information from the scenario to which the application control relates (DOES NOT COUNT MARKS)</td>
<td>Computerised application control over input – occurrence and authorisation</td>
</tr>
<tr>
<td>---</td>
<td>---</td>
</tr>
</tbody>
</table>
| • The following criteria have to be met in order to receive a reference number:  
  - The resident has to be a customer of one of the eight metropolitan municipalities.  
  - The resident has to lodge a formal dispute within 30 days of invoice date. | • The following checks should be performed by the computer:  
  - Limit check: e.g. that the complaint is lodged within 30 days of invoice date.  
  - Range check: e.g. the resident’s account number falls within the minimum and maximum ranges for a customer of one of the eight metropolitan municipalities.  
  - Verification check: e.g. the computer should verify that the resident lodging the complaint is indeed a customer of one of the eight metropolitan municipalities by verifying the resident’s account number to the Speedbill 9000 master file data.  
  - The computer should give an error message if an error is noted during any of the above program checks.  
  - A message box should appear after entry of the resident’s account number instructing the clerk to verify the resident master file details before continuing, to ensure the correct resident is being dealt with.  
  - There should be an alternative method of obtaining the resident’s account number, e.g. through a look-up facility.  
  - If another complaint already exists, that complaint should be opened, or an exception report of multiple claims per month should automatically be generated. | (1) | (1) | (1) | (1) | (1) | (1) | (1) | (1) | (1) | (1) | (1) |
| • The “Disputes” module only allowed the following types of disputes to be captured:  
  - Incorrect stand and physical addresses.  
  - Excessive billing amounts.  
  - Deeds transfers not correctly updated on the Speedbill 9000 system.  
  - Incorrect estimated meter readings.  
  - Bills not received.  
  - Receiving duplicate bills.  
  - Incorrect detail given on bills.  
  - Services unduly disconnected. | • A drop-down list should be available on the capturing screen for the clerk to choose from the various types of complaints.  
  - There should be standardised fields for the capturing of additional information, depending on the type of dispute selected. | (Bonus) | (Bonus) | (Bonus) | (Bonus) | (Bonus) | (Bonus) | (Bonus) | (Bonus) | (Bonus) | (Bonus) | (Bonus) |

Available 14  
Maximum 11
(ii) The completeness of the capturing of lodged disputes by the temporary clerks.

<table>
<thead>
<tr>
<th>Information from the scenario to which the application control relates (DOES NOT COUNT MARKS)</th>
<th>Computerised application control over input – completeness</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Completeness</strong></td>
<td></td>
</tr>
<tr>
<td>• A reference number, allocated by the “Disputes” module, was given to a customer on receipt of the formal dispute. This number was used by Billing4U to track the progress on the specific dispute.</td>
<td>• The “Disputes” module should follow up on the sequence of the reference numbers and report any missing numbers (possibly through an exception report). (1)</td>
</tr>
<tr>
<td>• Each clerk was allocated a personal computer on which the clerk captured the resident number, the date of lodging the dispute, the nature of the dispute etc., directly via a keyboard.</td>
<td>• Field presence checks (missing data checks) should be in place to ensure that all critical input fields (mandatory fields) are present e.g. the resident number and the drop-down box for the nature of the dispute should be present and completed before a reference number is allocated. (1)</td>
</tr>
</tbody>
</table>

Available 2
Maximum 2

Presentation: layout (table) - Part 1 (1) - Part 2 (1)

**MARKERS’ COMMENTS**

**Part 1**

- Students quoted the words from the scenario when identifying a weakness, rather than interpreting the information at a higher level.
- Answers were often in the format of recommendations.
- The obvious weaknesses were often identified, but many students failed to identify the more difficult weaknesses.
- Students did not seem to understand the difference between testing a conversion and testing software developed from scratch.

**Part 2**

- Students recommended many manual controls despite being asked for computerised controls.
- Many students listed edit checks without applying these to the case study.
- The edit checks used and the description thereof often did not match.
- Students obtained most of their marks from writing down access controls and not from recommending controls pertaining specifically to this case study.
Many students recommended controls that were not applicable to the scenario.

Many students did not understand the system where information is received via telephone. Students instead reverted back to generic manual controls as per the standard transaction cycles.

Students did not seem to understand the risks involved in the case study and the effect thereof on the specific controls.

Many students formulated audit procedures to test the system controls, rather than writing down the recommended controls.
# SELF-ASSESSMENT QUESTIONS

## Part 1

### APPLIED QUESTIONS ON AUDITING, 7TH EDITION

Please attempt the following questions included in Applied Questions on Auditing, seventh edition. The suggested solutions to these questions are included alongside the questions in the Applied Questions, seventh edition.

<table>
<thead>
<tr>
<th>Chapter</th>
<th>Question</th>
<th>Name</th>
<th>Topic</th>
<th>Marks</th>
<th>Reading time (minutes)</th>
<th>Writing time (minutes)</th>
</tr>
</thead>
<tbody>
<tr>
<td>2</td>
<td>1 Part A (a)</td>
<td>Wires (Pty)</td>
<td>Pre-engagement activities</td>
<td>10</td>
<td>3</td>
<td>15</td>
</tr>
<tr>
<td>2</td>
<td>3</td>
<td>Banting Ltd</td>
<td>Risk at financial statement level</td>
<td>40</td>
<td>12</td>
<td>60</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>Risk at assertion level</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>Auditing planning</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>3</td>
<td>2</td>
<td>Swimsons (Pty) Ltd</td>
<td>Control weaknesses and key controls (purchases cycle)</td>
<td>30</td>
<td>9</td>
<td>45</td>
</tr>
<tr>
<td>3</td>
<td>7</td>
<td>Client Ltd</td>
<td>Understanding of the entity (key internal controls)</td>
<td>60</td>
<td>18</td>
<td>90</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>Planning activities (audit strategy)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>Risk and audit response in a computerised environment</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>Understanding of the entity (business risk)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>3</td>
<td>11</td>
<td>Wingding (Pty) Ltd</td>
<td>Internal control in a computerised environment</td>
<td>40</td>
<td>12</td>
<td>60</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>(application controls – invoice generation, masterfile amendment controls, internet use controls)</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
Part 2

The following questions are included in this tutorial letter. The questions are extracts from previous Unisa tests, Unisa examinations and SAICA examinations. Please note that the reading and writing time were rounded up. As per SAICA you receive 30 minutes reading time for a 100 mark question and two and a half hours writing time.

<table>
<thead>
<tr>
<th>NR</th>
<th>Name</th>
<th>SOURCE</th>
<th>Topics covered</th>
<th>MARKS</th>
<th>READING TIME (minutes)</th>
<th>WRITING TIME (minutes)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1.</td>
<td>Ngwato &amp; Phahla</td>
<td>Unisa Test 2 – 2013</td>
<td>Audit plan. Risks at overall financial statement level. Planning materiality</td>
<td>40</td>
<td>12</td>
<td>60</td>
</tr>
<tr>
<td>2.</td>
<td>Maroteng</td>
<td>Unisa Test 2 – 2014</td>
<td>Application controls, risk at overall financial statement level and assertion level, audit response</td>
<td>40</td>
<td>12</td>
<td>60</td>
</tr>
<tr>
<td>3.</td>
<td>Electrocar</td>
<td>Unisa Test 1 – 2015</td>
<td>Audit risks, weaknesses wages systems, general computer controls</td>
<td>40</td>
<td>12</td>
<td>60</td>
</tr>
<tr>
<td>4.</td>
<td>Energy Solutions Ltd</td>
<td>Unisa Test 1 – 2016</td>
<td>Risk at overall financial statement and assertion level, internal control and application controls</td>
<td>40</td>
<td>12</td>
<td>60</td>
</tr>
<tr>
<td>5.</td>
<td>Jet Air</td>
<td>Unisa Supplementary exam AUE 4862 – adapted</td>
<td>Weaknesses and application controls</td>
<td>25</td>
<td>8</td>
<td>38</td>
</tr>
<tr>
<td>6.</td>
<td>Save-a-Lot</td>
<td>Unisa exam AUE4861 2012 – adapted</td>
<td>Masterfile weaknesses and controls</td>
<td>27</td>
<td>9</td>
<td>41</td>
</tr>
</tbody>
</table>

**COMMENT**

We recommend that you approach these questions in the same way you would in a test and examination. Read the scenario first for the time allocated prior to reading the requirements. Do not look at the requirements until your reading time is up. Once the reading time is up, read the requirements, plan your answers and write down your answers the same way you would in a test and examination. You should write down your answers in the time allocated (writing time). You need to stick to the writing time so you can train yourself on speed and adhering to time. When writing out your answers please do not refer to the suggested solution until you are done writing. Once you have finished writing your answers down please refer to the suggested solution of which you would use to mark yourself. When marking yourself you should pay attention to the following:
Points included in our suggested solution that you did not include when writing your answers. You should pay attention to these points as they are an area of concern to you. You will need to identify why you omitted to write these points from your solution. During this process you will easily identify and be able to explain why you missed some of these points in your solution. Make note of these points so that you don’t repeat the same mistake of omitting to write them (when applicable) in a test or examination. Some points however, might require you to read the requirement and scenario again to identify what has led to the point being included in the suggested solution. If you are still not certain as to why the points are included in the suggested solution please refer to the markers comments included under the suggested solution for a possible explanation. If you are then still not clear of the reason for the inclusion of some points in the suggested solution, please do not hesitate to contact us.

Points that you have written in your answer but that do not form part of our suggested solution. In this instance you will follow the same process as indicated in the above comment.

Please spend more time when marking yourself and don’t get anxious. This is when the real learning occurs. Don’t be discouraged by the low marks when attempting these questions. These questions are included to evaluate the knowledge you have and assist you in identifying areas to which you need to pay more focus and attention prior to the test and exam.

QUESTION 1  
40 marks

YOU HAVE 12 MINUTES TO READ THIS QUESTION

You are a trainee accountant at Kgopa & Associates Inc. (K&A), a firm of Registered Auditors responsible for the audit of Ngwato & Phahla (Pty) Ltd (N&P) for the year ended 31 March 2013.

An extract from the audit planning file describing N&P’s history and operations is shown below.

Extract from the audit planning file

N&P was incorporated 20 years ago. It was founded by Albert Ngwato, who established a small pottery making tableware such as dishes, plates and cups. The products quickly grew popular, with one range of products becoming highly sought after when it was used at a royal wedding. The company’s products have retained their popularity over the past two decades, and the brand enjoys a strong identity and good market share. N&P has a history of steady profitability and stable management.
You have received an email (included below) from Gustav Mahlare, the audit engagement partner.

From: gustav.mahlare@kgopaass.co.za  
Sent: Thursday 28 February 2013:11:50  
To: thabo.monare@kgopaass.co.za  
Subject: N&P audit planning

Dear Thabo

I have just been to a meeting with Charles Modise, the finance director of N&P; we were discussing recent events which will have a bearing on your forthcoming audit. One of the issues discussed is the acquisition of a 90% interest in Bauba (Pty) Ltd (Bauba) earlier this year, which is considered a significant component of N&P. Our firm has been appointed as auditor of Bauba, which also has a year ending 31 March 2013. The terms of the engagement have been agreed with the client. We need to start planning the audits of N&P and Bauba as soon as possible to ensure that we conduct a quality audit and meet the audit deadlines.

Regards

Gustav Mahlare CA(SA), RA  
Partner  
Kgopa & Associates Inc.

Please consider the environment before printing this email.

Your firm has audited N&P for the past five years. Bauba was audited by Nameng Inc., a firm of Registered Auditors for the year ended 31 March 2012.

Acquisition of interest in Bauba (Pty) Ltd

The most significant event for N&P this year was the acquisition of Bauba which took place on 1 October 2012. N&P purchased 90% of Bauba's equity shares for a cash consideration of R125 million, and a further contingent consideration of R30 million that will be paid on the third anniversary of the acquisition, if N&P's net profit before tax grows by 8% per annum. N&P engaged an external consultant to perform a due diligence on Bauba and to measure the non-controlling interest. His report estimated the fair value of Bauba's net assets to be R140 million and the non-controlling interest to be R12 million at the date of acquisition. It is the group's policy to measure non-controlling interest at fair value.

Goodwill arising on the acquisition has been calculated as follows:

<table>
<thead>
<tr>
<th>R million</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash consideration</td>
</tr>
<tr>
<td>Contingent consideration</td>
</tr>
<tr>
<td><strong>Fair value of consideration</strong></td>
</tr>
<tr>
<td>Non-controlling interest</td>
</tr>
<tr>
<td>Less: Fair value of identifiable net assets acquired</td>
</tr>
<tr>
<td><strong>Goodwill</strong></td>
</tr>
</tbody>
</table>
Bauba manufactures pottery figurines and ornaments. All manufacturing operations are based in Silverton, Pretoria. The company is considered a good strategic investment to the group, as its products are luxury items like those of N&P. The acquisition of Bauba will enable the group to diversify into a different market. Approximately 30% of Bauba’s sales are made to foreign customers. Foreign customers settle their accounts using their respective currencies. Prior to the acquisition, Bauba operated as a single company, this is the first year that it is part of a group of companies.

Inventory

Inventory as at 31 March 2013:

<table>
<thead>
<tr>
<th></th>
<th>Ngwato &amp; Phahla (Pty) Ltd</th>
<th>Bauba (Pty) Ltd</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>R million</td>
<td>R million</td>
</tr>
<tr>
<td>Raw materials</td>
<td>8</td>
<td>4</td>
</tr>
<tr>
<td>Work in progress</td>
<td>6</td>
<td>3</td>
</tr>
<tr>
<td>Finished goods</td>
<td>5.8</td>
<td>2.9</td>
</tr>
<tr>
<td>Consumables</td>
<td>0.2</td>
<td>0.1</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>20</strong></td>
<td><strong>10</strong></td>
</tr>
</tbody>
</table>

Raw materials used to manufacture luxury pottery figurines and ornaments are purchased from suppliers in Europe. These suppliers invoice Bauba in Euro’s. Raw materials are normally delivered by sea and small orders can be delivered by plane in emergencies. At year end there was inventory to the value of R950 000 at sea. This inventory was purchased free-on-board (FOB) terms. Work in progress for the group at 31 March 2013 was valued by Bauba’s production manager based on the estimated stage of completion of each product. Work in progress consists of direct materials, direct labour and allocated manufacturing overheads.

Financial performance and position of N&P and Bauba

For the period ending 31 March 2013, some indicators of the financial performance and position are as follows:

<table>
<thead>
<tr>
<th></th>
<th>Ngwato &amp; Phahla (Pty) Ltd</th>
<th>Bauba (Pty) Ltd</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>R million</td>
<td>R million</td>
</tr>
<tr>
<td>Revenue (actual)</td>
<td>149</td>
<td>42</td>
</tr>
<tr>
<td>Revenue (budget)</td>
<td>135</td>
<td>38</td>
</tr>
<tr>
<td>Gross Profit (actual)</td>
<td>80</td>
<td>20</td>
</tr>
<tr>
<td>Profit before tax (actual)</td>
<td>22</td>
<td>12</td>
</tr>
<tr>
<td>Profit before tax (budget)</td>
<td>20</td>
<td>11</td>
</tr>
<tr>
<td>Total assets</td>
<td>250</td>
<td>140</td>
</tr>
</tbody>
</table>

Note:
- Revenue is earned evenly throughout the year.
- Bauba’s results are for the six month period beginning on 1 October 2012 (date of acquisition). N&P’s results are for the year ended 31 March 2013.
- For group purposes, any component greater than 15% of actual consolidated revenue is considered to be a significant component.
Government grant and other matters

N&P received a grant of R35 million on 1 September 2012 in relation to the redevelopment of its main manufacturing site. The government is providing grants to companies for capital expenditure on environmentally friendly assets. N&P has spent R25 million of the grant received on solar panels to operate electrical machines to generate electricity in their production process. The remaining grant will be spent within a year on upgrading its production and packaging lines. In terms of a signed agreement with the government, if the grant is not spent within a year it must be repaid. It is the group’s accounting policy to recognise government grants as deferred income. Assume that the government grant is taxable. N&P’s finance director has limited knowledge of the International Financial Reporting Standards (IFRS) and this is his first time preparing consolidated financial statements. The group adopts IFRS.

Additional audit notes

K&A applies the following percentages in calculating materiality for N&P and Bauba:

- Revenue: 1½%
- Gross profit: 1%
- Profit before tax: 2%
- Total assets: 1½%

REQUIRED

YOU HAVE 60 MINUTES TO ANSWER THIS QUESTION

| (a) | Describe the effect that N&P’s acquisition of the interest in Bauba (Pty) Ltd will have on the audit planning for the 2013 financial statements audit of Bauba (Pty) Ltd. | 6 |
|     | Communication skills: clarity of expression | 1 |

| (b) | As part of the formulation of your overall group audit strategy and the development of your group audit plan; | Marks |
|     | (i) Identify the risks of material misstatement at the overall financial statement level relating to the company and group financial statements of Ngwato & Phahla (Pty) Ltd for the year ended 31 March 2013. | 6 |
|     | (ii) Briefly describe your proposed overall audit responses to address the risks identified in part (b) (i) above. | 4 |
|     | Note: Detailed audit procedures are not required as part of your audit responses. | |
|     | (iii) Identify the risks of material misstatement at the assertion level relating to the company and group financial statements of Ngwato & Phahla (Pty) Ltd for the year ended 31 March 2013 on the following: | 12 |
|     | • Goodwill | |
|     | • Revenue | |
|     | • Inventory | |
|     | • Government grant. | Communication skills: proper identification of risks | 1 |

| (c) | Calculate and discuss the planning materiality that should be used for the audit of Bauba (Pty) Ltd for the year ending 31 March 2013. | 10 |
BACKGROUND INFORMATION AND INFORMATION RELEVANT TO THE AUDIT:

You are an audit trainee at Tsebang Auditors Inc. (Tsebang). You are currently part of the audit team on the external audit of Maroteng Construction Ltd (Maroteng), a new audit client of Tsebang. Maroteng is listed on the Johannesburg Securities Exchange (JSE). The previous audit firm, Mlotshwa & Associates, were requested to resign at the end of the 2013 audit. The resignation was prompted by the issue of an adverse opinion.

Maroteng’s operations focus on the development and construction of properties and they undertake various construction projects countrywide. Maroteng develop properties in all the provinces of South Africa and its head office is situated in Sandton. You received the financial statements from the Chief Financial Officer (CFO). The CFO however has a problem with understanding IFRS and how to account all the accounting issues in the required manner. The following are extracts of the financial statements of Maroteng.

Extract of statement of profit or loss and other comprehensive income for the year ended 28 February 2014

<table>
<thead>
<tr>
<th>Description</th>
<th>Additional Notes</th>
<th>R’000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Gross profit</td>
<td></td>
<td>27 000</td>
</tr>
<tr>
<td>Operating expenses</td>
<td>1.1</td>
<td>(30 500)</td>
</tr>
<tr>
<td>Operating profit / (loss)</td>
<td></td>
<td>(3 500)</td>
</tr>
<tr>
<td>Finance costs</td>
<td></td>
<td>(1 250)</td>
</tr>
<tr>
<td><strong>Loss for the year</strong></td>
<td></td>
<td>(4 750)</td>
</tr>
</tbody>
</table>

Extract of the statement of financial position as at 28 February 2014

<table>
<thead>
<tr>
<th>Description</th>
<th></th>
<th>R’000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Non-current assets</td>
<td></td>
<td>80 000</td>
</tr>
<tr>
<td>Property, plant and equipment</td>
<td>1.2</td>
<td>80 000</td>
</tr>
<tr>
<td>Current assets</td>
<td></td>
<td>45 000</td>
</tr>
<tr>
<td>Inventory</td>
<td>1.3</td>
<td>26 000</td>
</tr>
<tr>
<td>Trade and other receivables</td>
<td></td>
<td>8 000</td>
</tr>
<tr>
<td>Cash and cash equivalents</td>
<td></td>
<td>11 000</td>
</tr>
<tr>
<td><strong>Total assets</strong></td>
<td></td>
<td>135 000</td>
</tr>
</tbody>
</table>
1. Additional notes to the extracts of the financial statements of Maroteng

1.1 Operating expenses

Operating expenses include a R4.5 million provision, relating to a potential fine that is payable to the Advertising Standards Regulatory Authority (ASA) of South Africa, for alleged inappropriate claims that were made in an advertising campaign. The fine is being disputed and Maroteng expect to receive the courts judgement by the end of April 2014.

1.2 Property, plant and equipment

Included in property, plant and equipment is the head office building, motor vehicles, machinery and office equipment. All items of property, plant and equipment are held for the use thereof in the production, supply of services and/or for administrative purposes. The head office building was damaged by heavy rain and floods which occurred countrywide on 14 February 2014. It is the accounting policy of Maroteng to value the head office building using the revaluation model and to value all the other items of property, plant and equipment at the cost model. The recent valuation of the head office building was performed by Mr Peter Ramabu, a recently qualified property valuer.

1.3 Inventory comprise of:

<table>
<thead>
<tr>
<th>Description</th>
<th>R</th>
</tr>
</thead>
<tbody>
<tr>
<td>Construction raw materials on site</td>
<td>5 200</td>
</tr>
<tr>
<td>Construction work in progress</td>
<td>7 800</td>
</tr>
<tr>
<td>Finished inventory (properties)</td>
<td>10 400</td>
</tr>
<tr>
<td>Consumables</td>
<td>2 600</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>26 000</strong></td>
</tr>
</tbody>
</table>

Construction raw materials on site are used to develop properties, it's purchased from local suppliers and are delivered by train. At year end construction raw materials to the value of R1 million were still on a train.

Construction work in progress consists of direct raw material, direct labour and allocated manufacturing overheads. Construction work in progress at 28 February 2014 was valued by Maroteng’s newly appointed engineer, Mr Werner Kruger, who based the valuation on the estimated stage of completion of each property under development. Up to 28 February 2013, the previous auditors made use of an independent external property valuator to provide them with a valuation report of the construction work in progress.

Finished inventory consist of the cost of all the completed properties and consumables consists of small tools.

1.4 Financial reporting framework

The financial statements are prepared according to the International Financial Reporting Standards (IFRS).
2. Other matters

2.1 Business review

Maroteng is facing difficult trading conditions. Consumer spending declined due to high interest rates in the economy. The construction and property industry remains very competitive and a major competitor has launched a very successful range of new low cost houses during the year, which led to a significant decline of Maroteng’s revenue.

2.2 Financial matters

Cash flow has been a problem this year, largely due to the cash that was spent on developing new houses. An increase in Maroteng’s bank overdraft was negotiated in December 2013 to finance working capital.

2.3 Directors remuneration

Maroteng’s Remuneration Committee determines the executive directors’ remuneration. A significant element of the performance bonus payable to the executive director’s, is linked to Maroteng’s profit before tax.

3. Internal control system over the acquisitions and payments cycle

Pheladi Mampuru, a third year trainee accountant at Tsebang, documented the following system description of the acquisitions and payments cycle in the audit planning file:

3.1 Acquisitions and payments

A detailed requisition list of raw materials required for each project is prepared in advance by a quantity surveyor, which is then approved by the construction manager, Hlabirwa Phala. A copy of the list of raw materials are then sent to the building site and the original list is filed.

Maroteng has a policy of not working on more than eight projects simultaneously. The project foreman and the project manager are responsible for the development of the houses. Once a project has been completed, that team starts with the next project. This enables Maroteng to allocate eight administrative teams of three members each to a project. The administrative team is responsible for all acquisitions and payments of suppliers, the payment of wages and the maintenance of inventory records. The senior administrative clerk is responsible for the acquisition of raw materials as well as the payment thereof. When the need arises, the foreman requests the senior administrative clerk to make out a requisition for raw materials. The senior administrative clerk then compares the requisition received from the foreman with the raw material requisition list and only thereafter places the order telephonically with the supplier. The senior administrative clerk may place the order with any supplier of his choice.

All purchases are made on credit. Upon receipt of the inventory, the senior administrative clerk counts the inventory, then signs a delivery note and keeps a copy thereof for administrative purposes. When the invoice is received the senior administrative clerk matches the invoice with the delivery note and files it for payment. On the 20th of each month the senior administrative clerk prepares a monthly list of all payable invoices for that particular month. The monthly list contains the creditor’s name, account number due and the payable amount. This list is then faxed to head office in order to process the payment. The payments to the suppliers are done on the 25th of each month.
The other two clerks are respectively responsible for the payment of wages and the maintenance of the inventory records.

**REQUIRED**

**YOU HAVE 60 MINUTES TO ANSWER THIS QUESTION**

<table>
<thead>
<tr>
<th>(a) Describe the automated application controls that Maroteng Construction Ltd will have to implement over the creditors masterfile.</th>
<th>Marks</th>
</tr>
</thead>
<tbody>
<tr>
<td>(b)(i) Describe the risks of material misstatement at the overall financial statement level of Maroteng Construction Ltd for the year ended 28 February 2014.</td>
<td>11</td>
</tr>
<tr>
<td>(b)(ii) For each of the risks identified above (b)(i), describe the most appropriate audit response to eliminate or reduce the risks to an acceptable level. Present your answer in a tabular format as follows:</td>
<td>7</td>
</tr>
<tr>
<td><strong>Risk of material misstatement</strong></td>
<td><strong>Most appropriate audit response</strong></td>
</tr>
<tr>
<td>Note: <em>Detailed audit procedures should not be provided when formulating the audit response.</em></td>
<td>1</td>
</tr>
<tr>
<td>Communication skills: Proper linking of the audit responses with the risks</td>
<td></td>
</tr>
<tr>
<td>(c) Describe the risks of material misstatement for inventory and the head office building, at the assertion level of Maroteng Construction Ltd for the year ended 28 February 2014.</td>
<td>11</td>
</tr>
<tr>
<td>Note: <em>Discussion of risks relating to presentation and disclosure are not required.</em></td>
<td>1</td>
</tr>
<tr>
<td>Communication skills: Layout</td>
<td></td>
</tr>
<tr>
<td>Total</td>
<td>40</td>
</tr>
</tbody>
</table>

**QUESTION 3**

**YOU HAVE 12 MINUTES TO READ THIS QUESTION**

**BACKGROUND INFORMATION**

You are an audit senior at Brown Incorporated, a firm of Registered Auditors in Pretoria, and you have been assigned to the audit of Electrocar Limited (Electrocar) for its financial year ended 31 December 2014. Electrocar is a new client of Brown Incorporated and requires an external audit in terms of its Memorandum of Incorporation. Electrocar is a JSE listed company.

Electrocar is a leader in the manufacture, marketing and selling of electrical motor vehicles in the South African automotive industry and is situated in Uitenhage in the Eastern Cape. Electrocar currently focuses mainly on their plug-in electric car production line. Their operations exclude the maintenance of motor vehicles following delivery to end-users. End users consist of Electrocar motor dealerships all across major centres in South Africa.
Electrocar made the decision to change external auditors and appoint Brown Incorporated, due to the previous auditors taking too long in their opinion, to conduct and finalise their annual audit. Electrocar requested that Brown Incorporated complete the 2014 annual audit within one month after year end. This request is due to Electrocar’s bankers requiring audited 2014 financial statements for purposes of providing finance for the research and development of a new hydrogen fuelled prototype car, to commence as soon as possible in 2015.

In recent times Electrocar experienced financial pressure due to stringent competition from affordable Korean motor vehicles being supplied to the South African market at very competitive prices, as well as a downturn in new vehicle sales in the South African automotive industry in general. In an attempt to mitigate the challenges of the South African market, Electrocar’s board of directors decided during the 2014 financial year to expand operations by supplying plug-in electric cars to motor dealerships in neighbouring African countries as well. This decision was particularly taken due to an agreement that was reached amongst Southern African Development Community (SADC) members to pay tax rebates to buyers of environmentally friendlier motor vehicles such as Electrocar’s plug-in electric cars. Electrocar believes that these rebates will make their cars more affordable and as a result turn them into a fierce competitor in the motor vehicle industry in Southern Africa.

The main concern related to the expansion of operations to neighbouring countries expressed by the operations director of Electrocar, is whether or not the company will be able to meet market demand for their electrical cars. This is due to extended national labour strikes of metal worker unions towards the end of 2014, to which Electrocar’s labourers belong. Electrocar reacted to the strikes by employing semi-skilled temporary workers in the manufacturing and assembly plants in 2014. However, these temporary workers struggled to meet the required production targets in 2014 due to the specialised skills required for the manufacturing and assembly of electrical cars.

Since you identified the labour related account balances as a possible high risk at an assertion level, you compiled the following planning working paper from the wage system description provided by Mrs Green, the accountant who prepares the weekly wages cheques. This system description forms part of your audit work in assessing Electrocar’s system of internal control as part of the planning phase of your audit.
The company’s premises consist of three buildings, namely the manufacturing plant, the assembly plant and an administrative building. All employees enter the premises through one guarded gate.

In addition to Electrocar’s large salaried staff, they employ approximately 650 skilled wage earners who mainly work in the manufacturing and assembling plants. Wages are paid on Fridays for the week ending the previous Wednesday.

The foreman of each plant is fully responsible for the functioning of the plant, as well as for the appointment and determination of the wage rate for each of the wage earners, which he keeps on file in his office in the plant. No distinction is made between the wages of permanent and temporary wage earners in terms of wage rates or working hours.

When wage earners arrive for work they sign an attendance register and swipe their clock cards at a central clocking machine situated at the centre of each building. As soon as employees submit their completed clock cards to the foreman on Thursdays, they are issued with blank clock cards for the next working week. Work shifts are eight hours each and no overtime is worked at Electrocar.

The foreman signs the completed clock cards on Thursday mornings and hand them, together with his own clock card for the week, over to one of two wage clerks, namely Miss Kruger assigned to the manufacturing plant and Mr Smith assigned to the assembly plant. They prepare separate wages payrolls for the manufacturing and assembly plants.

The number of hours worked for each wage earner is obtained from their clock cards and the fixed hourly wage rate is carried over from the previous week’s wages payrolls. Adjustments to wage rates are made once a year, as soon as the fixed annual wage increase percentage is agreed upon with labour unions. Deductions are made using the relevant deduction tables.

As soon as the wages payrolls for the week are prepared by Miss Kruger and Mr Smith, it is handed over to Mrs Green, the accountant who prepares one wage cheque. The cheque is given to a security firm that cashes the cheque on the day of the wages pay-out (Fridays).

The security company hands the cash over to Miss Kruger and Mr Smith who prepare the individual wage packets. They then give the wage packets to the foreman of each of the manufacturing and assembly plants who are responsible for the distribution of wage packets to employees. Employees sign the relevant previous week’s clock cards as proof of receipt of their wages.

Apart from the functions described above, no other internal controls are performed in Electrocar’s plant wages system over:

- appointment;
- time keeping;
- preparation of wages payrolls and wage packets;
- pay-out of wages; or
- unclaimed wages.
CONTINUITY OF OPERATIONS STRATEGIES

During the planning phase of your audit, you became aware of a threat made by striking employees that they plan to set fire to the buildings at Electrocar’s premises if their wage increase demands were not met.

Upon discussion of the likelihood of this threat with management, they expressed great concern about the threat as incidents of violence and damage to their properties during labour strikes, have occurred in the past. Management referred to incidents in 2013 when metal worker industry labour strikes followed violent mining industry strikes earlier that year. Management went on to explain that temporary workers appointed by Electrocar during the strike in 2013 as well as non-striking permanent labourers, were attacked and intimidated into not showing up for their work shifts in the production and assembly plants.

During the 2013 labour unrest, salaried employees in the administration building were instructed to perform their administrative duties from home by remotely logging on to the company’s computerised administrative and accounting system. Although this arrangement ensured administrative staff’s safety, some accounting information was lost due to the sheer number of financial transactions per day that the financial manager unsuccessfully attempted to back-up form his remote location.

Simultaneously in 2013, a delivery truck on its way to delivering five new electrical cars to end user motor dealerships were hijacked and set alight. All five new cars were irreparably damaged in the fire. The financial losses suffered by Electrocar due to the loss of production and the five electrical cars destroyed in the fire, had a significant impact on Electrocar’s reported profits in 2013.

Due to the eminence of the striking labourers’ threat and the fact that Electrocar’s operations are centralised at one premises, you advised management to urgently review their disaster recovery plans as part of the continuity of operations strategies. Based on the accounting information lost in 2013 due to the unsuccessful data back-up attempt by the financial manager, you advised them to place special emphasis on their information technology (IT) controls in this regard.

REQUIRED

YOU HAVE 60 MINUTES TO ANSWER THIS QUESTION

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<tr>
<td>(a)</td>
<td>Based on the information provided under the heading Background Information, describe the audit risks at the overall financial statement level of Electrocar for the year ended 31 December 2014. Communication skills: logical layout and argument</td>
<td>9</td>
</tr>
<tr>
<td>(b)</td>
<td>With reference to Electrocar’s wages system described on working paper V201, list the weaknesses that you identified during your evaluation of the system of internal control during the planning phase of the audit. (Weakness regarding unclaimed wages is limited to one.)</td>
<td>20</td>
</tr>
<tr>
<td>(c)</td>
<td>Advise the management of Electrocar on the general computer controls that should be implemented to ensure adequate control over continuity of operations in the event of an emergency. Restrict your answer to only disaster recovery controls. Communication skills: logical layout and argument</td>
<td>9</td>
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YOU HAVE 12 MINUTES TO READ THIS QUESTION

Background information

You are an audit trainee at Groenewald Auditors Incorporated (Groenewald). You are currently part of the audit team on the external audit of Energy Solutions Ltd (Energy Solutions), a new audit client of Groenewald. Energy Solutions is listed on the Johannesburg Stock Exchange. The previous audit firm, Thlabane & Associates, were requested to resign at the end of the 2015 audit. The resignation was prompted by the issue of an adverse audit opinion. Energy Solutions’ financial year end is on 29 February 2016.

Energy Solutions’ operations focus on the provision of alternative energy to industrial and household electricity consumers, in the light of challenges faced by Eskom to meet the electricity demand of the South African economy. To date, Energy Solutions manufactured and installed mainly solar panels across all provinces in South Africa, with their head office and manufacturing plant in Gauteng. Recently a new home battery developed by an American company has drawn Energy Solutions’ attention. The home battery charges using electricity generated from solar panels or when general electricity utility rates are low. The home battery can then be used during Eskom’s load shedding phases. The battery is automated, compact and simple to install and enables users to maximise self-consumption of solar power generation.

Energy Solutions are excited about the solution that the home battery can offer to frustrated South African households. In particular, Energy Solutions are delighted with being the first South African company to import these batteries from America. The long awaited pilot project for the sale of the new batteries has been launched in Gauteng in April 2015. The project entails a number of sales representatives going from door-to-door with information packs about the home batteries in suburbs where load shedding is active at the time. Sales representatives are able to illustrate the use of the batteries during door-to-door visits to prospective customers. If sales are good (which Energy Solutions are very optimistic about) sales will be expanded to other provinces in South Africa and the door-to-door marketing model will be expanded to more sophisticated marketing and sales models.

Based on the background information on Energy Solutions and with specific reference to the adverse audit opinion in 2015 by the previous auditor, audit risk is assessed as high during the planning phase of the 2016 year end audit. Working paper R102 below was prepared by you on the revenue and receipts system with regards to the new home battery.
The company has allocated nine of their most experienced sales representatives to the marketing and sale of home batteries across Gauteng, as part of the initial pilot project. Sales representatives are issued with boxes of pre-printed home battery information packs which they hand out to customers upon visit.

Sales representatives record orders on electronic order pads which generates blank order forms with pre-set home battery selling prices. Price increases are implemented by management on the sales price masterfile on an ad hoc basis based on product cost, import costs and the popularity of home batteries in the local market.

All sales are done on credit. Credit payment terms and any discounts negotiated are allowed at the discretion of sales representatives. The sales manager takes the discounts granted into consideration when calculating sales representatives’ commissions at the end of each month.

When sales representatives return to the company premises on a weekly basis, they hand their order pads to the store manager. The store manager prepares pre-numbered delivery notes in duplicate from the order pads. The delivery notes are handed to the store clerk who commences to pack the home batteries. Physical security over access to the warehouse is adequate.

The company’s delivery clerk then collects the goods for delivery, as well as the two copies of the delivery notes from the store clerk and delivers them to customers. One copy of the delivery note is kept by the customer, whilst the second copy is signed by the customer as proof of receipt. The second, signed copy of the delivery note is returned by the delivery clerk to the store manager.

The store manager attaches the signed delivery note to a copy of the order which he has printed and hands these to the invoice clerk. The invoice clerk prepares invoices from these documents. The bookkeeper enters the invoices in the sales journal and debtor’s ledger.

The bookkeeper opens incoming mail and is responsible for entering payments received from customers in the cash book and debtor’s ledger. She banks the money on a daily basis.

On the rare occasion that customers are unhappy with their home batteries and choose to return them, the bookkeeper issues a credit note which she enters on the system in the same way as invoices. Sales and debtors’ accounts are reversed with the relevant amount.
YOU HAVE 60 MINUTES TO ANSWER THIS QUESTION

(a) Discuss the effect of the assessment of audit risk as high, on the **overall response** for the 2016 audit of Energy Solutions.

(b) Based on all the information in the background information and working paper R102 above, describe the risk of material misstatement at **assertion level** relating to **revenue** on the sale of home batteries for Energy Solutions for the year ended 29 February 2016.

*Communication skills: logical layout and argument*

(c) With reference to the **revenue and receipts system – home batteries** described in working paper R102, list the **control weaknesses** that you identified during the planning phase of your audit.

*Communication skills: logical layout and argument*

(d) Advise the management of Energy Solutions on the **application controls** in a computerised environment that should be implemented to ensure that only authorised, accurate and complete amendments are made to the **sales price masterfile**.

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<td>(c)</td>
<td>14</td>
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<td>(d)</td>
<td>10</td>
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**QUESTION 5**

YOU HAVE 8 MINUTES TO READ THIS QUESTION

**Background information**

You are a first year trainee accountant at Abrahams, Gauta & Engelbrecht Incorporated (AGE), a medium size audit firm, situated in Centurion. The firm aims to be at the cutting edge of utilising the latest information technology in its audit engagements.

During 2011 AGE became aware that Jet Air Holdings Limited (Jet Air) would be changing its external auditors. This came to light when one of the partners (who is now in charge of the Jet Air statutory audit) was informed thereof by her husband, who holds 18% of the issued share capital in Jet Air. Prior to accepting the engagement AGE contacted the previous auditor of Jet Air.

The previous auditor indicated that he enjoyed his association with Jet Air and that there was no reason for AGE not to accept the appointment for the 2012 financial year.

Jet Air is an aviation company with three operating business segments, namely a low-fare airline (TwoJet), an aircraft maintenance business (TechJet) and an air charter business (CraftJet). The head office of Jet Air is situated in Kempton Park.
Information technology (IT) is one of Jet Air's cornerstones. It is specifically important to TwoJet, because since its inception six years ago, 90% of ticket sales took place through the internet. The board of directors of Jet Air as a result has established an IT governance committee. The Board discontinued the audit committee in December 2011, as it believes that its functions were duplicated by those of the internal audit department, which is said to be highly efficient.

AGE agreed to assist the system development department of Jet Air with the identification of the specific application controls that should be present in the newly upgraded internet-based on-line reservation system.

Jet Air has a 30 September year end and the audit report is required three weeks after year end. The CEO has informed the partner in charge that the audit report will be required when applying for finance to expand the operations of Jet Air. Four team members including the partner in charge and yourself have been allocated to the audit of Jet Air.

Upgrade of the internet-based on-line reservation system

The airline has enjoyed excellent growth in revenue and passenger numbers over the years and consequently internet traffic and system load has increased dramatically. The company is in the process of upgrading its website and plans for it to be operational by the end of October 2012.

The following user requirements were developed by Jet Air’s business analyst and flight administration department:

- A webpage must be designed that firstly allows customers to perform a search on the availability and costs of seats on one of the flights operated. TwoJet’s flight schedule includes flights to and from Johannesburg and the following destinations:

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<tr>
<th>DESTINATIONS:</th>
<th>FREQUENCY:</th>
<th>DESTINATIONS:</th>
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<tbody>
<tr>
<td>Domestic</td>
<td></td>
<td>Regional</td>
<td></td>
</tr>
<tr>
<td>Cape Town</td>
<td>Four times per day</td>
<td>Zanzibar</td>
<td>Daily</td>
</tr>
<tr>
<td>George</td>
<td>Daily</td>
<td>Maputo</td>
<td>Daily</td>
</tr>
<tr>
<td>Port Elizabeth</td>
<td>Daily</td>
<td>Livingstone</td>
<td>Daily</td>
</tr>
<tr>
<td>East London</td>
<td>Daily</td>
<td>International</td>
<td></td>
</tr>
<tr>
<td>Durban</td>
<td>Four times per day</td>
<td>London</td>
<td>Daily</td>
</tr>
<tr>
<td>Bloemfontein</td>
<td>Daily</td>
<td>Cairo</td>
<td>Daily</td>
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<tr>
<td>Kimberley</td>
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<tr>
<td>Mbombela</td>
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Flights operate seven days per week and 364 days per year (no flights occur on Christmas day).

☐ A customer who identifies an available seat on a flight that he or she wants to book must be able to book the flight by providing his or her name, surname, ID number or passport number, cell phone number, e-mail address and method of payment. Customers must also specify whether or not it is a one-way or return flight. A 10% discount is applicable to all bookings that are made on a return basis.

☐ According to TwoJet’s policy, unaccompanied passengers below the age of 12 are not allowed to fly on any of its flights. The flight fee for passengers younger than 12, accompanied by an adult, is 40% less than the normal flight fee.
Ticket fees are determined monthly by the Fees Committee and forwarded to the IT department on the first day of each month for updating. Airport taxes must also be paid by the passenger and must be added to the flight fee. These taxes depend on the destination of the flight, for example if the destination is Durban, the Durban airport tax amount must be paid by the passenger.

Once a customer confirms a booking on the website, the customer has 48 hours to pay for the ticket. Payment can either be done on-line by way of credit card while making the booking via a secure connection, or by electronic funds transfer (EFT), where the proof of payment must be faxed to the head office. The customer can also pay directly at the kiosk at the airport, but only if the booking is done there and the payment method at the kiosk is either cash or credit card. The ticket fee is recognised immediately as revenue at the time payment is made by a customer. The database is immediately updated and the seat reserved. The plane ticket is issued electronically to the customer shortly after the payment is made by a customer. At the end of each day the transaction file is updated to the general ledger.

Plane tickets may be cancelled by customers if JetAir is notified thereof, in writing, at least 30 days prior to the flight date. A penalty amounting to 20% of the ticket fee is payable upon cancellation. The balance of the ticket fee is refunded to the customer.

When a passenger arrives at the airport, he must report at the check-in desk. Here the ticket is scanned, the passenger’s identity is confirmed and, once payment and / or proof thereof is confirmed, the baggage is checked-in and a perforated boarding pass is printed and handed to the passenger.

Once passengers have received their boarding passes, they are directed to the airport security area. All carry-on baggage is scanned for unlawful items. Once through the security area, passengers are directed to the boarding gates.

At the boarding gate, passengers present their boarding passes and this information is captured on the Passenger Loading List transaction file. The boarding pass is torn and one part is kept at the gate while the other part is handed back to the passenger to indicate their seat in the aircraft. Once passengers progress through the boarding gate, they may not turn back and must proceed to the aircraft.

Fifteen minutes before the flight is scheduled to depart, the boarding gate closes and a Passenger Loading List is prepared by the system, indicating the names of the passengers on board the flight.

**REQUIRED**

<table>
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<tr>
<th>YOU HAVE 38 MINUTES TO ANSWER THIS QUESTION</th>
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<tbody>
<tr>
<td>1. Identify the weakness in the on-line reservation system that will significantly influence the occurrence of revenue recognised.</td>
<td>2</td>
</tr>
<tr>
<td>2. Discuss the specific application controls that should be present in the on-line reservation system. <strong>Note: Exclude application controls relevant to access controls, payments, and masterfile updates from your solution.</strong></td>
<td>21</td>
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Communication skills | 2 |

*(Unisa: Supplementary examination AUE4862, 2012 – adapted)*
Background information

You are an audit senior in the firm of AUE & Associates Registered Auditors. AUE & Associates was recently approached by Save-a-Lot Ltd (Save-a-Lot) to conduct the audit for its financial year ended 31 August 2012. You have been assigned to manage the audit of Save-a-Lot.

Save-a-Lot Ltd is listed on the JSE Ltd and operates in more than 40 cities in 20 different countries. Its registered offices are in Johannesburg. Save-a-Lot’s website (www.savealot.co.za) features unbeatable discounts on travel, leisure, meals, etc. on a daily basis in various cities and countries. It has been hailed a web phenomenon as it is changing the way businesses market themselves around the world. Save-a-Lot offers businesses increased brand awareness through their website and in turn receives large discounts for subscribers. Through collective buying power, businesses registered with Save-a-Lot could increase their sales volumes substantially. Save-a-Lot retains 8% of all revenue from sales transactions and the balance is paid to the relevant business. Since the website was launched in September 2009, Save-a-Lot has experienced rapid growth. It grew from 1.2 million registered subscribers in 2009 to just under 12.5 million by August 2012.

The following is a short description of how Save-a-Lot operates:

Becoming a registered business:

- A potential business that wants to offer deals to subscribers through Save-a-Lot, has to register on a separate page on the website (“Save-a-Lot partners”) by providing certain business particulars, product lines, etc. A thorough check is done on each potential business partner by Save-a-Lot’s sales director before being added to the official partner list.

Initial sign-up as a new subscriber:

- A potential subscriber logs onto www.savealot.co.za and signs up as a new subscriber by providing his/her e-mail address (which serves as the user identification) and a password (chosen by the subscriber). The subscriber then has to re-enter his/her chosen password to confirm it. The subscriber is not allowed to continue with the sign-up process if these two passwords do not correlate. A sequentially generated subscriber number is allocated to each subscriber.

- The new subscriber is also required to complete certain fields with personal information such as name, surname, ID number (subscribers should be 18 years or older), physical address (for deliveries), banking details for refunds, etc. These fields with personal information are mandatory fields and the subscriber cannot sign up without completing these fields.

- The subscriber selects (from a drop-down menu) the country and city for which he/she wants to receive information on discounted deals.
Purchase of Save-a-Lot vouchers:

- Each day, after the initial sign up, the subscriber receives an e-mail providing details on unbeatable deals at discounted prices in the country and city he/she selected upon registration.

- Should the subscriber be interested in a particular deal, he/she selects the link (as provided in the e-mail) which then takes him/her directly to the Save-a-Lot website.

- Each deal is only available for 24 hours, after which it is automatically removed from the website. A minimum number of 100 different subscribers is needed for a deal to become effective. During the 24 hours that the deal is available on the website, the number of subscribers that have purchased the deal up to that time is shown on the website.

- To purchase a deal, the subscriber clicks on the “Purchase” button on the website which then opens the purchase screen. The purchase screen provides a drop-down list with the deals available for that day, as well as a drop-down list with the number of vouchers that the subscriber wants to purchase (maximum of 30 per subscriber per deal). After selecting the deal as well as the number of vouchers (vouchers are sequentially numbered), the total price is automatically calculated and displayed on the screen (this includes VAT for South African businesses).

- Should the subscriber want to pay by credit card, he/she selects this option on the purchase screen and then completes card details such as initials, surname, account number, CVV number (last three digits on the back of the card) and the expiry date of the credit card. These fields are mandatory. Should he/she decide to pay by EFT (Electronic Funds Transfer), this option should be selected which then provides the subscriber with the company’s banking details and other particulars.

- The subscriber has to tick the tick box that states “I am at least 18 years old and I have read and understood the terms and conditions” for a purchase to be accepted.

- If the subscriber is satisfied with the total of the purchase and other details relating to it, he/she then has to click on the “Submit purchase” option.

- After a few minutes, the subscriber will receive an e-mail confirming that his/her credit card has been charged or payment has been received via EFT. The actual receipt voucher is provided in a second e-mail to the subscriber (after the deal has expired and there is confirmation that 100 or more different subscribers have purchased that particular deal). This e-mail also provides details on how to print the voucher. As soon as a voucher has been issued, no changes can be made to it and no refunds will be given. The voucher states that it is only valid for six months from the date of purchase.

- Should the minimum number of 100 different subscribers for a specific deal not be met by the time the 24 hours expire, subscribers are refunded and the deal voucher will not be redeemable.
Subscriber master file amendments prior to 21 July 2012

1. Subscribers who wished to change any of their details (including e-mail addresses, passwords, physical addresses, banking details and other personal information) could merely log onto Save-a-Lot’s website and change their details by selecting the “change my details” option. All changes could be made electronically by the subscribers themselves on the website.

2. Save-a-Lot however received numerous complaints during the year under review from subscribers. These complaints mostly related to the fact that the “change my details” option was not user-friendly. The subscribers complained that the website did not provide user-friendly information on how to go about making changes.

3. After numerous discussions, management instructed the IT department of Save-a-Lot during July 2012 to modify the current subscriber master file amendment process on the website to make it more user-friendly. As at 31 August 2012, the IT department was still in the process of testing the new format on a copy of the live system.

Subscriber master file amendments as from 21 July 2012 (only for interim purposes until programme changes are made)

4. As from 21 July 2012, subscribers were no longer allowed to merely log onto the website to make changes to their details.

5. After signing up as a new subscriber on www.savealot.co.za, the subscriber’s details are reflected in the subscriber master file together with the unique sequential subscriber number and the e-mail address as user identification (this remained unchanged from 21 July 2012).

6. Should a subscriber wish to make changes to personal details after 21 July 2012 (for the interim period until programme changes have been made), the subscriber is requested by the Save-a-Lot website to send an e-mail to change@savealot.co.za requesting the change.

7. All the requests e-mailed to this e-mail address are received by Peter Makeachange. He is responsible for all subscriber master file amendments and receives approximately 50 change requests per day.

8. Upon receipt of an e-mail from a subscriber requesting certain changes, Peter completes a subscriber master file amendment form (MAF) electronically on a blank Word template. This Word document is not password protected.
9. The subscriber MAF contains the following fields:
   - Date;
   - Subscriber number;
   - Description of change(s) requested; and
   - Date of request received.

10. After completing the form, Peter prints out a copy and files it in a hardcopy file for audit purposes and deletes the e-mail from the subscriber. He does not save the changes on the Word document.

11. Peter then logs onto the subscriber master file with a generic username and password. There are currently eight personal computers (PCs) that run this application and Peter can log onto any of these. He then makes the necessary amendments as per the subscriber MAF that he completed.

12. On a weekly basis, Peter prints out a listing of all subscriber master file changes and agrees the detail to the printed subscriber MAFs in the hardcopy file.

13. During the audit it was discovered that the financial manager, Michael Altin, made unauthorised changes to subscriber details on the master file despite the generally strong computerised control environment. In most instances he altered the subscriber’s banking details to reflect his own personal banking details in order to receive refunds that were supposed to be paid to the subscribers. Due to the complexity of identifying all these changes, the number and value of these master file changes and refunds still have to be determined.

REQUIRED

YOU HAVE 41 MINUTES TO ANSWER THIS QUESTION

Based on the information presented on **working paper 100-2**:  
(i) identify the weaknesses in the controls relating to the occurrence and authorisation (validity) of changes to personal details in the subscriber master file as from 21 July 2012; and  
(ii) for each weakness identified, give possible recommendations for improvements to the controls.

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**Communication skills**

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(Unisa: Final examination 2012, Paper 1, AUE4861 – adapted)
SELF-ASSESSMENT SUGGESTED SOLUTIONS

QUESTION 1

(a) The effect that the acquisition of Bauba (Pty) Ltd will have on the audit planning

- From our audit of N&P we will already have knowledge of the pottery industry, however, Bauba’s operations are different in that it specialises in figurines and makes some foreign sales, and therefore we would be required to obtain an understanding of Bauba’s operation in this regard. (1)

- We may request access to Nameng Inc’s. working papers, especially in respect of any matters which appear contentious or significant. We should also review their prior year audited AFS and audit opinion as this may include matters that impact on the current year’s audit. (1)

- As the opening balances were audited by Nameng Inc., we should plan to perform additional work on opening balances as required by ISA 510.6 Initial Audit Engagements – Opening Balances. (1)

- We should obtain information relevant to identifying risks of material misstatement associated with related party relationships and transactions (e.g. transactions between Bauba and N&P). (1)

- The acquisition of Bauba resulted in a change of auditors and the risk of material misstatement will increase. (1)

- The effect of the increased risk of material assessment will impact on planning and performance materiality, which should set at a lower level. (1)

- We will have to communicate with the group audit team to obtain an understanding of their requirements with regard to:
  - coordinating work and agreeing on reporting deadlines (1)
  - the consistent application of accounting policies (1)

Communication skills: clarity of expression (1)

Available 8
Maximum 6

(b) (i) Risks of material misstatement at the overall financial statement level

Risks at company level

- The AFS of N&P may be materially misstated as related party relationships and transactions might not be accounted for at arm’s length and disclosed properly. (1)

Risks at group level

- The group AFS of N&P might be misstated as Bauba’s financial statements will be audited for the 2013 year by K&A but only six month results will be consolidated. (1)

- The consolidated AFS may be materially misstated if the group companies do not apply accounting policies consistently. (1)
The consolidated AFS may be materially misstated as intercompany transactions may not be correctly eliminated on consolidation.

The consolidated AFS may be materially misstated because this will be the first time that the finance director is preparing consolidated financial statements. Lack of personnel with appropriate financial reporting and accounting skills, increases the likelihood of error in the financial statements.

The group AFS of N&P may be materially misstated as management may have felt pressure to overstate Bauba’s financial performance and position in order to secure a good sale price for the company.

The group AFS of N&P may be materially misstated as the opening balances of Bauba might be incorrect since it was previously audited by Nameng Inc. who might not have been competent or independent.

The group AFS of N&P may be materially misstated as Bauba might not comply with the relevant laws and regulations, such as foreign regulation leading to going concern problems.

Risks at both company and group level

- N&P’s revenue and expenses may be understated to avoid the payment of the contingent consideration for the acquisition of the interest in Bauba.

(ii) Overall responses to address the risks of material misstatement at the financial statement level (ISA 330.A1)

Due to high risks of material misstatement at the overall financial statement level relating to (opening balances, pressure to manipulate financial statements (fraud) and related parties) the auditor shall design and implement the following overall responses to address the identified risks:

- Emphasizing to the members of the engagement team the need to maintain professional scepticism
- Assigning more experienced staff or those with special skills or using experts, e.g. valuers of goodwill and NCI, valuers to value the fair value of assets
- Providing more supervision.
- Incorporating additional elements of unpredictability in the selection of further audit procedures to be performed.
- Making general changes to the nature, timing or extent of audit procedures, for example: performing substantive procedures at the period end instead of an interim date, or modifying the nature of audit procedures to obtain more persuasive audit evidence.
(iii) **Risks of material misstatement at the assertion level**

**Goodwill**

There is a risk of misstatement of goodwill due to:

- The risk of overstatement of the contingent consideration if the assessment of probability of payment is incorrect. (valuation and allocation)  
- The risk that the contingent consideration might not be discounted to its present value.  
- The high degree of uncertainty involved in estimating fair value of identifiable assets acquired (existence and valuation and allocation)  
- The external consultant possibly not being competent and appropriately qualified in valuing the goodwill. (valuation and allocation)  
- Management’s failure to perform an annual impairment test of goodwill as required by IAS 36 (valuation and allocation)  
- The possible misstatement of the value of the non-controlling interest as it may be difficult to establish its appropriate fair value.  

**Revenue**

- There is a risk that revenue may not be recognised in line with the requirements of IAS 18 Revenue (completeness, occurrence and cut off)  
- There is a risk that foreign sales revenue may not be translated using the correct exchange rate at the date of the transaction. (accuracy)  
- There is a risk that revenue may be understated because of the contingent element of the consideration for the acquisition of the interest in Bauba. (completeness)  

**Inventory**

**Raw material**

- There is a risk that all costs (e.g. purchase price, import duties, insurance and transport costs) incurred in importing raw materials may not be included in the cost price as required by IAS 2 Inventories. (completeness and valuation and allocation)  
- There is a risk that inventory purchased FOB at sea at year end may not be included in the balance of inventory at year end (completeness and rights & obligations).  
- There is a risk that inventory purchased may be translated to ZAR at the incorrect foreign exchange rate prevailing at the transaction date  

**Work in progress**

- There is a risk that work in progress may not include the appropriate allocation of labour and manufacturing overheads as required by IAS 2 Inventories. (valuation and allocation)
There is a risk that work in progress may be overstated because the stage of completion is determined by the production manager who is an employee of Bauba. The likely subjectivity of the estimation process, the risk of material misstatement exists. (valuation and allocation)  

Finished goods
There is a risk that finished goods may not be valued at lower of cost or net realisable value. (valuation and allocation)  

Government grant
There is a risk of premature recognition of the government grant as revenue rather than as deferred income. (occurrence, classification and cut off)  
There is a risk of possible underestimation of the deferred income (liability) to be raised on the portion of the grant to be repaid. (completeness)  
There is risk that a deferred tax asset may not be recognised on deferred income (completeness)  
Communication skills: proper identification of risks

(c). Discussion and calculation of planning materiality

A. Determine which figures to use
We are given actual and budgeted figures. As the actual figures are available and the budget is a projection, we will use actual figures.  

B. Discuss and determine appropriate benchmarks
ISA 320.A4 states that profit before tax is often used for entities which are profit orientated, and Bauba is profit orientated.
There is also nothing in the scenario indicating that profit before tax is not a stable base to use in the calculation of materiality.
Bauba is dependent on the sales it makes. Therefore revenue and gross profit are also considered appropriate benchmarks.
Bauba is a manufacturer of pottery figurines and ornaments and has a total asset base of R140 million. Bauba is a capital intensive entity and total assets may be considered an appropriate benchmark as well.

C. Perform calculations
Turnover \((42\,000\,000 \times \frac{1}{2}\%)\) = R210\,000  
Gross profit \((20\,000\,000 \times 2\%)\) = R400\,000  
Profit before tax \((12\,000\,000 \times 2\%)\) = R240\,000  
Total assets \((140\,000\,000 \times 1.5\%)\) = R2 100\,000  

Available 4  
Maximum 3
• Total assets seem to be an outlier and will be excluded from the determination of materiality. (1)

• Since Bauba is a new audit client of K&A the inherent risk might be considered high and therefore a lower materiality should be chosen. (1)

• Planning materiality is also generally more conservative by nature. (1)

D. Conclusion

Therefore the planning materiality for the audit of Bauba for the year ended 31 March 2013 will be set at R240 000. (Note to markers: a student can earn a mark for planning materiality amount of between R210 000 and R400 000) (1)

MARKERS’ COMMENTS

Part (a) This section dealt with the effect that N&P’s acquisition of the interest in Bauba will have on the audit planning

• A presentation mark (communication skills) was awarded for clarity of expression and for logical application of the ISAs dealing with planning an audit to the given scenario.

• It was evident that most students did not study the auditing standards dealing with planning an audit. Those who studied the standards failed to apply their theoretical knowledge to the given scenario.

• Most of the students confused audit planning with audit approach. They extensively discussed audit approach (nature, timing and extent) of audit procedures in this part and lost easy marks.

• It is concerning at this level to note students failing to articulate basic factors to be considered during the planning stage of an audit (e.g. understanding an entity including its control environment, identifying risks of material misstatement, planning materiality, staffing issues, etc.).

• This part of the question was poorly answered by majority of the students.

Part (b). This section dealt with Risks of Material Misstatement (ROMM) at overall financial statements and assertion levels as well as overall responses.

• A presentation mark was awarded for proper identification of risks at the assertion level.

• Most of the students did not understand the difference between ROMM at overall financial statement level and at assertion level, although this area has been adequately covered at undergraduate studies. It is clear that most of the students did not study ISA 315.

• Most of the students are still unable to describe the ROMM and list the risk indicators of ROMM. Some of the students mentioned that Bauba is new client (risk indicator) but failed to describe that AFS may be materially misstated because of possible misstatement of the opening balances.
Some of the students are still unable to differentiate between Audit Risk (AR) and ROMM. AR includes Inherent Risk (IR), Control Risk (CR) and Detection Risk (DR) and ROMM refers to only IR and CR. Some of the students mentioned that Bauba is new client and we may not be familiar with the operations and therefore we may not be able to detect material misstatements. This is a DR and not ROMM which was asked.

The majority of students did not identify risk relating to a contingent consideration based on net profit as a risk at overall financial statement level.

Some of the students wrongly treated the risk relating to valuation of the non-controlling interest by the consultant as financial statement level risk rather than as assertion level risk (goodwill).

The risks at assertion level relating to goodwill were poorly handled by the majority of students. It is clear that students are unable to apply their theoretical knowledge of IFRS 3 to the given auditing scenario. Most of the students stated how the goodwill is calculated. It will never earn you a mark to say goodwill may not be properly valued without stating why.

A limited number of students identified that the contingent consideration should be discounted to present value and goodwill should be tested for impairment, and properly described the risks. It is concerning to note that students failed to apply their knowledge of financial accounting to the given auditing scenario. Students should practice to answer integrated questions.

ROMM relating to revenue was fairly handled by the students, but most of the students failed to identify risk relating to misstatement of revenue because of the contingent element of the consideration for the acquisition of the interest.

With regard to ROMM relating to inventory, very few students identified that Bauba’s production manager valued work in progress and properly described the risk relating to overstatement of inventory.

It is concerning to note that majority of the students don’t understand how to treat inventory in transit when shipped FOB terms from an accounting point view. Most of the students were confused whether inventory in transit should be included or excluded at year end.

It is concerning to note the majority of students lack basic principles of cost and management accounting. Most of the students failed to mention obvious risk relating to inappropriate allocation of overheads as required by IAS 2. This area is adequately covered in management accounting.

Very few students lost an easy mark, by failing to mention that inventory may not be valued at lower of cost or net realisable value.

Risks relating to government grant were poorly handled by the majority of students. Students failed to describe the risks but rather stated the accounting requirements of the government grant as required by IAS 20. Risk relating to deferred tax was not mentioned at all by the students.

The section dealing with overall responses to ROMM at overall financial statement level was well handled by most of the students. Students, who did not do well here, did not study ISA 330 Par 1. This was a direct theory from the standard.
Overall, this section was poorly handled by the students, although a lot of marks were available.

**Part (b). This section dealt with discussion and calculation of planning materiality**

- Overall, this section was well handled by the majority of students. The calculations were well handled, but a few students adjusted the figures for a full year, although the question clearly stated that revenue is earned evenly throughout the year.
- It has been noted with concern that students are still unable to discuss or motivate their chosen benchmarks. Very few students noted that Bauba is also a capital intensive company (having total assets of R140 million and manufacturing operations) and total assets could also be used as a chosen benchmark.

**General**

- It is important to know the underlying accounting and auditing standards as well as the principles for instance addressed in management accounting in order to properly describe risks. You should apply your knowledge pertaining to all four subjects to the information in the scenario.
- Students should make sure with what assertions they are dealing with in terms of ISA315 par A124 in order to properly describe relevant risks.
- General risks relating to groups (inter-company transactions, related parties, complex consolidations IFRS 3 & IFRS 10). This should have been made applicable to the scenario. This was easy marks and should always be remembered when dealing with ROMM at group level.
- Some students did not properly describe ROMM. It is essential to properly learn how to describe risks in order to deserve marks. You should always remember what may go wrong with AFS and account balances when you describe the ROMM.
- Study the ISAs indicated in this tutorial letter. It is crucial to make use of your ISAs and be able to apply them.
- Read the required properly. Students should make time to properly read and understand the requirement, as a misunderstanding could cost you a lot of marks.

**QUESTION 2**

(a) **Automated application controls that Maroteng Construction Ltd will have to implement over the creditors masterfile**

- Restrict write access to a specific member of the creditors section by the user ID and passwords (1)
- All Masterfile Amendments should be automatically logged by the computer on sequenced logs and there should be no write access to the logs (1)
- To enhance the accuracy and completeness of keying in of masterfile amendments and to detect invalid conditions, screen aids and programme checks will be implemented, e.g.
  - Minimum keying in of information (1)

HJB
Screen formatting, screen looks like MAF, screen dialogue (1)
New creditors account number automatically generated by the system (1)

- Programme checks e.g.
  - Verification/ matching checks to validate a creditor account number against the creditors masterfile (invalid account number, no amendment) (1)
  - Alpha numeric checks (1)
  - Range and/or limit/data approval checks on terms and credit limit field (1)
  - Field size check and mandatory/ missing data checks, e.g. credit limit and terms must be entered (1)
  - Sequence check on MAFs entered (1)
  - Dependency check on MAFs entered (1)

- The sequenced of the logs themselves should be checked for any missing logs (1)

(b) (i) Identify the risk of material misstatement in the 2014 financial statements of Maroteng at the overall financial statement level

<table>
<thead>
<tr>
<th>Risk of material misstatement</th>
<th>Most appropriate response</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. For any valid risk(s) identified at overall AFS level.</td>
<td>• Engagement team to maintain professional scepticism.</td>
</tr>
<tr>
<td></td>
<td>• Assigning more experienced staff or those with special skills or using experts.</td>
</tr>
<tr>
<td></td>
<td>• Providing more supervision.</td>
</tr>
<tr>
<td></td>
<td>• Incorporate additional elements of unpredictability.</td>
</tr>
<tr>
<td></td>
<td>• Lower the materiality level.</td>
</tr>
<tr>
<td></td>
<td>• Performing more substantive procedures at period end instead of at an interim date.</td>
</tr>
<tr>
<td>Note to makers: Please award a maximum of 1 mark per response mentioned by the students anywhere in their answer.</td>
<td></td>
</tr>
<tr>
<td>2. The AFS may be materially misstated as opening balances may contain material misstatements as we were not the auditors of Maroteng in the previous year.</td>
<td>• Engage or assign experienced staff to audit this client.</td>
</tr>
<tr>
<td></td>
<td>• Obtain detailed knowledge of Maroteng Ltd’s business, control environment and accounting practices.</td>
</tr>
<tr>
<td></td>
<td>• Inspect prior year working papers of previous auditor.</td>
</tr>
<tr>
<td></td>
<td>• Audit opening balances in terms of ISA 510.</td>
</tr>
<tr>
<td>3. The AFS may be materially misstated because:</td>
<td>• Assign an engagement partner with experience of listed company audits, especially companies in the construction industry.</td>
</tr>
<tr>
<td>• management or directors might overstate profits and assets to inflate the share price; and</td>
<td>• Have the firm’s IFRS specialist review all accounting treatments/ issues and disclosure.</td>
</tr>
<tr>
<td>• Maroteng does not comply with the JSE listing requirements resulting in incomplete disclosures, delisting, etc.</td>
<td>• Greater involvement by engagement partner and senior staff throughout the audit to ensure significant risks are detected and responded to.</td>
</tr>
<tr>
<td>Risk of material misstatement</td>
<td>Most appropriate response</td>
</tr>
<tr>
<td>-------------------------------</td>
<td>---------------------------</td>
</tr>
<tr>
<td>4. The AFS may be materially misstated because Mr Ramabu (recently qualified property valuer) and Mr Kruger (newly appointed engineer) may not be objective and competent to perform a valuation of head office building and inventory. The subjectivity of the valuation process, the likely risk of overstatement of the head office and inventory. (1)</td>
<td>• Evaluate the objectivity, competence, methods and assumptions used by Mr Ramabu and Mr Kruger in arriving at the value of head office building and inventory. (ISA 620) (1)</td>
</tr>
<tr>
<td><strong>Note to markers:</strong> Students must refer to both inventory and head office building in order to earn a mark (more than one account balance is affected).</td>
<td></td>
</tr>
<tr>
<td>5. The AFS may contain material misstatements due to lack of integrity of management. This is substantiated by the following: • auditors were dismissed as a result of issuing an adverse opinion and on disagreements with IFRS. (1)</td>
<td>• Place less reliance on management representation letter. (1)</td>
</tr>
<tr>
<td>6. The AFS may be materially misstated as the control environment in Maroteng locations might not be operating effectively and result in undetected fraud and error. (1)</td>
<td>• Plan the audit carefully with the emphasis on testing decentralised operations with high risk of misstatements. (1)</td>
</tr>
<tr>
<td>• Liase with client staff and internal audit to test regional offices and inspect inventory of properties. (1)</td>
<td></td>
</tr>
<tr>
<td>7. AFS may be materially misstated by overstating income and/or understating expenses to maximise profits due to their financial interest in the company's results. (1)</td>
<td>• Test directors’ bonuses in detail, especially for overstatement. (1)</td>
</tr>
<tr>
<td>• Place emphasis on testing income for overstatement, expenses for understatement. (1)</td>
<td></td>
</tr>
<tr>
<td>8. The AFS may be materially misstated because it is much more likely that a material misstatement could occur during the financial statement preparation process as the CFO has limited knowledge of IFRS as he usually finds IFRS confusing. (1)</td>
<td>• Perform detail testing of accounting estimates and judgements made by the CFO. (1)</td>
</tr>
<tr>
<td>9. The AFS may be materially misstated due to the going concern assumption not being properly applied in the preparation of the financial statements of Maroteng. (1) The going concern risk is increased due to the following: • the company is experiencing difficult trading conditions due to high interests rates; (1) • the company reported an operating loss; (1) • the company does not have enough cash to cover current liabilities; (1)</td>
<td>• Discuss the going concern issues with management. (1)</td>
</tr>
<tr>
<td>• Test budgets, forecasts, cash projections and management assessment of going concern assumption. (1)</td>
<td></td>
</tr>
</tbody>
</table>
### Risk of material misstatement

<table>
<thead>
<tr>
<th>Risk of material misstatement</th>
<th>Most appropriate response</th>
</tr>
</thead>
<tbody>
<tr>
<td>• liabilities are more than assets);</td>
<td>(1)</td>
</tr>
<tr>
<td>• extension of bank overdraft;</td>
<td>(1)</td>
</tr>
<tr>
<td>• the company is in a process of being sued by the Advertising Standards Authority (ASA) of South Africa, and the fine of R4.5 million may deepen the company’s going concern woes.</td>
<td>(1)</td>
</tr>
</tbody>
</table>

**Communication skills: Linking risks to responses (1)**

<table>
<thead>
<tr>
<th>Available</th>
<th>Maximum</th>
</tr>
</thead>
<tbody>
<tr>
<td>15</td>
<td>12</td>
</tr>
</tbody>
</table>

(c) **Identify the risk of material misstatements at the assertion level**

**Inventory**

Reliance on engineer

- The AFS may be materially misstated as the newly appointed architect might not be objective, competent and properly qualified in performing the work required for audit evidence. The architect may overstate the valuation of properties to impress the management (Valuation and allocation). (1)

**Construction materials on site**

- There is a risk that all costs (purchase price, insurance and transport costs) incurred in purchasing construction materials may not be included in the cost price as required by IAS 2 Inventories (Completeness and valuation & allocation). (1)
- There is a risk that construction materials purchased and in transit (on train) may not be included in the balance of inventory at year end (completeness and rights & obligations). (1)

**Construction work in progress**

- There is a risk that construction work in progress may not include the appropriate allocation of labour and manufacturing overhead as required by IAS 2 Inventories (Valuation and allocation and completeness). (1)
- There is a risk that construction work in progress may be overstated because the stage of completion is determined by the newly appointed employee (engineer) of Maroteng. (Existence and Valuation and allocation). (1)
- The likely subjectivity of the estimation process, the risk of material misstatement exists (Valuation and allocation). (1)

**Finished inventory of properties**

- There is a risk that finished inventory of properties may not be valued at a lower of cost or net realisable value (Valuation and allocation). (1)
Consumable supplies

- There is a risk that consumables are incorrectly classified as inventory (Classification). (1)

Property, plant and equipment (head office building)

- There is a risk that the head office building may not belong to Maroteng Ltd. (Rights and obligations) (1)

- There is a risk that Peter Ramabu, property valuer may not be competent, experienced and objective to perform a valuation of the head office building. The revalued amount may be likely overstated. (Valuation and allocation). (1)

- There is a risk that a revaluation surplus may not be correctly calculated according to the requirements of IAS 16 (Property, Plant and Equipment) (Valuation and allocation and accuracy). (1)

- There is a risk that revaluation surplus may not be recognised as part of other comprehensive income in the statement of profit or loss and other comprehensive income (Completeness). (1)

- There is a risk that deferred tax on revaluation surplus may not be recognised in other comprehensive income or not recognised at all. (Completeness). (1)

- There is a risk that the head office building may not be identified as an impaired asset and not tested for impairment at all. (Valuation and allocation). (1)

- There is a risk of unrecognised impairment loss in accordance with the requirements of IAS 36 Impairment of Assets (Valuation and allocation). (1)

- There is a risk that impairment loss may be incorrectly calculated (Valuation and allocation). (1)

- There is a risk that calculated impairment loss may not be recognised as a deduction against a revaluation surplus in terms of the requirements IAS 16 (Valuation and allocation). (1)

- There is a risk that deferred tax asset on impairment loss may not be recognised in terms of the requirements of IAS 12 Income Taxes (Valuation and allocation). (1)

- There is a risk that depreciation expenses may not be adjusted for the effect of revaluation and may be misstated (Valuation and allocation). (1)

Communication skills: Splitting inventory and head office building (1)

Available 20
Maximum 12
MARKERS’ COMMENTS

(a) Describe the automated application controls that Maroteng Construction Ltd will have to implement over the creditors masterfile.
   - This part of the question was poorly answered by majority of the students.
   - It evident that students don’t understand what a masterfile is.
   - Most of the students mentioned manual controls when answering this part of the
     question, while automated controls were asked.
   - It is recommended that students study computer controls seriously, including
     masterfile controls.

(d) (i) Describe the risks of material misstatement at the overall financial statement level of Maroteng Construction Ltd for the year ended 28 February 2014.

(ii) For each of the risks identified above (b)(i), describe the most appropriate audit response to eliminate or reduce the risks to an acceptable level. Present your answer in a tabular format as follows:
   - A presentation mark was awarded for linking risks and responses
   - Most of the students did not understand the difference between ROMM at overall financial statement level and at assertion level, although this area has been adequately covered at undergraduate studies. It is clear that most
     of the students did not study ISA 315.
   - Most of the students we unable to describe the ROMM but listed risk indicators of ROMM. Some of the students mentioned that Maroteng is new client (risk indicator) but failed to describe that AFS may be materially misstated because of possible misstatement of the opening balances.
   - Some of the students are still unable to differentiate between Audit Risk (AR) and ROMM. AR includes Inherent Risk (IR), Control Risk (CR) and Detection Risk (DR) and ROMM refers to only IR and CR. Some of the students mentioned that Maroteng is new client and we may not be familiar with the operations and therefore we may not be able to detect material misstatements. This is a DR and not ROMM which was asked.
   - It is concerning to note that majority of the students don’t understand how to
     treat inventory in transit when shipped FOB terms from an accounting point view. Most of the students were confused whether inventory in transit
     should be included or excluded at year end.
   - It is concerning to note that majority of the students still lack the basic principles of cost and management accounting. Most of the students failed to mention obvious risk relating to inappropriate allocation of overheads as required by IAS 2. This area is adequately covered in management accounting.
   - Very few students lost an easy mark, by failing to mention that inventory may not be valued at lower of cost or net realisable value.
   - It is concerning to have noted that most of the students were able to
     describe the risks but were not in a position to provide an appropriate responses to address those risks. In practice, it unacceptable to identify the risks and leave those identified risks unresponded.
   - The responses to the risk were not well handled by most of the students. Students, who did not do well here, did not study ISA 330 Par 1. This was a direct theory from the standard. Five (5) marks could have been earned by rewriting overall responses directly from ISA 330 Par 1.
   - Overall, this section was fairly handled by the students.
QUESTION 3

(a) Audit risk at overall financial statement level of Electrocar for the year ended 31 December 2014

The AFS may be materially misstated due to the following factors:

1. Electrocar is a new client of Brown Incorporated and there is a risk that:
   - opening balances might be materially misstated; and (1)
   - material misstatements could go undetected due to Brown Incorporated’s limited knowledge of the business. (1)
   - due to Brown Incorporated’s limited knowledge of the business, management may intentionally misstate the AFS. (1)

2. Electrocar is listed on the JSE and should therefore comply with stringent JSE requirements. There is a risk of an oversight of JSE requirements. (1)

3. There is a risk of fraud that management might manipulate the financial statements in order to increase the share price to attract more investors (JSE Listed). (1)

4. There is a risk of a weak internal control environment in general in the organisation, considering the weak salaries and wages / HR practices control environment (1)

5. There is a risk of a weak internal control environment in general in the organisation due to decentralised operations (expansion to neighbouring countries). (1)

6. Brown Incorporated is under time pressure to complete the audit within three weeks. This deadline might be unrealistic and restrict Brown Incorporated in its ability to perform the necessary audit field work, for example detect subsequent events. (1)
7. There is a risk of error by management when they are under pressure to prepare the financial statements to enable the auditors to meet the audit deadline (for example subsequent events). (1)

8. The approval of finance by Electrocar's bankers is subject to providing them with audited financial statements. There might be a risk of management manipulating financial statement figures to stand a better chance of obtaining finance. (1)

9. There is a legal risk for Brown Incorporated due to third party reliance on the financial statements. (1)

10. Electrocar expanded operations to neighbouring African countries and there is increased risks related to:
   - risk of error due to additional statutory requirements (for example regarding exports, customs and excise, meeting SADEC requirements for customers to qualify for the tax rebate, etc.). (1)

11. The combination of strong competition in the market, poor economic conditions and/or a possible risk of failure of the new production line could result in the company incurring financial losses. These factors could pose a possible future going concern risk. (1)

12. The industry is plagued by labour strikes. The following factors could pose a possible going concern risk:
   - Electrocar's ability to meet production targets which could adversely affect business relations with end user motor dealerships; (1)
   - a reputational risk for the Electrocar brand as temporary workers could manufacture and produce inferior quality motor vehicles to the market; and (1)
   - financial losses as settlements with unions could lead to Electrocar having to pay permanent labourers for the strike period as well as temporary workers (as was the case in the mining industry in 2014). (1)

(b) Weaknesses in the wages system of Electrocar

Appointments

1. New employees are appointed by the plant foreman and not by Electrocar's human resources (HR) department. As such appointments are not authorised by senior management and employees added to the wages payroll without authorisation. (1)

2. The plant foreman determines the wage rates of new employees. Wage rates are not based on fixed company policy and are not authorised by senior management. (1)

Time keeping

3. Clock cards are kept by employees and not locked away under the supervision of a security guard. (1)

4. No control exists over the clocking machines: there is no mention of a security guard or foreman supervising the clocking-in process. (1)

5. The clocking machines are not located at a single entrance point at each plant. (1)
6. Clock cards are not controlled: they are not checked for numerical sequence completeness or duplications and there is no mention of cards being issued in employees' names.

7. Hours worked are not authorised in that the foreman does not check and authorises each clock card. He simply hands them over to the wages clerk without checking for, for example possible overtime hours.

8. No reconciliations are performed between clock cards and an employee list kept by the warehouse foreman before handing them to the wages clerk.

9. The foreman's hours worked and clock card is not reviewed for accuracy by his supervisor or senior personnel for example Mrs Green.

10. No security exists over clock cards and employee files kept in the foreman's office.

**Preparation of wage payrolls and wage packets**

11. No segregation of duties exists between the preparation of the wages payroll and the preparation of the wage packets by the wages clerks.

12. The calculations on the wages payroll is not checked to confirm accuracy in terms of hours recorded on clock cards, wage rates and adjusted wage rates on personnel records, deductions according to wage tables.

13. No reconciliations are performed between hours worked per clock cards and the wages payroll to ensure the accuracy of the wages payroll.

14. The wages payroll is not compared to previous months' payrolls and supporting documentation.

15. The wages payroll is not authorised for pay-out by a senior manager.

16. The wages cheque is signed by only one signatory (Mrs Green) and is not compared to the wages payroll before it is signed.

17. No physical security exists over the cash handed over to Miss Kruger and Mr Smith by the security company (for example, the cash should be counted on receipt and the prepared wage packets should be locked away in a safe until pay-out).

**Pay-out of wages**

18. The foremen do not sign for the cash on receipt from Miss Kruger and Mr Smith.

19. The foreman pays the wages to employees without them having to identify themselves (large workforce of approximately 650 employees with two foremen).

20. Wage earners do not count their cash in the pay-packets in the presence of the foreman in order to confirm the correct amount received.

21. Wage earners do not sign the wages payroll as proof of receipt of their wages packets. This is a better control than signing weekly clock cards.

22. No segregation of duties exist between the appointment of staff (a human resources function) and the pay-out of wages. Both functions are performed by the warehouse foreman.
General

23. No controls exist over unclaimed wages (Note: limited to any one valid weakness related to unclaimed wages).  
   (1)

24. No surprise visits are performed by management on clocking, wage payroll preparation or wage pay-out activities.  
   (1)

(c) General computer controls over the continuity of operations at Electrocar in the event of an emergency disaster recovery controls:

1. A written disaster recovery plan document should be widely available and there should be more than one copy thereof (physical and electronic versions).  
   (1)

2. The disaster recovery plan should be tested (ideally annually) to ensure that the plan works as intended.  
   (1)

3. The disaster recovery plan should set out the procedures and tasks which should be carried out by each employee in the case of a disaster.  
   (1)

4. The disaster recovery plan should be communicated to all employees and during the testing of the plan the roles and responsibilities should be evaluated.  
   (1)

5. Uninterrupted UPS and SSL service.  
   (1)

6. The back-up server and on-site back-ups should be maintained in fireproof safes or off-site at an undisclosed location.  
   (1)

7. On-site servers should be kept away from computer facilities.  
   (1)

8. Back-ups of all significant accounting and operational data and programmes should be carried out frequently and regularly.  
   (1)

9. The most recently backed-up information should be stored off-site.  
   (1)

10. There should be three generations of back-ups maintained (grandfather, father, son).  
    Communication skills  
    Available 12  
    Maximum 10

QUESTION 4

(a) The effect of the assessment of audit risk as high, on the overall response

1. Engage more experienced staff, in particular staff with experience of listed company audits.  
   (1)

2. The audit team needs to exercise professional scepticism.  
   (1)

3. Providing more senior supervision, in particular management that will not be intimidated (with reference to previous auditor’s resignation)  
   (1)
4. Obtain detailed knowledge of Energy Solutions’ control environment and accounting practices, with focus on the new product line. (1)

5. Audit opening balances in terms of ISA 510. (1)

6. Lower the materiality level in order to lower the audit risk to an acceptable level. (1)

7. Increase the sample size of the items to be tested. (1)

8. The audit team must incorporate an element of unpredictability in performing audit procedures. (1)

9. Perform more substantive procedures with more test of detail (less analytical procedures) and less reliance on tests of control. (1)

10. Put less reliance on management’s representation given the fact that their integrity is questionable (requesting the previous auditor to resign). (1)

11. Consider the use of an expert in areas where you don’t possess the required skills as auditors, for example foreign exchange transactions and inventory valuation. (1)

12. Perform procedures close to year end. (1)

(b) Risk of material misstatement at assertion level relating to revenue and receipts on the sale of home batteries for Energy Solutions for the year ended 28 February 2016

1. There is a risk that management might recognise fictitious sales due to the JSE listing (meeting listing requirements and attract shareholder investment) (Occurrence). (1)

2. There is a risk that revenue on home batteries ordered close to year end might be recognised incorrectly in the current year if stock levels are insufficient at year end (stock availability is not checked during ordering, nor is completeness of despatched goods) (Cut-off and Occurrence). (1)

3. There is a risk that revenue on home batteries sold at a discount might be recognised inclusive of the discount (Accuracy). (1)

4. There is a risk that revenue is recognised at incorrect prices should the home batteries prices not be updated on the ordering pads with recent prices (Accuracy). (1)

5. There is a risk that revenue is not completely or accurately recognised as sales are captured by the bookkeeper and not reviewed or reconciled by management (completeness and accuracy). (1)

6. There is a risk of overstatement of revenue in order to meet budgets and projections as this is a highly anticipated pilot project with anticipation for good sales. (Occurrence) (1)

7. There is a risk that revenue might not be presented correctly in the notes to the financial statements (for example separate from other alternative energy products) (Presentation and disclosure). (1)

Logical lay-out and presentation (1)

Available 8
Maximum 5

HJB
Weaknesses in the revenue and receipts system of Energy Solutions February 2016

Sales orders

25. The sales representatives do not keep record of home battery orders taken and customers are not given a copy of the order to verify the details of the order. (1)

26. Sales are made on credit at the sales representatives’ discretion and no credit worthiness checks or management authorisation is required for credit terms arranged with customers. (1)

27. No authorisation is given for the discounts granted by the sales representatives to customers. (1)

28. Orders are accepted without consideration given to the availability of home batteries on hand. (1)

29. No proper control exists over orders on order pads, i.e. without sequential numbers and no weekly reconciliations for outstanding/duplicate orders, cancelled orders etc. (sales representatives issue orders at free will which could be susceptible to fraud) (1)

Despatch

30. No picking slips are prepared from order notes to guide/control the store man in packing home batteries for delivery. (Batteries may be unavailable for picking and delivering). (1)

31. The store’s manager doesn’t review picked goods by comparing the purchase order to a picking slip and delivery note and then to actual home batteries picked and packed. (1)

32. Goods are delivered without it being checked at the gate by a security guard who compares actual goods to delivery notes and signs off on the goods leaving the premises. (1)

Invoicing

33. Controls over the completeness of invoices are poor as they are not pre-numbered and no independent checks are done on the sequence of invoices (for missing or duplicated invoices). (1)

Recording of sales

34. No debtor’s statements are sent to debtors. (1)

35. A debtor’s age analysis is prepared, but not reviewed by a manager. (1)

36. The reconciliation of the debtors control account to the debtor’s ledger is not reviewed by a manager and exceptions not followed up. (1)

Receipts

37. Mail opening procedures are insufficient. The bookkeeper opens the mail alone. (1)

38. The bookkeeper receives cash and also banks the cash herself. These are incompatible functions; no segregation of duties exists between these functions. (1)
39. No bank reconciliations are done. (1)

**Sales returns**

40. Credit notes are issued without proper authority from management and without reference to supporting documents. (1)

41. The bookkeeper issues credit notes and captures them on the system. These are incompatible functions, segregation of duties are lacking. (1)

**General**

42. Overall there is no/insufficient management review and reconciliation. (1)

43. Overall employees are not held accountable for functions performed by them, i.e. employees are not required to sign off on duties performed (isolation of responsibility). (1)

44. Any one other valid weakness in the system of internal control over revenue. (1)

(d) **Application controls in a computerised environment that should be implemented to ensure that only authorised, accurate and complete amendments are made to the sales price masterfile**

1. Write access to the sales price masterfile should be restricted to the sales manager by a user ID and password. (or any other one valid access control measure) (1)

2. All masterfile amendments should be automatically logged by the computer on sequenced logs and there should be no write access to the logs. (1)

3. To enhance the accuracy and completeness of keying in of masterfile amendments and to detect invalid conditions, screen aids and programme checks should be implemented, (1)

**Screen aids:**

4. Minimum keying in of information should be required, for example product codes, effective dates of price increases, the price increase percentage. (1)

5. Screen formatting, screen looks like the masterfile amendment form (MAF), screen dialogue. (1)

6. The new price should be automatically calculated by the system once the increase percentage is entered for a product range. (1)

**Programme checks:**

7. Verification/matching checks should automatically be performed to validate a price amendment for a specific inventory item against the inventory item code in the inventory masterfile. (invalid item code, no amendment) (1)

8. Alpha numeric checks should be performed, for example the system rejects an alpha numeric item code (number item codes) or percentage increase. (1)
9. Range and/or limit/data approval checks on increase percentage field. (1)

10. Field size check and mandatory/missing data checks should be carried out, for example the product code, pre-increase price and cost price must be entered. (1)

11. Sequence checks should be performed on MAFs entered to detect duplicate or missing MAFs. (1)

12. Dependency checks should be done on MAFs entered, for example price increase ranges for specific product ranges. (1)

13. Masterfile amendments should be reviewed to ensure they occurred, were authorised and were accurately and completely processed. (1)

Available 13
Maximum 10

QUESTION 5

1. WEAKNESS IN THE ON-LINE RESERVATION SYSTEM THAT SIGNIFICANTLY INFLUENCES OCCURRENCE OF REVENUE

☐ Revenue is recognised when the payment is made instead of on the flight date, when the risks and rewards will pass to the customer. (1)

☐ For cancelled flights, revenue should be recognised on the date of cancellation for the 20% penalty. (1)

Available 2
Maximum 2

2. APPLICATION CONTROLS IN THE ON-LINE RESERVATION SYSTEM.

Customer search and quotation

☐ The layout of the webpage must be user friendly. (1)

☐ There must be sufficient customer instructions or a help function available on the webpage to enable customers to make a booking without any difficulty. (1)

☐ There must be drop-down menus for the following fields to limit data entry errors/limited keying of information (1)
  o Airports
  o One-way / return
  o Dates (providing a calendar)
  o Times Max (1)

☐ Upon accepting the quotation the screen must prompt the customer to enter the following information: first name, last name, ID number, passport number, cell phone number, e-mail address and method of payment. (2)

☐ The following edit checks must be present:
  o Alpha-numeric tests on the cell phone number / ID number / Passport number. (1)
  o ID number test for the age of the passenger to determine whether or not he is entitled to discount. (1)
  o ID number test for the age of the passengers to confirm that there are no un-accompanied passengers below 12. (1)
Field presence on all compulsory fields (1)
mandatory field check to ensure processing only allowed when all compulsory fields completed.

Validity checks to confirm no booking on 25th Dec. (1)

Limit test/range check based on total seats available per aircraft. (1)

Size check on ID numbers for 13 digits / passport number. (1)

Reasonability tests to ensure the total number of booked seats does not exceed the available seats per aircraft. (1)

Arithmetic accuracy checks on the airline ticket fee and airport taxes. (1)

Sign check, total number of booked seats cannot be negative. (1)

Error messages should pop up when information is inputted incorrectly or incompletely by the customer. This can also be in the form of screen dialogue and prompts. (1)

Prices must be automatically retrieved from the price masterfile and displayed on the screen with no customer access to the price field i.e. verification check. (2)

Seats on the flights should be reserved when booking is in the process to prevent simultaneous booking for the same seats. (1)

A summary of the flight details and selections made as well as the full pricing calculation, including discounts and airports taxes should be displayed on the screen as a final quotation so that the customer can check it for correctness. (2)

All bookings should be allocated a sequence number to identify missing bookings. (1)

System should generate logs/exception reports with missing/duplicate number in sequence. (1)

A customer should be required to complete a tick box to agree to any terms and conditions. (1)

A customer should be required to click on a submit button in order to confirm the deal. (1)

A unique transaction number should be allocated and emailed/sms’ed to the customer once the booking is made. (1)

If the ticket is not paid within 48 hours, the system should automatically cancel the booking made and notify the passenger by email. (1)

Communication skills: systematic flow of answer (2)
Available 31
Maximum 21

**QUESTION 6**

<table>
<thead>
<tr>
<th>Weaknesses</th>
<th>Recommendations</th>
</tr>
</thead>
<tbody>
<tr>
<td>The Word document is not saved after it has been completed/MAF is not pre-printed. (1) (See par 8 and 10 on working paper 100-2)</td>
<td>The subscriber MAF should preferably be pre-printed with space for the necessary detail. (1)</td>
</tr>
<tr>
<td></td>
<td>The unused pre-printed subscriber MAFs should be kept locked away OR Access to the unused pre-printed subscriber MAFs should be limited. (1)</td>
</tr>
<tr>
<td></td>
<td>A register should be kept detailing all subscriber MAFs issued and/or Peter should sign in the register upon receiving a MAF. (1)</td>
</tr>
<tr>
<td>Weaknesses</td>
<td>Recommendations</td>
</tr>
<tr>
<td>------------</td>
<td>-----------------</td>
</tr>
</tbody>
</table>
| The subscriber MAFs are **not sequentially numbered/prenumbered/incorrect design of MAF.**  
(See par 8 on working paper 100-2) | **Subscriber MAFs should be sequentially numbered** (preferably pre-printed on the hardcopy to avoid duplicate MAFs for validity purposes).  
(1)  
**Provision** should be made on the MAF for the **signatures** of the preparer and the authoriser.  
(1) |
| The Word document is not password protected.  
(See par 8 on working paper 100-2) | **The Word document should only allow access when a unique password is entered OR should be password protected.**  
(1) |
| The e-mail from the subscriber requesting the change is deleted by Peter.  
(See par 10 on working paper 100-2) | **The e-mail from the subscriber should be printed out and attached to the subscriber MAF.**  
(1)  
**The e-mail should be retained as part of the audit trail and should not be deleted.**  
(1) |
| Subscriber MAFs are not authorised/reviewed.  
(See par 10 on working paper 100-2) | **The subscriber MAF should be authorised/signed by another employee.**  
(1)  
**The MAF should only be authorised by the reviewer after the MAF details have been agreed to the supporting e-mail from the subscriber.**  
(1) |
| Peter then logs onto the subscriber master file with a **generic username and password.**  
(See par 11 on working paper 100-2) | **Unique username and password for each user.**  
(1)  
**Access to the subscriber master file should be restricted through e.g. user profiles/least privilege/access tables.**  
(1)  
**Access should be restricted at both systems level (network/PC) and at the application (subscriber master file) level.**  
(1) |
| There are currently **8 personal computers (PCs)** with this application and Peter can log onto any of these.  
(See par 11 on working paper 100-2) | **The number of PCs with access to the subscriber master file should be restricted.**  
(1)  
**Physical access to PCs with the subscriber master file application on should be restricted.**  
(1)  
**The PCs should have a time-out facility and/or automatic shut down when access violations are detected.**  
(1) |
| Lack of segregation of duties as Peter performs incompatible functions.  
(See par 10, 11 and 12 on working paper 100-2) | **The following functions should be segregated:**  
- **Safekeeping** of the unused subscriber MAFs.  
(1)  
- **Recording** the email particulars on the MAFs.  
(1)  
- **Authorising** the completed MAFs.  
(repeat)  
- **Updating the master file** on the computer.  
(1)  
- **Reconciling** master file changes to MAFs and e-mails.  
(1)  
**The authorising and reconciliation functions should be performed by a more senior person.**  
(1) |
### Weaknesses

<table>
<thead>
<tr>
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<th>Recommendations</th>
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</thead>
<tbody>
<tr>
<td>• There is an insufficient audit trail of master file changes. (1)</td>
<td>• The details of all master file amendments should be automatically logged by the computer on sequenced logs. (1)</td>
</tr>
<tr>
<td>(See par 10 on working paper 100-2)</td>
<td>• The username and the nature of the activity performed by each user should also be automatically recorded in activity logs. (1)</td>
</tr>
<tr>
<td>• The details of all master file amendments should be automatically logged by the computer on sequenced logs. (1)</td>
<td>• Write access to these logs should be restricted. (1)</td>
</tr>
<tr>
<td>• The username and the nature of the activity performed by each user should also be automatically recorded in activity logs. (1)</td>
<td>• Audit trails, activity logs, override reports and exception reports should be regularly reviewed. (1)</td>
</tr>
<tr>
<td>• Write access to these logs should be restricted. (1)</td>
<td>• Any exceptions should be investigated. (1)</td>
</tr>
<tr>
<td>• Audit trails, activity logs, override reports and exception reports should be regularly reviewed. (1)</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Available</th>
<th>9</th>
<th>Maximum</th>
<th>5</th>
</tr>
</thead>
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### MARKERS’ COMMENTS

Students were requested, based on the information in a certain working paper, to identify the weaknesses in the controls for the occurrence and authorisation (validity) of changes to personal details in the subscriber master file as from 21 July 2012. For each weakness identified, possible recommendations were required.

Presentation marks (2) were awarded for presenting the answer in a tabular format. Most students received these presentation marks.

Most students obtained the maximum of 5 marks for identifying the weaknesses in the scenario. There were 9 possible marks available for the weaknesses that were considered to be easier marks.

Some students wasted time by raising concerns on changes made to subscriber master file detail PRIOR to 21 July 2012. This was not required and received no marks.

Students wasted time by wording their weaknesses as risks. These risks did not receive any marks as only weaknesses were required. Students also wasted time by repeating the same recommendations over and over.

In general, students performed fairly well in this part.

Refer to page 8/39 to 8/40 of Auditing Notes for detailed Master file amendment controls.