Tutorial letter 102/0/2017

APPLIED AUDITING

AUE4862/ZAU4862/NAU4862

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>
<th>Telephone number</th>
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<tr>
<td>Lecturers</td>
<td></td>
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<td>Barend Barnard</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 may contact the Helpdesk either by e-mail or telephonically between 08:00 and 16:00, from Monday to Friday.

<table>
<thead>
<tr>
<th>E-mail</th>
<th><a href="mailto:AUDpostgrad@unisa.ac.za">AUDpostgrad@unisa.ac.za</a></th>
</tr>
</thead>
<tbody>
<tr>
<td>Telephone</td>
<td>012 429 4943</td>
</tr>
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</table>

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 unit. Only refer to the prescribed material if 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) covered by the study unit.

3. Do the questions in the study unit and make sure you understand the principles contained in the questions.

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

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.
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HOW THE TOPICS OF THIS TUTORIAL LETTER RELATE TO THE AUDIT PROCESS

STAGES OF THE AUDIT PROCESS

Preliminary 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)

The Code of Professional Conduct (CPC) of SAICA and by-Laws as well as IRBA CPC and rules regarding improper conduct (TL 103)

The Auditing Profession Act (IRBA) (TL 103)

The Companies Act (TL 103)

The Auditing Processon Act (TL 103)

King III (TL 103)

The Companies Act (TL 103)

Perform substantive procedures (TL 104)

Evaluation, conclusion and reporting (TL 105)

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

Establish overall audit strategy (TL 102)  Develop an audit plan (TL 102)

Planning (TL 102)

Preimininary engagement activities (TL 102)

The Code of Professional Conduct (CPC) of SAICA and by-Laws as well as IRBA CPC and rules regarding improper conduct (TL 103)

The Auditing Profession Act (IRBA) (TL 103)

The Companies Act (TL 103)

King III (TL 103)
INTRODUCTION

The diagram on the previous page sets out the different stages of the audit process. The audit process can be divided into four stages. The first phase is the pre-engagement phase. The second phase is the planning phase which includes obtaining an understanding of the entity and its environment, the assessment of risks and establishing the overall audit strategy and audit plan. The third phase is the auditor's response to the assessed risks and includes the performance of tests of controls and substantive audit procedures. The fourth phase is the evaluation, conclusion and reporting phase. This diagram will be included in each of the tutorial letters to follow during the year. It will demonstrate to you where the topics covered by the tutorial letter fit into the audit process. The topics covered in this tutorial letter as depicted on the diagram are shaded.

While studying the diagram, you will note that the CPC, by–Laws, APA, rules regarding improper conduct, King III and Companies Act are included in all the stages of the audit process. It implies that they are applicable not only at a specific stage of the audit process but also throughout the whole audit process. The auditor has to 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

STUDY UNIT 2 – PRE-ENGAGEMENT ACTIVITIES

INTRODUCTION
The first phase of the audit process is the preliminary engagement activities.

The terms **preliminary engagement activities** and **pre-engagement activities** may be used interchangeably in questions.

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

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

- discuss the preliminary engagement activities you would 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.

SECTION A – ADDITIONAL INFORMATION

Overview

As per ISA 300, par 6, the auditor shall undertake the following activities at the beginning of the current audit engagement:

(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

As per ISA 220, par 12, and A8 and ISQC 1, par 26, before an audit firm can accept or continue a client relationship, it has to consider the following:

1. whether the engagement team is competent to perform the audit engagement and has the necessary capabilities, including time and resources to do so;

2. whether the audit firm and engagement team can comply with the relevant ethical requirements;

3. whether the audit firm has considered the integrity of the principal owners, key management and those charged with governance of the entity; and

4. if there are any 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. Competence, capabilities and resources of the engagement team

When considering the competence and capabilities of the engagement team, the engagement partner may consider the following (ISA 220, par A11) (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;
- whether the firm has sufficient personnel with the necessary competence and capabilities;
- the technical expertise within the team or access to other auditors or experts who 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.
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 Code of Professional Conduct (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 discusses 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 was only one of the following, it will be incomplete, resulting in a loss of marks:

- 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:

Ethical requirements:

- There is a familiarity threat, as the engagement partner is married to the CEO of the audit client.

- There is a self-interest threat – the audit partner is married to the CEO and she has a financial interest in ABC Ltd.

- There is an intimidation threat, as the audit team might be reluctant to ask challenging questions for 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 them to the information in the scenario, whereas the threats in the top part of the answer were not linked to the information in the scenario.

3. The integrity of the principal owners, key management and those charged with governance of the entity (ISQC 1, par A19)

When considering the integrity of the client, the engagement partner may take the following into account (ISQC 1, par A19):

- The identity and business reputation of the client’s principal 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, 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 criminal activities.
- The reasons for the proposed appointment of the firm and non-reappointment of the previous firm (indicate the reason for the change of auditors).
- The identity and business reputation of related parties.

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).
- 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 above four aspects, 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 have 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 15 marks

YOU HAVE 5 MINUTES TO READ THIS QUESTION.

You are a first-year trainee accountant at Andre Gauta Ephraim Incorporated (AGE), a medium-sized audit 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 2015, AGE was awarded a tender to audit DanChrome and its newly acquired subsidiary company, SamCoal (Pty) Ltd (SamCoal) for the year ended 31 August 2015. 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 was a direct result of the previous auditors filing a notice of resignation. The previous auditors resigned because they regarded themselves as not having adequate resources to service DanChrome due to the company's growth. When AGE contacted the previous auditors, 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 2014. At the time, the year end for SamCoal was on 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 Mpumalanga and a newly established mining site in Limpopo. Each coal mining site has accounting staff responsible for capturing financial data. The head office of SamCoal is situated in Middelburg.
During mid-March 2015, 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 its shares in DanChrome. The sale was completed successfully in May 2015. This resulted in the delisting of DanChrome from the JSE Ltd. The new shareholding of DanChrome is as follows:

<table>
<thead>
<tr>
<th>Shareholders of DanChrome</th>
<th>Shareholding %</th>
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<tr>
<td>Steel South Africa (Pty) Ltd</td>
<td>80</td>
</tr>
<tr>
<td>Directors and staff</td>
<td>15</td>
</tr>
<tr>
<td>Other</td>
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</table>

In May 2015, 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 2015 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 2015 financial year, for the first time in years.

On 30 June 2015, 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 mainly to 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 it has caused to the cultural heritage site.

James Taylor, Limpopo

On 5 September 2015, the attorneys of the DanChrome Group indicated that the court was 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 into a different direction.

REQUIRED

YOU NOW HAVE 23 MINUTES TO ANSWER THIS QUESTION.

SUGGESTED SOLUTION

(a) With regard to the opening paragraph and the DanChrome Group business background information:

1. Discuss the matters to consider and the concerns AGE would have prior to accepting the DanChrome Group as an audit client.

   (i) Competence, capabilities and resources
   - AGE should have considered whether it has the necessary and sufficient competencies and resources (skills, resources and time) to render a service to the DanChrome Group.
   - There is a concern about the number of people (six only) assigned to the audit of the DanChrome Group. Six does not seem like an adequate number of people, as Dan Chrome has a subsidiary that operates in geographically spread areas.
   - The deadline for the audit work seems tight; consequently, AGE might not have adequate time to complete the audit.
   - AGE was only appointed in April and there might not be adequate time to perform an interim audit or to gain an understanding of the business.
   - AGE should consider engaging an expert for the audit of environmental issues.
   - AGE should have considered whether it has sufficient knowledge of and experience in the legal and regulatory environment of the company.

   (ii) Relevant ethical requirements
   - The independence of the audit partner and of the audit firm appears to have been impaired.
   - There is an advocacy threat. Two weeks prior to AGE being awarded a tender to audit DanChrome, the audit partner was requested by the major shareholders at the time to sell their shareholding in DanChrome on their behalf.
   - The audit partner (Denzil Phillips) should not be involved in the audit or sale negotiation as a safeguard.

   (iii) Integrity of the client’s principal owners, key management and those charged with governance.
   - There appears to be concerns about the integrity of the client, as SamCoal is involved in illegal mining.

HJB
However, it should be considered that the previous auditors resigned due to their lack of resources and not because they had concerns about management’s integrity. (1)

The previous auditors stated that DanChrome has a good reputation in the industry; however, the fact that the remuneration of the directors is decided by the audit committee raises concerns about the compliance of the company with regard to corporate governance. (2)

The MD and CEO have been with DanChrome for 10 years, which decreases AGE’s standing risk. (1)

DanChrome seems capable of paying the audit fee based on its growth and performance in successive financial years. Losses made in the current year do not appear significant enough to hinder DanChrome’s ability to pay the audit fee. (1)

(iv) Other significant matters
- Establish whether there are any reasons for the firm not to establish a professional relationship with the client. Certain factors suggest that such a relationship would in fact be desirable, namely (1)
  – DanChrome has a good reputation in the industry. (1)
  – The previous auditors enjoyed a long association with the company. (1)
- Determine whether there is a legal vacancy. The fact that the previous auditors resigned could possibly indicate that there is a legal vacancy in terms of section 91 of the Companies Act. (1)
- Establish the professional and legal responsibilities in terms of sections 45 and 46 of the Auditing Profession Act due to possible reportable irregularities resulting from illegal mining operations by SamCoal Mines (forming part of the DanChrome Group). (1)

(v) Terms of the engagement
The terms of the engagement should be agreed on in the engagement letter highlighting the responsibility of the auditors and that of management. The engagement letter should also highlight the auditors’ responsibility to report reportable irregularities. (2)

Total 20
Maximum 15
INTRODUCTION

“A goal without a plan is just a wish.” – Antoine de Saint-Exupery (1900 to 1944).

“Falling to plan is planning to fail.” – Alan Lakein

From the above quotes, we see that planning is a very important part of the audit to ensure that the audit is executed and conducted properly.

Planning an audit of the financial statements forms the second phase of the audit process.

For ease of discussion, the basic concepts that will be discussed are as follows:

1. Obtaining an understanding of the entity and its environment
2. Assessment of risks of material misstatement at the financial statement level
3. Assessment of risks of material misstatement at the assertion level
4. Planning activities
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 can obtain 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 a response to the identified risks of material misstatements at the overall financial statement level and at assertion level;
- know the difference between an audit plan and audit strategy and discuss the details dealt with in the audit plan and audit strategy;
- calculate planning materiality and apply planning materiality calculated to a given scenario; and
- identify weaknesses in the calculation of materiality presented to you in a scenario.
PRESCRIBED STUDY MATERIAL

ISA 200: Overall objectives of the independent auditor and the conduct of an audit in accordance with International Standards on Auditing
ISA 300: Planning an audit of financial statements
ISA 315: Identifying and assessing the risks of material misstatement through understanding the entity and its environment
ISA 320: Materiality in planning and performing an audit
ISA 330: The auditor’s responses to assessed risks
ISA 600: Audits of group financial statements (including the work of component auditors)

Also refer to Auditing Notes for South African Students, 9th edition, chapter 7.

SECTION A – ADDITIONAL INFORMATION

1. Obtaining an understanding of the entity and its environment

During the planning phase, the auditor will gain an understanding of the entity and its environment including the entity's internal control. The auditor should obtain this understanding to be able to identify and assess the risks of material misstatement whether due to fraud or error, at the financial statement and assertion level. This risk assessment will then provide the auditor with a basis for designing and implementing responses to the assessed risks of material misstatement (ISA 315, par 3).

ISA 315, par 11 to 24, sets out the aspects of which the auditor shall obtain an understanding of. It is important for the auditor to obtain an understanding of the entity and its environment (ISA 315, par 11) as well as the entity's relevant internal controls (ISA 315, par 12–24). It is a matter of the auditor’s professional judgement whether a control, individually or in combination with others, is relevant to the audit. For a detailed discussion on the understanding that the auditor should obtain with regard to the entity’s internal control, refer to study unit 4.

The auditor shall obtain an understanding of the entity and its environment, including the entity's internal control, in order to identify and assess the risks of material misstatement. In identifying and assessing the risks of material misstatement the auditor shall perform risk assessment procedures.

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

(a) inquiries

(b) analytical procedures

(c) observation and inspection
EXAMINATION TECHNIQUE

It is important to understand the difference between the following definitions of risks. Please refer to the glossary of terms included in the SAICA Handbook, Volume 2, 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
7. Significant risk

*Audit risk* is a function of the risks of material misstatement (*inherent risk and control risk*) and *detection risk*.

If you are required to describe the risks of material misstatement, you will not discuss the 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 financial statement level**

Risks of material misstatement at the financial statement level refer to risks that relate pervasively to the financial statements as a whole and potentially affect many assertions (*ISA 315, par A118*).

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 complete. Refer to *ISA 315, Appendix 2*, for the list of these examples.

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<th>No</th>
<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>
</tbody>
</table>
| 2. | –Liquidity issues  
–Operating losses  
–Loss of significant customers or suppliers  
–Constraints on availability of capital and credit  
–Changes or loss of key personnel | 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 because of the entity engaging in fraudulent financial reporting to hide a going concern threat. | Inherent risk |
<table>
<thead>
<tr>
<th>No</th>
<th>Risk indicator</th>
<th>Description of risk</th>
<th>Component of audit risk</th>
</tr>
</thead>
<tbody>
<tr>
<td>3.</td>
<td>Changes in the industry to which management do not want to comply</td>
<td>The AFS may be fraudulently materially misstated, as the <strong>entity might not comply with the changes to laws</strong> (Companies Act, King III, etc), in the industry within which it operates, <strong>indicating lack of integrity by management</strong>.</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 <strong>control environment</strong> 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 <strong>errors might be occurring in the preparation of financial records</strong>.</td>
<td>Control risk</td>
</tr>
</tbody>
</table>
| 6. | New client | - The AFS may be materially misstated, as material misstatements and errors **could go undetected** as we are not familiar with the client.  
- The AFS may be fraudulently materially misstated by management because the new auditors have limited knowledge of the entity. | Detection risk  
Inherent risk |
<p>| 7. | Management’s integrity questionable | The AFS may be materially misstated, as the <strong>control environment might be compromised by management who lack integrity</strong>. | Control risk/Inherent risk |
| 8. | Use of work of third party (component auditor [ISA 600]/ internal auditor [ISA 610]/expert [ISA620]) | The AFS may be materially misstated, as the <strong>third party might not be competent and appropriately qualified</strong> to perform the work required for audit evidence. | Inherent risk |
| 9. | Management receive bonuses driven by profits | The AFS may be materially misstated, as directors might <strong>engage in fraudulent financial reporting</strong>, i.e. overstatement of revenue and understatement of expenses to maximise bonuses. | Inherent risk |
| 10. | Financials to be used to obtain financing from the bank | The AFS may be materially misstated, as directors might <strong>engage in fraudulent financial reporting</strong>, i.e. overstatement of assets and profits and understatement of liabilities and expenses to ensure that financing will be obtained. | Inherent risk |</p>
<table>
<thead>
<tr>
<th>No</th>
<th>Risk indicator</th>
<th>Description of risk</th>
<th>Component of audit risk</th>
</tr>
</thead>
</table>
| 11. | Tight deadline | - The AFS may be materially misstated, as management might not have sufficient time to properly account and disclose post-balance-sheet events (subsequent events).  
- There is a risk that the auditor might not have sufficient time to obtain the audit evidence, resulting in material misstatement going undetected. | Inherent risk  
Detection risk |
| 12. | Listed on the JSE Ltd | The AFS might be materially misstated, as the company might not comply with JSE regulations, resulting in the delisting of the company and affecting the going concern of the company. | Inherent risk |
| 13. | Change of the accounting software | 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. | Control risk  
Inherent risk |
| 14. | History of errors or significant adjustment at year end | The AFS may be materially misstated, as the current financial statements might include material misstatements. | Inherent risk |
| 15. | Managers are the owners of the entity | The AFS may be materially misstated, as directors might engage in fraudulent financial reporting to present the performance and position of the entity in a more favourable light. | Inherent risk |
| 16. | Entity required to produce group financial statements/Different accounting policies in a group/Different accounting systems/reporting dates | The AFS may be materially misstated, as errors might occur during consolidation because it involves an intricate process possibly resulting in material misstatements.  
The AFS may be materially misstated, as related party transactions might not be eliminated on consolidation.  
The AFS may be materially misstated, as the consolidation might not be properly done in terms of IAS 27. | Inherent risk |
| 17. | Obtaining control of another company | The AFS may be materially misstated, as IFRS 3/IFRS 10 might not be properly accounted for. | Inherent risk |
3. **Assessment of risks of material misstatement at the assertion level**

Assertions are management representations that are embodied in the financial statements, and they are used by the auditor to consider the different types of potential misstatements that may 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 may 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. (Please note that these conditions and events evident from the example below 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 made 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 it sold to one of its once-off foreign customers in order 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 receive 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) Present your answer using assertions.

**SUGGESTED SOLUTION**

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

(b) and (c) Risks of material misstatement at the assertion level.
### Conditions or events affecting risks at assertion level

<table>
<thead>
<tr>
<th>Conditions or events</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></td>
<td></td>
</tr>
<tr>
<td>Complexity of the underlying transaction</td>
<td>Foreign customers are invoiced in foreign currencies.</td>
<td>There is a risk that revenue from foreign customers <strong>might not be</strong> translated at the correct exchange rate.</td>
<td>Accuracy</td>
</tr>
<tr>
<td>Susceptibility of the account to misstatement</td>
<td>Management receive a bonus based on profit for the year.</td>
<td>There is a risk that revenue <strong>might recognised in the incorrect period</strong> in order to inflate the revenue figure for bigger bonuses.</td>
<td>Cut-off</td>
</tr>
<tr>
<td></td>
<td></td>
<td>There is a risk that management <strong>might record fictitious sales</strong> in order to inflate the revenue figure for bigger bonuses.</td>
<td>Occurrence</td>
</tr>
</tbody>
</table>

(a) 1. Significant account balance: **Trade receivables**
2. Significant class of transactions: **Allowance for credit losses**.

(b) Risk of material misstatement at the assertion level

<table>
<thead>
<tr>
<th>Conditions or events</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></td>
<td></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 <strong>might not be translated at the correct closing rate</strong> at year end.</td>
<td>Valuation and allocation</td>
</tr>
<tr>
<td>Completion of unusual and complex transaction And/or Complexity of the underlying transaction making up the account balance And/or Transaction not subject to routine processing</td>
<td>Once-off FEC for goods sold to foreign customers.</td>
<td>There is a risk that FEC gains/losses <strong>might not be accurately accounted for</strong>, resulting in a misstatement of the trade receivables account.</td>
<td>Valuation and allocation</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 <strong>fictitious debtors could be recorded</strong> in the financial records in order to inflate the revenue figure for bigger bonuses.</td>
<td>Existence</td>
</tr>
<tr>
<td>Conditions or events affecting risks at assertion level</td>
<td>Risk indicator</td>
<td>Risk (b)</td>
<td>Assertion (c)</td>
</tr>
<tr>
<td>--------------------------------------------------------</td>
<td>----------------</td>
<td>----------</td>
<td>--------------</td>
</tr>
<tr>
<td>Appendix 2 (ISA 315)</td>
<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>
</tr>
<tr>
<td></td>
<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>
</tr>
</tbody>
</table>

**Please note**

1. The first two columns were not required. They are included in the suggested solution to demonstrate to you how conditions or events may affect risks at the assertion level.

2. The assertions at risk for the relevant class of transactions (statement of comprehensive income line item) revenue, are **accuracy**, **cut-off** and **occurrence** in this instance.

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

The *completeness* assertion has not been dealt with for the trade receivables account, as it is not at risk for ABC Ltd.

**EXAMINATION TECHNIQUE**

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

4. When you are required to describe the risks at the assertion level, do not confuse it with the question on audit procedures. Audit procedures will be covered in Tutorial Letter 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) and so forth
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. the 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 on components regarding 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 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 from other engagements performed by the engagement partner for the entity is relevant.

(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. selection of the engagement team
2. the engagement budget

(Refer to ISA 300, Appendix.)

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

The completion of the overall audit strategy guides the development of the audit plan.

**IMPORTANT PRINCIPLE**

Risks at the overall financial statement level will be dealt with by the overall responses (ISA 330, par 5 and A1 to A33). The risks at the assertion level will be dealt with by the audit procedures responsive to the assessed risk of material misstatement at the assertion level (ISA 330, par 6 and A4 to A8).

The audit plan is more detailed than the overall audit strategy and includes 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 should be carried out to ensure that the engagement complies with 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 substantive audit approach) for designing and performing further audit procedures (ISA 330, par A4).

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

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

OR

A **substantive approach** may be followed, which entails both tests of detail and substantive analytical procedures.

**IMPORTANT PRINCIPLE**

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

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

**Timing (ISA 330, par A6):** The timing of an audit procedure refers to when the audit is performed. The auditor can perform procedures as follows:
- 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 in the interim and after year end.
(The auditor has to incorporate an element of unpredictability in the timing of performing certain audit procedures.)

**Extent (ISA 330, par A7):** The extent of an audit procedure refers to the quantity to be performed. This entails the quantity of tests of control, tests of detail and/or analytical procedures the auditor will perform. For instance, if you have a strong control environment, you will perform more tests of controls, with fewer tests of detail and more analytical procedures (and vice versa).

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

It is important to understand that the approach that the auditor will follow is generally governed by
- the *necessity* to place reliance on controls;
- the *possibility* of placing reliance on controls; and
- the *desirability* of relying on the controls.

*For an example on audit approach, please attempt self-assessment question 9.*

---

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

Materiality in planning and performing an audit is determined when developing an 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 materiality and performance materiality (*Refer to ISA 320, par 10–11.*) Please note that the performance materiality calculated will be lower than the 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:
- If inherent risk is assessed as high, a **low** materiality will be set to compensate for the high inherent risk.
- If inherent risk is assessed as low, a **high** materiality will be set because there is a smaller chance that a material misstatement will 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>
<tbody>
<tr>
<td>High (0.5%)</td>
<td>R25,000 (low)</td>
<td>• Increased sample sizes</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• Can tolerate less errors in sample tested</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• Most conservative</td>
</tr>
<tr>
<td>Medium (1%)</td>
<td>R50,000 (medium)</td>
<td>• Sample sizes smaller than above</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• Can tolerate a few more errors in samples tested</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• More conservative</td>
</tr>
<tr>
<td>Low (2%)</td>
<td>R100,000 (high)</td>
<td>• Smallest sample sizes</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• Can tolerate more errors (we do not expect many errors)</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• Less conservative</td>
</tr>
</tbody>
</table>

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 ½–1%
   - Gross profit 1–2%
   - Net income 5–10%
   - Total assets 1–2%
   - Equity 2–5%

You may 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 – QUESTION ON PLANNING AN AUDIT (RISK ASSESSMENT, PLANNING ACTIVITIES AND MATERIALITY)

QUESTION 1

The following is an extract from a Unisa examination question. This question has been selected to assist you in using the information in the scenario to answer the auditing questions properly. Read the required part, analyse it, and answer the question in the way you would in the examination. Mark your answer and identify the areas in which you fell short.

Once you have completed this exercise, see the same question from page 31 to page 34 and see how we have analysed the “required” section (to make sure you understand what is required of you and how to link it to what you have studied). We have also taken you through the suggested solution to show you how to answer this type of question in order to earn maximum marks. Note the markers’ comments that follow after the suggested solution.

YOU HAVE 7 MINUTES TO READ THIS QUESTION.

BACKGROUND INFORMATION

You are an audit partner at Motaung & Khoza Inc (Motaung & Khoza), a medium-sized auditing firm based in Southern Africa. You were promoted to partnership seven years ago after being with the firm for 11 years.

You are currently conducting the audit of Paparazzi (Pty) Ltd (Paparazzi) for the year ended 31 August 2016. You have worked on the audit of Paparazzi since joining Motaung and Khoza, first as a trainee accountant and now as the partner in charge of the audit. Paparazzi has never had a modified audit opinion. During a discussion held with the CEO of Paparazzi, Tumisho Khumalo, he promised you and your family of four a free subscription to the Paparazzi magazine if an unmodified audit opinion were issued for the 2016 financial year. Realising that your 18-year-old daughter wants to become a journalist, Mr Tumisho Khumalo also indicated that the company would grant her a comprehensive study bursary (to the value of approximately R40 000) if you expressed an unmodified audit opinion. To remain ethical, your daughter will have a commitment to work at Paparazzi for five years after her graduation.

Attached are the following documents that deal with various aspects of the audit.

Description

Additional information on the business
Working paper A1: Revenue

ADDITIONAL INFORMATION ON THE BUSINESS

Paparazzi is a magazine company that was founded 18 years ago by Tumisho Khumalo. The magazine, called Paparazzi, covers the lives of local and international celebrities. Paparazzi is sold in South Africa, Botswana and Namibia.
The head office of Paparazzi is situated in Cape Town, with branches in Durban and Johannesburg. Each branch and the head office are responsible for the printing of the magazines for selected regions. All printing machines are acquired on lease and are replaced every second year. At the end of the second year, the printing machines are sent back to the lessor. The printing machines have a useful life of five years.

The shareholders of Paparazzi are as follows:

<table>
<thead>
<tr>
<th>Shareholders</th>
<th>% holding</th>
<th>Position</th>
</tr>
</thead>
<tbody>
<tr>
<td>Mr Tumisho Khumalo</td>
<td>30%</td>
<td>CEO and chairperson of the board</td>
</tr>
<tr>
<td>Mr Michael Strauss</td>
<td>25%</td>
<td>Financial director</td>
</tr>
<tr>
<td>Ms Ursula Mol</td>
<td>25%</td>
<td>Managing director</td>
</tr>
<tr>
<td>Other</td>
<td>20%</td>
<td></td>
</tr>
</tbody>
</table>

During the 2015 financial year, 15% of the shares were issued to the directors in terms of a share incentive scheme. Share options have not yet vested. One of the vesting conditions is that Paparazzi yield earnings per ordinary share of at least 180 cents. Paparazzi intends listing on the JSE Ltd in the next financial year.

Michael Strauss has informed you that the audited financial statements will be used to apply for financing at the bank. This financing will be used to pay a settlement amount on the acquisition of an 80% interest in Top Decor Ltd (Top Decor), a magazine company that caters for upmarket homeowners. Top Decor was acquired by Paparazzi on 15 May 2016. Top Decor is the brainchild of Lee Zing, a world-renowned interior decorator, originally from Namibia. The company is situated in Namibia and is audited by one of the other medium-sized audit firms in Namibia.

The following took place during the year under review:

- Paparazzi created a website (refer to working paper B1) to cater for the increased demand for the Paparazzi magazine. The website will be used for information and trading purposes.

- Lorraine & Mable (Pty) Ltd (Lorraine & Mable), a cosmetics company, was running a competition in the Paparazzi magazine, whereby five lucky readers would each win a Volkswagen Polo vehicle. The competition disclosed in the Paparazzi magazine, however, stated erroneously that the lucky readers would each win a Mini Cooper vehicle. In accordance with the advice from its legal advisors, Lorraine & Mable had to award the winning prizes, five Mini Coopers, to the lucky readers on 25 August 2016. Lorraine & Mable is now suing Paparazzi for the difference in cost between the Mini Cooper vehicles and the Volkswagen Polo vehicles, which amounts to R750 000. The legal counsel of Paparazzi is studying the claim and at this point, they cannot comment on the likelihood of possible significant liability arising from this dispute.
## Accounting policies

The accounting policies used in the preparation for the 2016 financial statements are consistent with those applied in the previous financial year. The following are extracts from these policies:

1. **Revenue**
   
   Revenue is recognised at fair value to the extent that it is probable that the economic benefits will flow to the entity and the revenue can be reliably measured. The following specific recognition criteria are adopted: turnover from net invoiced sales and circulation; revenue is recognised when risk is transferred to the customer; dividend income is recognised when the last date to register for the dividend has passed; and interest is recognised on a time proportion basis which takes into account the effective yield on the asset over the period it is expected to be held.

2. **Operating leases**
   
   Leases, whereby the lessor retains the risks and rewards of ownership of the underlying asset, are classified as operating leases. Payments made under operating leases are charged against income on a straight-line basis over the period of the leases.

3. **Financing leases**
   
   Leases that transfer substantially all the risks and rewards of ownership of the underlying asset to the group are classified as finance leases. Assets acquired in terms of finance leases are capitalised at the lower of fair value and present value of the minimum lease payments at the inception of the lease, and depreciated over the estimated useful life of the asset.

   The capital element of future obligations under the leases is included as a liability in the statement of financial position. Lease payments are allocated using the effective interest method to determine the lease finance cost, which is charged against income over the lease period, and the capital repayment, which reduces the liability of the lessor.
Revenue

<table>
<thead>
<tr>
<th>Description</th>
<th>2016 R'000</th>
<th>2015 R'000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sale of magazines</td>
<td>18 993</td>
<td>12 999</td>
</tr>
<tr>
<td>Local sales</td>
<td>14 962</td>
<td>9 833</td>
</tr>
<tr>
<td>Foreign sales</td>
<td>4 031</td>
<td>3 166</td>
</tr>
<tr>
<td>Advertising income</td>
<td>321 600</td>
<td>310 978</td>
</tr>
</tbody>
</table>

- Sales of magazines are up 46% when compared to the previous year. This is attributed to the increased demand for the magazines and the introduction of a website to accept orders.

- Sales of magazines comprise sales made to retail outlets and subscribers.
  - Sales to retail outlets are made at a discount of 20% of the selling price of the magazine. The retail outlets acquire the magazines on credit. At the end of the month, the magazines, which were not sold, are sent back to Paparazzi. Paparazzi then invoices the retail outlets for the actual magazines sold.
  - Sales to the subscribers are made at a discount of 15% on the selling price of the magazine. For the subscription to be valid, the subscribers are required to pay upfront. The subscription for the magazine is for a 12-month period. The subscription can take place any time during the year.

- Foreign sales comprise sales made in Botswana and Namibia. Individuals who wish to purchase the *Paparazzi* in these foreign countries can only purchase it at their local retail outlet.

- Advertisers are contracted with Paparazzi for a period of at least one year to advertise in the *Paparazzi* magazine. The cost differs depending on space (the number of pages) and location (specific part of magazine) used by advertisers in order to advertise their products. The advertisers are required to pay the one-year advertising fee at the inception of the contract. This advertising fee is non-refundable, regardless of whether advertising opportunities are used during the contracted period or not.
YOU NOW HAVE 35 MINUTES TO ANSWER THIS QUESTION.

<table>
<thead>
<tr>
<th>REQUIRED</th>
<th>Marks</th>
</tr>
</thead>
<tbody>
<tr>
<td>(a) Identify the significant audit risks of Paparazzi and its group at the overall financial statement level for the 2016 financial year by using the additional information on the business.</td>
<td>15</td>
</tr>
<tr>
<td>(b) Regarding working paper A1 (Revenue): 1. Identify the risks at the assertion level relating to revenue. You have to refer to all the revenue sources of Paparazzi.</td>
<td>8</td>
</tr>
</tbody>
</table>

EXAMINATION TECHNIQUE

What follows is the same question, but with notes to indicate how to answer this type of question. The notes on the scenario are the same type of notes a student should be making during the reading time, to organise the information logically, to mark important key words or phrases and to be on the lookout for certain types of questions that might be asked based on the scenario provided.

QUESTION 1 23 marks

BACKGROUND INFORMATION

You are an audit partner at Motaung & Khoza Inc (Motaung & Khoza), a medium-sized auditing firm based in Southern Africa. You were promoted to partnership seven years ago after being with the firm for 11 years.

You are currently conducting the audit of Paparazzi (Pty) Ltd (Paparazzi) for the year ended 31 August 2016. You have worked on the audit of Paparazzi since joining Motaung and Khoza, first as a trainee accountant and now as the partner in charge of the audit. Paparazzi has never had a modified audit opinion. During a discussion held with the CEO of Paparazzi, Tumisho Khumalo, he promised you and your family of four a free subscription to the Paparazzi magazine, if an unmodified audit opinion were issued for the 2016 financial year. Realising that your 18-year-old daughter wants to become a journalist, Mr Tumisho Khumalo also indicated that the company would grant her a comprehensive study bursary (to the value of approximately R40 000) if you expressed an unmodified audit opinion. To remain ethical, your daughter will have a commitment to work at Paparazzi for five years after her graduation.

Attached are the following documents that deal with various aspects of the audit.

Description

Additional information on the business
Working paper A1: Revenue
ADDITIONAL INFORMATION ON THE BUSINESS

Paparazzi is a magazine company that was founded 18 years ago by Tumisho Khumalo. The magazine, called Paparazzi, covers the lives of local and international celebrities. Paparazzi is sold in South Africa, Botswana and Namibia (risks a1 and a3) (risks b3).

The head office of Paparazzi is situated in Cape Town, with branches in Durban and Johannesburg (risks a3 and a5.7). Each branch and the head office are responsible for the printing of the magazines for selected regions. All printing machines are acquired on lease (risks a5.1) and are replaced every second year. At the end of the second year, the printing machines are sent back to the lessor. The printing machines have a useful life of five years.

The shareholders of Paparazzi are as follows:

<table>
<thead>
<tr>
<th>Shareholders</th>
<th>% holding</th>
<th>Position</th>
</tr>
</thead>
<tbody>
<tr>
<td>Mr Tumisho Khumalo</td>
<td>30%</td>
<td>CEO and chairperson of the board (risk a2)</td>
</tr>
<tr>
<td>Mr Michael Strauss</td>
<td>25%</td>
<td>Financial director</td>
</tr>
<tr>
<td>Ms Ursula Mol</td>
<td>25%</td>
<td>Managing director</td>
</tr>
<tr>
<td>Other</td>
<td>20%</td>
<td></td>
</tr>
</tbody>
</table>

During the 2015 financial year, 15% of the shares were issued (risk a11) to the directors in terms of a share incentive scheme. Share options have not yet vested. One of the vesting conditions is that Paparazzi yield earnings per ordinary share of at least 180 cents (risk a4.1 and risk b1.1). Paparazzi intends listing on the JSE Ltd (risk a4.4) in the next financial year.

Michael Strauss has informed you that the audited financial statements will be used to apply for financing at the bank (risks a4.3 and a6). This financing will be used to pay a settlement amount on the acquisition of an 80% interest in Top Decor Ltd (Top Decor), a magazine company that caters for upmarket homeowners (risk a7). Top Decor was acquired by Paparazzi on 15 May 2016 (risks a5.4 and a10). Top Decor is the brainchild of Lee Zing, a world-renowned interior decorator, originally from Namibia. The company is situated in Namibia and is audited by one of the other medium-sized audit firms in Namibia (risks a5.5 and a7).

The following took place during the year under review:

- Paparazzi created a website (risk a5.6) to cater for the increased demand for Paparazzi magazine. The website will be used for information and trading purposes (risk a8, risk b2).

- Lorraine & Mable (Pty) Ltd (Lorraine & Mable), a cosmetics company, was running a competition in the Paparazzi magazine, whereby five lucky readers would each win a Volkswagen Polo vehicle. The competition disclosed in the Paparazzi magazine, however, stated erroneously that the lucky readers would each win a Mini Cooper vehicle. In accordance with the advice from its legal advisors, Lorraine & Mable had to award the winning prizes, five Mini Coopers, to the lucky readers on 25 August 2016. Lorraine & Mable is now suing Paparazzi (risk a9) for the difference in cost between the Mini Cooper vehicles and the Volkswagen Polo vehicles, which amounts to R750 000. The legal counsel of Paparazzi is studying the claim and at this point, they cannot comment on the likelihood of possible significant liability arising from this dispute (risk a5.3).
Accounting policies

The accounting policies used in the preparation for the 2016 financial statements are consistent with those applied in the previous financial year. The following are extracts from these policies:

1. **Revenue (revenue recognition – incorporate accounting knowledge relating to revenue recognition)**
   Revenue is recognised at fair value to the extent that it is probable that the economic benefits will flow to the entity and the revenue can be reliably measured. The following specific recognition criteria are adopted: turnover from net invoiced sales and circulation; revenue is recognised when risk is transferred to the customer (risk a5.2); dividend income is recognised when the last date to register for the dividend has passed; and interest is recognised on a time proportion basis which takes into account the effective yield on the asset over the period it is expected to be held.

2. **Operating leases**
   Leases, whereby the lessor retains the risks and rewards of ownership of the underlying asset, are classified as operating leases. Payments made under operating leases are charged against income on a straight-line basis over the period of the leases.

3. **Financing leases**
   Leases that transfer substantially all the risks and rewards of ownership of the underlying asset to the group are classified as finance leases. Assets acquired in terms of finance leases are capitalised at the lower of fair value and present value of the minimum lease payments at the inception of the lease, and depreciated over the estimated useful life of the asset.

   The capital element of future obligations under the leases is included as a liability in the statement of financial position. Lease payments are allocated using the effective interest method to determine the lease finance cost, which is charged against income over the lease period, and the capital repayment, which reduces the liability of the lessor.
Revenue

<table>
<thead>
<tr>
<th>Description</th>
<th>2016 R'000</th>
<th>2015 R'000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sale of magazines</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Local sales</td>
<td>18 993</td>
<td>12 999</td>
</tr>
<tr>
<td>Foreign sales (risk b1.3)</td>
<td>4 031</td>
<td>3 166</td>
</tr>
<tr>
<td>Advertising income</td>
<td>321 600</td>
<td>310 978</td>
</tr>
</tbody>
</table>

- Sales of magazines are up 46% when compared to the previous year. This is attributed to the increased demand for the magazines and the introduction of the website to receive orders (risk b1.2).

- Sales of magazines comprise sales made to retail outlets and subscribers.
  - Sales to retail outlets are made at a discount of 20% of the selling price (risk b1.8) of the magazine. The retail outlets acquire the magazines on credit. At the end of the month, the magazines, which were not sold, are sent back to Paparazzi. Paparazzi then invoices the retail outlets for the actual magazines sold (risk b1.7).
  - Sales to the subscribers are made at a discount of 15% on the selling price (risk b1.8) of the magazine. For the subscription to be valid, the subscribers are required to pay upfront. The subscription for the magazine is for a 12-month period. The subscription can take place at time during the year (risk b1.4).

- Foreign sales comprise sales made in Botswana and Namibia (risk b1.3). Individuals who wish to purchase the Paparazzi in these foreign countries may only purchase it at their local retail outlet.

- Advertisers are contracted with Paparazzi for a period of at least one year to advertise (risk b1.5) in the Paparazzi magazine. The cost differs depending on space (the number of pages) and location (specific part of magazine) used by advertisers in order to advertise their products. The advertisers are required to pay the one-year advertising fee at the inception of the contract. This advertising fee is non-refundable, regardless of whether advertising opportunities are used during the contracted period or not.
YOU NOW HAVE 35 MINUTES TO ANSWER THIS QUESTION.

REQUIRED

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>(a)</td>
<td>Identify the significant audit risks of Paparazzi and its group at the overall financial statement level for the 2016 financial year, by using the additional information on the business.</td>
</tr>
</tbody>
</table>
| (b) | Regarding working paper A1 (Revenue):
1. Identify the risks at the assertion level relating to revenue. You have to refer to all the revenue sources of Paparazzi. | 8 |

(Suggested solution)

(a) Significant audit risks at the overall financial statement level of Paparazzi

1. The company trades in neighbouring countries and it has a subsidiary in Namibia, which has foreign exchange implications (Reserve Bank regulations).

2. The CEO, Tumisho Khumalo, is also the chair of the board.
   2.1 There is a risk of a weak corporate governance structure and autocratic management domination (risk of management overriding controls).

3. The business is decentralised (branches in both Durban and Johannesburg) and magazines are sold in neighbouring states and in South Africa, which may result in fragmented internal controls and complicated accounting.

4. Management have an incentive to engage in fraudulent financial reporting by overstating profits and understating expenses and liabilities due to the following:
   4.1 The directors’ share incentive scheme has a vesting condition attached to earnings.
   4.2 The executive directors hold a significant number of shares in the company.
   4.3 The audited financial statements will be used to apply for an overdraft extension at the bank.
   4.4 Paparazzi is planning to list on the JSE Limited.

5. The fairly complex requirements for complying with IFRS (International Financial Reporting Standards) increase the risk of incorrect accounting treatment of measurement, recognition and disclosure of the following:
   5.1 leased assets, specifically compliance with International Accounting Standards (IAS 17) regarding the publishing machines under operating leases
   5.2 the accounting and recognition (IAS 18/IFRS 15) of revenue on the sale of magazine and advertising income (including complexity related to sales on consignment)
   5.3 the accounting and recognition (IAS 37) of the disputes, and possible provisions or contingencies, with regard to the claim instituted by Lorraine & Mable
   5.4 the acquisition of Top Decor magazine, which needs to be accounted for in accordance with IFRS 3
   5.5 the consolidation of the foreign subsidiary
   5.6 the cost relating to capitalising the website as per IAS 38 – intangible asset
5.7 Verification of branch financial information in terms of IFRS 8

6. The audited financial statements will be used to obtain financing from a financial institution.
   6.1 There is a risk that the auditor will be liable to the third party should an incorrect opinion be expressed and the bank relied on the audited financial statements. (1)

7. Top Decor, in which Paparazzi holds an 80% interest, is audited by another medium-sized audit firm.
   7.1 There is a risk that the other auditor might not be competent and/or independent, leaving us with a legal liability. (1)

8. The new website and internet sales system have the risk of
   8.1 loss of data; (1)
   8.2 continuity problems if the system does not function effectively; (1)
   8.3 risk of unauthorised access if firewalls are not effective; and (1)
   8.4 risk of errors if staff are not properly trained. (1)
   8.5 Any other valid point. (1)

9. The company is being sued: There is a risk of reputational damage, which could lead to possible client loss (advertisers) should the company be at fault. (1)

10. Related-party transactions might not be at arm’s length. (1)

11. The company issued share options during the year. There is a risk that Paparazzi does not comply with Company Act requirements. (1)

   Available 21
   Maximum 15

(b) 1. Identification of risks at the assertion level relating to revenue

   1. There is a risk that the revenue from all sources might be overstated because the directors received a share incentive scheme with a vesting condition based on earnings per share (all assertions).
      1.1 The occurrence assertion is at risk: Fictitious or very risky revenue from all sources might be recorded to inflate the sales. (1)
      1.2 The accuracy assertion is at risk: Revenue from all sources might be recorded at inflated amounts. (1)
      1.3 The cut-off assertion is at risk: Sales after year end might be recorded as current-year sales. (1)

   2. Internet sales might be recognised before risks and rewards of ownership have passed (before delivery has occurred – occurrence). (1)

   3. With regard to export sales, there is a risk that sales are translated at the incorrect spot rate (accuracy). (1)

   4. With regard to the subscription contracts, there is a risk that the revenues are not recognised at the correct stage of completion (accuracy and cut-off). (1)

   5. There is a risk that revenue from advertising may not be properly recognised at the correct stage of completion (accuracy and cut-off). (1)
6. The revenue for all sources accounts comprises complex transactions, and there is a risk of errors being made (accuracy). (1)

7. Sales to retail outlets may be recognised incorrectly if magazines are delivered, instead of being treated as consignment goods (accuracy, occurrence and cut-off). (1)

8. The sales to retail outlets and subscribers are made at a discount. There is a risk that discounts might not be excluded when accounting for revenue (accuracy). (1)

9. Revenue comprises sale of goods (magazines) and rendering of services (advertising clients' products in the magazine). There is a risk that revenue might not be disclosed or classified properly as per IFRS 15. (1)

MARKERS' COMMENTS

General
- Poor numbering was a problem throughout question one. Students did not use the same numbers that were used in the required part, making the marking process very difficult.
- Some students even numbered question 2 as question 1, and vice versa.
- Students also did not indicate properly if they finished one question to continue with another, and then subsequently continued with the first question.
- Illegible handwriting also made the marking process difficult.

Part (a)
- This part of the question dealt with significant risks at the financial statement level.
- There were 21 possible marks with a maximum of 15 for the answer.
- This part of the question was poorly answered although you could have earned marks easily.
- Many students became confused, and formulated audit procedures instead of identifying risks.
- Students do not understand the difference between risks at financial statement level and at assertion level.
- Most students mentioned the risk factors instead of discussing the audit risk, which should include the impact/effect of the risk factor on the financial statements, should it materialise.
- Some students made general comments such as “the risk is that we will have to rely on the work of other auditors”. In itself, this is of course not a risk if the student failed to demonstrate correctly why they perceive it as a risk, that is, that they might not be independent or competent enough, which would lead to material misstatements in the financial statements not being detected.
Some students gave recommendations instead of risks, thereby wasting precious time, as these were not asked. For instance, such students wrote “The company is planning to list on the JSE Ltd; therefore, the company will have to familiarise itself with stringent JSE regulations, or appoint an expert in this field.” This is incorrect. When you are asked to formulate a risk you are supposed to write: “The company is planning to list on JSE Ltd; therefore, there is a risk that the financial statements might be materially misstated to meet JSE requirements”. When wording an audit risk, think about what can go wrong with the financial information.

Part (b)
- This part of the question related to risks at the assertion level.
- Students who battled with risk questions made the same mistake as in (a) above, by not wording the risk adequately enough to earn the mark.
- Several students included all assertion level risks, even though the risk may not relate to revenue.
- Even though the scenario clearly indicates that revenue would be prone to overstatement, students incorrectly included the completeness of revenue as a risk.
STUDY UNIT 4 – PLANNING AN AUDIT (OBTAINING AN UNDERSTANDING OF THE CONTROL ENVIRONMENT)

INTRODUCTION

Obtaining an understanding of the entity and its environment, including its internal control, forms part of the planning phase of the audit process. For ease of discussion, the basic concepts that will be discussed are as follows:

1. internal control and business cycles
2. general and application controls
3. advanced CIS environment
4. IT governance

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;
- evaluate the general control environment as well as the application controls of a specific computer system;
• apply your knowledge of advanced computer technology and how it affects transaction processing and the system of internal controls in a computerised information system (CIS) environment;
• explain how the audit approach should be adapted when advanced computer technology is utilised in a CIS environment; and
• apply the principles and recommended practices relating to King III – IT governance.

PRESCRIBED STUDY MATERIAL

ISA 265 : Communicating deficiencies in internal control to those charged with governance and management
ISA 315 (Revised) : Identifying and assessing the risks of material misstatement through understanding the entity and its environment
ISA 402 : Audit considerations relating to an entity using a service organisation
ISAE 3402 : Assurance reports on control at a service organisation


Although it might seem as if you will have to work through a lot of material, it is only revision of work you already covered during your undergraduate studies and CTA level 1.

COMMENT

It is very important that you work meticulously through the theory in Auditing Notes regarding the business cycles. This will build the foundation that you will need to answer questions on risks in a manual and CIS environment.

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

You need to have sound basic knowledge (acquired from your undergraduate studies and prescribed study material) before attempting to answer any questions. We as lecturers can clearly see from a test/examination which students lack this basic knowledge, specifically relating to computer auditing. It is highly unlikely that you will ever audit in a fully manual environment. You must, however, be able to apply the basic principles of auditing in a manual environment to an audit in a computerised environment.

You have to be comfortable with these basic principles in a manual system before moving on to the more complex principles of auditing in a computerised information system (CIS) environment.
Due to its integrated nature, computer auditing should not be viewed in isolation. It can be combined and integrated into almost all the other auditing topics and tutorial letters. You can therefore expect integrated computer auditing questions in almost every test during the year, in the final examination and on board level.

We as lecturers do not expect you to be information technology (IT) experts. The basic concepts covered in this tutorial letter and in the relevant chapters of Auditing Notes should be 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
- 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 internal control relevant to the audit. Internal control is designed and implemented to deal with 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) do the following:*

- **Evaluate the design of those controls.** Does a control (individually or in combination with others) effectively prevent, or 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 as well.

**COMMENT**

Internal control, according to *ISA 315, par 14-24,* 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 examination.

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 information technology (IT), as the use of IT affects the way in which 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–A105).

**COMMENT**

As you can see, controls in an IT system (including general and application controls) form part of the entity’s 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 of how the entity responds to risks arising from IT (ISA 315, par 21), the auditor needs to understand controls in an IT system (including general and application controls).

These controls (general and application) may be manual and/or automated controls. For both manual and automated controls, you have to be comfortable with the theory on business cycles as discussed in chapters 10 to 14 of Auditing Notes.

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 completely manual system, it is relatively easy to trace the path of a transaction from its 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 the data move through the live processing phases of a computer system.

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

Organisations would typically 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

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

<table>
<thead>
<tr>
<th>What should the auditor consider when deciding if a risk is significant?</th>
<th>ISA 315, par 28</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>• Is the risk a risk of fraud?</td>
</tr>
<tr>
<td></td>
<td>• Is the risk related to recent significant economic, accounting or other developments and does it therefore require specific attention?</td>
</tr>
<tr>
<td></td>
<td>• Is (are) the transaction(s) complex?</td>
</tr>
<tr>
<td></td>
<td>• Does the risk involve significant transactions with related parties?</td>
</tr>
<tr>
<td></td>
<td>• What is the degree of subjectivity in the measurement of financial information related to the risk?</td>
</tr>
<tr>
<td></td>
<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>

<table>
<thead>
<tr>
<th>Why do significant risks often relate to significant non-routine transactions or judgmental matters?</th>
<th>ISA 315, par A132</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>• Non-routine transactions</td>
</tr>
<tr>
<td></td>
<td>- are unusual (due to size or nature) and</td>
</tr>
<tr>
<td></td>
<td>- occur infrequently.</td>
</tr>
<tr>
<td></td>
<td>• Judgmental matters</td>
</tr>
<tr>
<td></td>
<td>- may have significant measurement uncertainty (e.g., development of accounting estimates).</td>
</tr>
</tbody>
</table>

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

<table>
<thead>
<tr>
<th>How should the auditor respond to a significant risk?</th>
<th>ISA 330, par 15</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<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>

|                                                               | ISA 330, par 21 |
|                                                               | 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. |

If the approach is to perform substantive procedures only 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). |
| What if management have not appropriately responded to significant risks of material misstatement by implementing controls over significant risks? | This is an indicator of a significant deficiency in internal control. |
| 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 fail to implement appropriate remedial action regarding significant deficiencies that have been communicated to them (by us) in the past.  
- Evidence that management do 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  
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. Refer to par 10 and 11 for details 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 (eg 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). |
EXAMINATION TECHNIQUE

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 (eg only the weaknesses), or it can require a combination of two (eg 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 and 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 discuss those internal controls that are performed incorrectly (as indicated in the given scenario);
  - but also discuss the key internal controls that should be performed but are not mentioned in the scenario.

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

EXAMPLE

John is responsible for the maintenance of the fixed asset register of the company. He is also responsible for preparing a reconciliation of the fixed asset register to the general ledger accounts on a regular basis. He also records all purchases and sales of fixed assets in the accounting records. John signs all documents and reconciliations he prepares.

Required

Identify the weaknesses from the above-mentioned scenario.
Weaknesses

- Firstly, identify those weaknesses from the scenario (i.e. those internal controls that are not performed correctly):
  - John performs incompatible duties, since he
    - is responsible for the maintenance of the fixed asset register;
    - prepares a reconciliation between the fixed asset register and the general ledger accounts; and
    - records all purchases and sales of fixed assets in the accounting records.

- Secondly, identify those internal controls that you know should be performed, but are not mentioned in the given scenario (but which are still relevant to the scenario):
  - No one reviews and authorises the reconciliation between the fixed assets register and the general ledger accounts.
  - No one investigates the discrepancies or long outstanding items in the reconciliation.

As you can see, these internal controls are not mentioned in the scenario and are therefore considered to be weaknesses (as they are not performed). They are however still relevant to the given scenario.

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 on internal control, always keep the control activities in mind and apply them to the given scenario.

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

Always remember that you should mainly discuss 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 influence on the financial statements and/or the financial/reputational influence on the client’s business.
EXAMPLE

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

- **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 only 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) and positive aspects of the controls being performed. An evaluation means that you compare the negative and the positive elements of a certain matter and come to a conclusion.

A question can require you to identify/list/describe the internal controls (both manually and automated) that should be present in a client's 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.

HJB
EXAMPLE

Control →

- 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 examination 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 discuss 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 will 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 relating to many applications and supporting 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*, pages 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 and that govern the functions of developing, maintaining and operating systems to process data.

Refer to Auditing Notes, pages 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 in which the computerisation of the particular business cycle is discussed. 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 dealt with in the scenario (e.g. payroll cycle). Secondly, determine which function of the process in the transaction cycle is being discussed in the scenario. Does the scenario deal with any of the following:

- 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 discussed. Does the question require you to deal with the following:

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

List the controls that management of company 1X 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 would 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 will only discuss the input phase of the payroll cycle and the accuracy and completeness control objectives.

- Most marks in the test or examination will normally be allocated to the input and processing phases. Master file change controls are VERY popular, 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.
  - 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 program)
  - Physical controls
    - For example, servers kept in locked server rooms

- Application controls
  - Access on the application level
    - For example, user ID and password to gain access to the payroll application (e.g., VIP payroll program)
Remember that general controls are very important. You will not test application controls if you cannot rely on the general controls. For example, if a company does not have proper personnel practices regarding the employment of honest, qualified, competent staff (general control), it is highly unlikely that we will be able to rely on the application controls (i.e. transactions and data will probably not be very reliable).

A weakness in general controls may influence many applications, as it encompasses the overall controls over all IT activities.

General controls are very popular for tests and examinations:

- **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 apply it to a given scenario.

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

- **Continuity of operations:**
  - This includes 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 may be set out as follows:

**Internal controls in IT systems**

### Automated (programmed) controls
These controls are embedded in computer programs
Examples:
- Access controls on the computer, for example user names and passwords
- Program checks, for example limit checks, range checks, size checks, etc
- Exception reports

### Manual controls

#### Manual dependent
These manual controls are performed with the use or assistance of a computer.
Examples:
- A person using an exception report generated by a computer to follow up on exceptions
- A person authorising reconciliations on the computer via a unique password

#### Manual independent
These manual controls are performed without the use or assistance of a computer.
Examples:
- Physical paper reconciliation being authorised by a person
- A person following up on reconciling items without using a computer.

3. **Advanced CIS Environments**

**Overview**

You should by now have an understanding of the fundamental operational activities, transaction flows and controls that constitute a transaction processing cycle as they pertain to manual and CIS environments. Transaction processing may also be affected by the utilisation of advanced or complex computer technology. It is important for an auditor to obtain a general understanding of the risks and controls and to have a sense to realise when/if expert knowledge may be required.

**PRESCRIBED STUDY MATERIAL**

<table>
<thead>
<tr>
<th>Topic</th>
<th>Relevant chapter in <em>Auditing Notes</em></th>
</tr>
</thead>
<tbody>
<tr>
<td>Introduction <em>(read only)</em></td>
<td>Chapter 9</td>
</tr>
<tr>
<td>Networks</td>
<td>Chapter 9</td>
</tr>
<tr>
<td>Databases</td>
<td>Chapter 9</td>
</tr>
<tr>
<td>Electronic messaging systems (often asked in tests and examinations)</td>
<td>Chapter 9</td>
</tr>
<tr>
<td>The internet (often asked)</td>
<td>Chapter 9</td>
</tr>
<tr>
<td>Computer bureaux (often asked)</td>
<td>Chapter 9</td>
</tr>
<tr>
<td>Viruses (often asked)</td>
<td>Chapter 9</td>
</tr>
</tbody>
</table>

Study the topics above from *Auditing Notes*. The theory covered in chapter 9 should be sufficient to enable you to answer advanced CIS environment-related questions.

The topics on an advanced CIS environment may easily be integrated with the application controls topic in a question.
4. IT GOVERNANCE

Information technology governance

Information technology is becoming more important in every aspect of business.

As per the 2009 Institute of Directors in South Africa – King Code of Governance for South Africa:

"Information systems were used as enablers to business, but have now become pervasive in the sense that they are built into the strategy of the business. The pervasiveness of IT in business today mandates the governance of IT as a corporate imperative.

In most companies, IT has become an integral part of the business and is fundamental to support, sustain and grow the business. Not only is IT an operational enabler for a company, it is an important strategic asset to create opportunities and to gain competitive advantage. Companies have made, and continue to make a significant investment in IT. Virtually all components, aspects and processes of a company include some form of automation. This has resulted in companies relying enormously on IT systems. Further, the emergence and evolution of the internet, ecommerce, on-line trading and electronic communication have also enabled companies to conduct business electronically and perform transactions instantly. These developments bring about significant risks and should be well governed and controlled.

We, therefore, deal with IT governance in detail in King III for the first time. The IT governance chapter (Chapter 5) is focused on providing the most salient aspects of IT governance for directors. Due to the broad and ever-evolving nature of the discipline of IT governance, the chapter does not try to be the definitive text on this subject but rather to create a greater degree of awareness at director level.

There is no doubt that the complexity of IT systems does create operational risks and when one outsources IT services, for instance, this has the potential to increase risk because confidential information is outside the company. Consideration has to be given to the integrity and availability of the functioning of the system; possession of the system; authenticity of system information; and assurance that the system is usable and useful. Concerns include unauthorised use, access, disclosure, disruption or change to the information system.

In exercising their duty of care, directors should ensure that prudent and reasonable steps have been taken in regard to IT governance. To address this by legislation alone is not the answer. International guidelines have been developed through organisations such as ITGI and ISACA (COBIT and Val IT), the ISO authorities (e.g.: ISO 38500) and various other organisations such as OCEG. These may be used as a framework or audit for the adequacy of the company’s information governance for instance, but it is not possible to have 'one size fits all'. However, companies should keep abreast of the rapidly expanding regulatory requirements pertaining to information."
Study chapter 5 – “The governance of information technology” (IT) from the King Code of Corporate Governance for South Africa. This is very topical and the theory can be integrated into any test and/or examination.

EXAMPLE

Music4U (Pty) Ltd is a company offering its clients online music download facilities. Customers may purchase their favourite songs by means of SMS downloads. Customers are required to register online by supplying certain personal details such as name, surname, ID number, address, etc.

John Daily was recently appointed as the Chief Information Officer (CIO).

John is a registered internal auditor and has no IT governance experience. He however indicated to management that he was willing to learn. Due to financial constraints, the financial manager appointed John based purely on the fact that a lower salary could be paid to John.

Apart from other tasks, John was also given the sole responsibility for the management and protection of all customers’ personal information. During the year, John sold customer details to a cellphone provider. John explained that he was not aware that it was private information.

REQUIRED

Identify and discuss any governance of information technology concerns that you may have.

How do you approach a question like this?

- Firstly, identify the concerns. For this, you will need to know the theory to be able to identify procedures that are not followed correctly.
- Secondly, discuss why you are concerned about something by giving the principle (theory) from chapter 5.
- Give a conclusion.

Do not discuss things that are done correctly if you are required to give concerns (i.e. things that are done incorrectly).

CONCERN 1

- John, the recently appointed CIO, is a registered internal auditor and has no IT governance experience = CONCERN
- According to principle 5.3 (par 21 of King III), the CIO should be a suitably qualified and experienced person = PRINCIPLE
- John is not suitably qualified, as he is a registered internal auditor and he does not have the required IT governance experience = CONCLUSION

CONCERN 2

- The financial manager appointed John as the CIO = CONCERN
- According to principle 5.3 (par 20 of King III), the chief executive officer (CEO) should appoint the CIO = PRINCIPLE
- John was thus not correctly appointed, as he was appointed by the financial manager and not the CEO = CONCLUSION
CONCERN 3
- John was given the sole responsibility for the management and protection of all customers' personal information. During the year, John sold customer details to a cellphone provider = CONCERN
- According to principle 5.6 (par 38 of King III), the board should ensure that systems are in place that will ensure that the company treats all personal information as an important business asset and that all personal information processed by the company is identified = PRINCIPLE
- The board should take responsibility for the protection of personal information and should not assign it to the CIO. They should put systems in place to protect the information = CONCLUSION

SECTION B – QUESTIONS ON PLANNING AN AUDIT (OBTAINING AN UNDERSTANDING OF THE CONTROL ENVIRONMENT)

QUESTION 1 15 marks

YOU HAVE 5 MINUTES TO READ THIS QUESTION.

BACKGROUND INFORMATION
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 that is conducting the audit of Cottonworth Holdings Limited (Cottonworth). AMG was recently reappointed at Cottonworth's annual general meeting as the external auditor of the company and of the group’s financial statements for the year ended 31 August 2016. AMG is also the external auditor of Cottonworth (Proprietary) Limited (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 e-mail you sent to the senior trainee accountant on the audit:

From: unisa.student@amg.co.za
Sent: Friday, 12 August 2016, at 14:32
To: Helen.Peterson@amg.co.za
Subject: General and application controls at Cottonworth

Dear Helen

I just wanted to draw your attention to a few matters.

The IT control environment

I had a meeting with the current CIO, Don Futherton, on Monday, 1 August 2016. 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 liked the feeling of having sensitive company information at the push of a button and the power to use it as he saw fit. I formed 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 was currently only one copy of this document and that employees were welcome to come and read it in his office if they had ethical concerns. He mentioned that this was not specifically communicated but that he believed employees would speak up if they had issues.

Don informed me that a database administrator, Mark Jacobs, was appointed during January 2016. 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 2016: “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 2017 and that Mark will continue to work as a database administrator until such time.

I had a discussion with Mark on Tuesday, 9 August 2016. 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.

I had a meeting with the IT manager, Will Smithers, on Wednesday, 10 August 2016. 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 a fire that broke out at head office during August 2016. Luckily no employees suffered any injuries. 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).

**General controls over the continuity of operations**

The disaster recovery document was lost in the fire and everyone was a bit confused about 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 the 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 backups are made weekly and on a monthly basis all data are 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 2016).

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 management of Cottonworth, and it was an isolated incident only.

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 as a bouncer at a club 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 who I am: a born leader... (Just joking!)

Regards
Unisa student

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**YOU NOW HAVE 23 MINUTES TO ANSWER THIS QUESTION.**

**REQUIRED**

<table>
<thead>
<tr>
<th>Evaluate the reasoning and conclusions of the second-year trainee accountant with reference to the change in salary information mentioned in the e-mail to Helen Peterson. <strong>Note: Detailed reporting requirements of significant risks and significant deficiencies in internal controls are not required.</strong></th>
<th>Marks</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Communication skills: Logic, structure and layout</strong></td>
<td>1</td>
</tr>
</tbody>
</table>

(Unisa – examination, adapted)

**SUGGESTED SOLUTION**

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

**Fraud:**

1. The trainee accountant’s statement 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; and (1)
   (b) he used 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 trainee accountant's statement 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, par 35), the auditor shall evaluate the implications of the misstatement in relation to other aspects of the audit and the auditor should recognise that fraud is unlikely to be an isolated incident. (1)

Significant risk

6. The trainee accountant's statement that the incident is not a significant risk is incorrect. (1)

7. In terms of ISA 315, paragraph 28, the auditor shall, in exercising judgment about 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 trainee accountant's statement 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. (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. According to 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 – in this case, the asset, namely salaries, is susceptible to fraud. (1)
17. In terms of ISA 265, par A7, **misstatements, which 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. (1)

18. The deficiencies in the access controls over payroll data would therefore constitute a significant deficiency in internal control. (1)

19. The trainee accountant’s comment about it being not necessary to discuss this with management is incorrect. (1)

20. In terms of ISA 265, par 9, the auditor should respond to a significant deficiency in internal control by **communicating it in writing on a timely basis to those charged with governance**. (1)

**Communication skills: Logic, structure and layout**

Available 23

Maximum 15

QUESTION 2

YOU HAVE 11 MINUTES TO READ THIS QUESTION.

BACKGROUND INFORMATION

Your audit firm was recently appointed as the auditors of Gym2Earn (Pty) Ltd (Gym2Earn). After completing his master's degree through Unisa, John Fitness (the founder and CEO of Gym2Earn) developed an idea for a new cellphone application. He did research for his master's degree on the topic “Motivation through financial incentives”. John, being a gym fanatic himself, realised that people need some form of financial incentive to fulfil gym commitments, as finding the time and energy to go to the gym has become increasingly difficult.

John founded Gym2Earn in March 2016 after approaching RedBerry, a cellular service provider in South Africa, with his innovative idea for the Gym2Earn application. He signed a five-year contract with RedBerry for the exclusive rights to manage the Gym2Earn application.

The aim of the Gym2Earn application is to add a financial incentive for RedBerry users to exercise. The RedBerry user stands to lose money for not meeting gym commitments but could also earn money as an incentive for meeting them.

The following is a description of how the Gym2Earn application works:

1. **Gym2Earn application set-up**

   a. **Initial sign-up**
      - The user (gym member) downloads the Gym2Earn application from RedBerry Application World, available on the internet for free. The user should have his/her personal RedBerry phone to be able to use the Gym2Earn application. Additional information on the application is also available on the website at www.gym2earn.co.za via the internet.
      - Upon registration, the user completes his/personal details such as name, surname and banking details on the Gym2Earn application. The user also has to enter an e-mail address which serves as the user identification.
The user is then requested to choose the gym of his/her choice from a drop-down menu containing South African Gym2Earn-accredited gyms. The user is not able to add a gym to this list.

The Gym2Earn application then requires the user to enter a unique password and to re-confirm the chosen password.

A link to the terms and conditions is given so that the user can read and accept them. If the user selects the option, “I accept the terms and conditions”, the initial sign-up is complete. If the option, “I do not accept the terms and conditions”, is selected, the application does not allow the user to complete the initial sign-up.

The user lastly has to agree to the fixed monthly fee of R30 by selecting a “yes” or “no” option. If the “no” option is selected, the user will not be able to complete the sign-up process. If the “yes” option is selected, the user will be billed a fixed fee of R30 on a monthly basis. This amount will automatically be deducted from the user’s bank account monthly via a debit order.

b. Weekly gym commitment

After the initial sign-up has been completed, the next screen requires the user to make his/her gym commitment by choosing the number of times he/she intends going to the gym per week. A drop-down menu with the options of 0 to 7 days appears on the screen and the user may choose the number of days to which he/she wants to commits. The number 0 days may be chosen if the user will not be able to attend gym sessions in a particular week. A minimum of 1 day per week is, however, required if the user wants to qualify for a payout. This section has to be completed only after initial sign-up and it will remain applicable until the user subsequently amends his gym commitment via the application. The user is allowed to change his commitment only at the beginning of a week (each Monday morning).

The application then requires the penalty amount the user is willing to pay per gym session missed (minimum penalty of R10 per day missed). Again a drop-down menu is given with the options of R10, R20, R30, R40, R50 and “other amount” to choose from. Should the user select the “other amount” option, any round amount higher than R50 may be entered up to a maximum of R1 000. This, as with the number of days, may be changed only at the beginning of a week. If unchanged, the initial penalty amount chosen by the user applies.

2. Going to an accredited gym

The user goes to an accredited gym and accesses the Gym2Earn application on his/her RedBerry upon entering the gym.

The Gym2Earn application then links to the global positioning system (GPS) on the user’s RedBerry and confirms that he/she is actually at the accredited gym that he/she selected upon initial sign-up.

The work-out session at the gym needs to be for at least 30 uninterrupted minutes and is calculated from the moment the member selects the “start session” option on the application, enters his/her password and the position is confirmed by GPS. This logs the user’s attendance at the specific accredited gym. The Gym2Earn application will show a clock on the user’s RedBerry on which the user’s time at the gym is shown.

The user receives an e-mail notification (sent to the e-mail address selected as user identification number) to confirm that a gym session was started.

When the user leaves the gym, he/she must select the “end session” option on the application, which will stop the clock on the application. The clock shows the total time the user spent at the specific gym. The Gym2Earn application then again links to the GPS on the user’s RedBerry to confirm that the user is still at the accredited gym.
- An e-mail notification is then received by the user to notify him/her that the gym session was ended.

3. Penalty charges

- Each Sunday evening, the user is billed for committed gym sessions missed during the week (charged at the penalty amount chosen by the user) and the total amount due is deducted automatically from his/her credit card. Should the member be able to e-mail a valid doctor’s sick note by Sunday mornings, the amount will not be charged. The user receives an e-mail notification on Sunday evenings detailing the total penalty amount deducted from his/her bank account as well as the dates of the week to which the penalty applies.

4. Reward payouts

- All penalty charges collected from users who did not meet their commitments for the week are pooled each Tuesday. Gym2Earn retains 20% as an administrative fee and pays RedBerry 10% of the total money pool.
- The remaining 70% is paid out as rewards every Tuesday afternoon by Gym2Earn to users who did indeed meet all their gym commitments for the week through automatic electronic funds transfer (EFT) transactions.
- Each Tuesday, a list of all amounts received from users for the previous week is downloaded into an Excel spreadsheet by the accountant of Gym2Earn. The list contains the following detail:

<table>
<thead>
<tr>
<th>User ID (e-mail address)</th>
<th>Gross amount collected</th>
<th>Less 20% administrative fee</th>
<th>Less 10% RedBerry fee</th>
<th>Net amount collected</th>
</tr>
</thead>
<tbody>
<tr>
<td>For example: <a href="mailto:jpharding@gmail.com">jpharding@gmail.com</a></td>
<td>R500</td>
<td>R100</td>
<td>R50</td>
<td>R350</td>
</tr>
<tr>
<td>TOTAL</td>
<td>R500</td>
<td>R100</td>
<td>R50</td>
<td>R350</td>
</tr>
</tbody>
</table>

The total of the “net amount collected” column is the amount used to do the distribution each Tuesday afternoon. A distribution file is downloaded into an Excel spreadsheet each Tuesday and used to do the EFT payments.
- The pay-out is made to all users who met their gym commitments for the week based on the total amount each user was willing to forfeit for missed gym sessions that week.
YOU NOW HAVE 54 MINUTES TO ANSWER THIS QUESTION.

### REQUIRED

<table>
<thead>
<tr>
<th>Marks</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>5</td>
<td>1. Describe the <em>automated (programmed) controls</em> that exist and/or should be implemented in the Gym2Earn application to ensure the completeness of the initial sign-up process.</td>
</tr>
</tbody>
</table>

2. Recommend *controls* that could be put in place to ensure validity (occurrence and authorisation) and accuracy of the EFT payments made every Tuesday afternoon to users (gym members) who fulfilled their gym commitments in the previous week.

   Present your answer under the following headings:
   - Validity (occurrence and authorisation) (22)
   - Accuracy (7)

   Communication skills: Language, layout and logic (2)

### SUGGESTED SOLUTION

#### PART 1

Describe the automated (programmed) controls that exist and/or should be implemented in the Gym2Earn application to ensure completeness of the initial sign-up process.

**COMPLETENESS**

(MARKS ARE AWARDED FOR VALID EXAMPLES AND NOT FOR MERELY NAMING THE EDIT/PROGRAMME CHECK. STUDENTS MAY BE AWARDED THE MARK FOR ANY VALID EXAMPLE, AS THE EXAMPLES BELOW ARE ONLY GIVEN AS A GUIDELINE.)

1. The following screen aids should be present on the Gym2Earn application:
   - Mandatory fields where the sign-up process cannot continue unless certain fields, such as user ID or banking details, have been completed. These fields are normally indicated with an asterisk. (1)
   - An error message should appear stating that certain mandatory fields have not been completed. (1)
   - The terms and conditions (“I agree”) field and the “yes” option to agree to the monthly fixed fee of R30 should be completed; otherwise, the user will not be able to complete the sign-up process. (1)

2. The following programme checks may be performed by the Gym2Earn application:
   - Missing data checks that detect blank fields (eg user did not complete name and surname, etc). (1)
   - An error message should appear stating that data are missing. (1)

3. Users should be given sequential numbers by the application upon initial-sign up (or sequential account numbers should be allocated to users). (1)

4. The application should report on missing numbers in the sequence through exception reports. (1)
5. An exception report of accounts created which contain missing information should be generated for management review.

PART 2

Recommend controls that could be put in place to ensure validity (occurrence and authorisation) as well as accuracy of the EFT payments made every Tuesday afternoon to users (gym members) who fulfilled their gym commitments in the previous week.

VALIDITY (OCCURRENCE and AUTHORISATION)

1. A senior employee (e.g., financial manager) of Gym2Earn should authorise the EFT payment file after scrutinising the list downloaded by the accountant. He could, for example, sign on the payment file.

2. Only a restricted (limited) number of personal computers (PCs) should be used to do the EFT transfers (preferably only one PC).

3. In order to make the transfers effective, two or more passwords should be required by the EFT application (multi-level passwords).

   One-time passwords could be used where Gym2Earn's bank sends a password (each time the EFT application is accessed, but that can only be used once) to the authorised employee's cellphone, e-mail address or handheld PIN device.

   The employee who enters the password to make the EFT payment and the employee receiving the one-time password should not be the same person.

4. The various banks to which the EFT payments are made should be able to identify the Gym2Earn PC(s) as an authorised PC to make the transfer. This should be done before the payments are accepted (e.g., address resolution protocol, digital signatures/certificates, dial-back facilities, SSLs [secure socket layers], key pairs, etc.). MARKS MAY BE AWARDED FOR VALID EXAMPLES.

5. After three unsuccessful attempts to make the transfer (e.g., if incorrect passwords were entered), the terminal should switch off or the EFT application should be locked.

6. Any security breaches/violations should be logged by the EFT application.

   These breaches/violations should be followed up by Gym2Earn management or senior employees.

7. The least privilege principle and segregation of duties should apply where EFT payment functions are restricted to specific employees only.

   Access can be restricted through the use of user identification (user ID), passwords, user profiles, etc.

   The accountant, who downloads the Excel lists, should preferably not be the person doing the EFT transfers (segregation of duties).

8. EFT data transmitted over telephone lines should be protected through, for example, encryption, dial-and-dial-back, etc.
9. Gym2Earn should make use of clearing/suspense/"imprest" bank accounts when transfers from their main bank account are first made to the clearing/suspense account and individual transfers are made from there to users' bank accounts. (1) The clearing/suspense/"imprest" bank account should not be able to go into "overdraft" (i.e. payments over and above the amount received from the Gym2Earn main bank account will not be possible).

10. A limit on the total amount that may be transferred on a Tuesday afternoon should be agreed on with the bank. (1)

11. EFT transfers should be restricted to a Tuesday afternoon (e.g. between 12:00 and 18:00). (1)

12. The EFT application should perform a validity/existence test (edit check) to test whether payments are made to valid users found in the master file. (1)

13. The various banks receiving the EFT transfers should acknowledge receipt thereof and should request final confirmation before these amounts are transferred to the individual users' bank accounts. (2)

14. Confirmation of all EFT payments for that week (received from the bank) should serve as an audit trail of each EFT transfer made (e.g. electronic or hard copy bank statements listing all EFT transactions). (1)

15. The audit trail (bank confirmation) should be reviewed by Gym2Earn management and the EFT transactions should be reconciled with the approved list prepared by the accountant (both validity and accuracy). (2)

16. The accountant should perform weekly bank reconciliations which should be reviewed and approved by a senior employee (e.g. the financial manager). (1)

17. Management should be aware of IT risks and the need for sound controls (IT governance). (1)

18. Timely follow-up of exception reports should take place, for example, following up on exception reports on security breaches/violations, etc. (1)

19. Management review and timeous corrective action of user complaints are critical. (1)

20. Use of firewalls (digital certificates for security) is essential. (1)

21. Physical access controls over EFT terminal(s), for example terminal locks, should be in place. (1)

ACCURACY

1. The senior employee (e.g. financial manager) authorising the EFT should test the calculations and mathematical accuracy of the payments file. This person may review the list for any duplications, etc. (1)

2. The senior employee (e.g. the financial manager) should also agree the total amount of the "net amount collected" column with the total amount of the payments file. (1)

3. The following edit checks/tests could be put in place to address the accuracy of EFT payments made:
(MARKS ARE AWARDED FOR VALID EXAMPLES AND NOT FOR MERELY NAMING THE EDIT/PROGRAMME CHECK.)

- **Formatting tests/alpha numeric checks:** The EFT application should test whether the names of the users, to whom payments are made, are in alphabetic order and whether amounts and bank account numbers are numeric, etc. (1)

- **Screen dialogue/prompts:** The screen prompts the person making the EFT transfer to verify certain detail, for example, “are you sure” with reference to the amounts to be transferred. Errors are immediately corrected by users (no further input until errors are corrected). (1)

- **Limit/reasonableness tests:**
  - The amount paid to each user should not exceed a predetermined reasonable limit per week. (1)
  - A limit of one (1) payment may be made to a user per week. (1)

- **Check digits:** The EFT application tests the accuracy of codes or account numbers entered. (1)

- **Control totals:** The EFT application agrees the total for all EFT transactions to be made on that Tuesday afternoon with the bank totals (i.e. the total amount of the EFT payment may not exceed the amount in the suspense/clearing/"imprest" bank account). (1)

- **Field size tests:** The EFT application should test the field size of payment instructions, for example, bank account numbers should have a certain number of digits, etc. (1)

- **Sign tests:** The amount paid should be a positive amount. (1)

4. Exception reports should be generated and exceptions should be investigated, for example all amounts paid out, which were not “round amounts”, should be indicated as exceptions. (1)

5. Monthly reconciliation of EFT payments to Excel calculation pay out totals should be done. (1)

- Available 13
- Maximum 7

Communication skills: Language, layout and logic (2)

### MARKERS’ COMMENTS

Part (1)

The "required" section of part 1 specifically referred to automated (programmed) controls only. It therefore excluded any manual controls. Many students gave controls such as “All exceptions indicated in the exception reports should be investigated by a senior person”. This is a manual control and not an automated (programmed) control and therefore no marks were awarded for these controls.

Students also received no marks for merely stating the names of certain controls (eg, “Missing data check”, “Error message”, “Mandatory fields”, etc.). It was specifically required that the controls be described. Students were therefore required to provide a description of the control by applying it to the scenario (sign-up process). On CTA and board level, you will almost never be awarded marks for merely giving the name of a control or programme check. It is expected of you at this level to be able to give a valid example of how the control will work in the context of that scenario.

Only the completeness control objective was required. Many students gave controls relating to the validity (occurrence and authorisation) and accuracy control objectives. No marks were awarded for these controls. (For example, “The user should have a user name and unique password”. This control deals with validity and NOT with completeness.)
Part (2)

It is a point of concern that most students failed this part of the question, as we considered this part easy.

It is required of students on CTA and board level to relate the controls to a specific scenario (where possible). A “memory dump” of controls over EFTs was not required.

As the "required" section mentioned that controls should be recommended only, you should have included both manual and computerised controls. These controls were directly obtained from *Auditing Notes for South African students*.

Students again received no marks for merely stating the names of programme checks under the accuracy control objective.

Students also received two marks for presentation for merely attempting to answer this part of the test.

On the next page you will find the self-assessment questions. If you feel after attempting the self-assessment questions, that you want to do some more questions, you can attempt the following questions from *Applied Questions on Auditing, 7th Edition*.

<table>
<thead>
<tr>
<th>Question</th>
<th>Name</th>
<th>Relevant chapter</th>
</tr>
</thead>
<tbody>
<tr>
<td>Question 1, Part A and B</td>
<td>Wires (Pty) Ltd</td>
<td>Chapter 2</td>
</tr>
<tr>
<td>Question 4</td>
<td>Volks-Benz Ltd</td>
<td>Chapter 2</td>
</tr>
<tr>
<td>Question 1</td>
<td>Skin Care Ltd</td>
<td>Chapter 3</td>
</tr>
</tbody>
</table>

The solutions to these questions are included in the text-book.
SELF-ASSESSMENT QUESTIONS

The following questions are included in this tutorial letter. The questions are extracts from previous Unisa tests and Unisa examinations. Please note that the reading and the 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>NO</th>
<th>NAME</th>
<th>SOURCE</th>
<th>TOPICS COVERED</th>
<th>MARKS</th>
<th>READING TIME (minutes)</th>
<th>WRITING TIME (minutes)</th>
<th>PAGE</th>
</tr>
</thead>
<tbody>
<tr>
<td>1.</td>
<td>Billing4U Ltd</td>
<td>Unisa examination – 2011</td>
<td>Pre-engagement activities, risks at overall financial statement level and assertion level, general controls and application controls</td>
<td>75</td>
<td>23</td>
<td>113</td>
<td>69</td>
</tr>
<tr>
<td>2.</td>
<td>Howzit (Pty) Ltd</td>
<td>Unisa test – 2011</td>
<td>Pre-engagement activities, risks at overall financial statement level and assertion level, and audit strategy</td>
<td>50</td>
<td>15</td>
<td>75</td>
<td>78</td>
</tr>
<tr>
<td>3.</td>
<td>New-Age Taxi Corporation Ltd (SANATACO)</td>
<td>Unisa test 1 – 2012</td>
<td>Risks at overall financial statement level and assertion level, audit plan, and internal controls</td>
<td>34</td>
<td>11</td>
<td>52</td>
<td>82</td>
</tr>
<tr>
<td>4.</td>
<td>Cottonworth (Pty) Ltd</td>
<td>Unisa test 1 – 2013</td>
<td>Risks at overall financial statement level and assertion level</td>
<td>22</td>
<td>7</td>
<td>33</td>
<td>85</td>
</tr>
<tr>
<td>5.</td>
<td>Top Electric (Pty) Ltd</td>
<td>Unisa test 2 – 2011</td>
<td>Weaknesses, business risks and recommendations</td>
<td>30</td>
<td>9</td>
<td>45</td>
<td>87</td>
</tr>
<tr>
<td>6.</td>
<td>Save-a-Rhino</td>
<td>Unisa test 4 – 2012</td>
<td>Advanced computers – internet, and programmed application controls</td>
<td>15</td>
<td>5</td>
<td>23</td>
<td>90</td>
</tr>
<tr>
<td>7.</td>
<td>Paparazzi (Pty) Ltd</td>
<td>Unisa examination 2009</td>
<td>Advanced computers – internet, and application controls</td>
<td>33</td>
<td>10</td>
<td>50</td>
<td>92</td>
</tr>
<tr>
<td>8.</td>
<td>Express Railway Services (ERS) Ltd</td>
<td>Unisa test 2 – 2014</td>
<td>Risk at financial statement level and assertion level, application controls, and advanced computers – internet</td>
<td>40</td>
<td>12</td>
<td>60</td>
<td>94</td>
</tr>
</tbody>
</table>
We recommend that you approach these questions in the same way you would in a test and examination. Read the scenario first in 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 in 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 to train yourself in speed and adhering to time. When writing out your answers please do not refer to the suggested solution until you have finished writing. Once you have finished writing your answers down, refer to the suggested solution, which you would use to mark your own work. When marking your work, you should pay attention to the following:

- **Points included in our suggested solution, which 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 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 notes of them so that you don’t repeat the same mistake of omitting 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 about why the points are included in the suggested solution, refer to the marker’s comments included under the suggested solution for a possible explanation. If you are then still not clear about the reason for the inclusion of some points in the suggested solution, 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.

Spend enough time when marking your own work and don’t get anxious. This is when real learning occurs. Don’t be discouraged by low marks when attempting to answer these questions. The questions are included to evaluate the knowledge you have and assist you in identifying areas to which you need to pay more attention prior to the test and examination.
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 has increased.

You are currently involved in the 31 July 2011 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 2010, 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 was listed on the AltX of the JSE in 2002. Billing4U deals exclusively with providing billing solutions to eighth (8) metropolitan municipalities in South Africa. Billing4U bills the residents living in the relevant municipalities for services, including water, electricity and rates, on behalf of the municipalities. Billing4U has provided this service to metropolitan municipalities since 2001, following the first municipal elections held in South Africa in December 2000.

Billing4U’s policy is to evaluate the reappointment of the audit firm every five (5) years. The audit committee of Billing4U believes this is in accordance with the Companies Act, 2008, and that this will ensure that the independence of the audit firm is not threatened. Motholo & Terblanche assigned the following audit team members to the statutory audit and tax return preparation of Billing4U:

<table>
<thead>
<tr>
<th>Name</th>
<th>Position</th>
<th>Experience</th>
</tr>
</thead>
<tbody>
<tr>
<td>Gareth Lewis CA(SA), RA</td>
<td>Audit partner</td>
<td>• Has been the audit partner of Billing4U since 2001</td>
</tr>
<tr>
<td>Unathi Cliff CA (SA)</td>
<td>Audit manager</td>
<td>• Has been the audit manager of Billing4U since 2007</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• Assists Billing4U in the preparation of tax returns</td>
</tr>
<tr>
<td>John Naidoo</td>
<td>Audit senior</td>
<td>• Has been part of the Billing4U audit since 2009</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• Assists Billing4U in the preparation of tax returns</td>
</tr>
<tr>
<td>Thabo Chauke (You)</td>
<td>First-year trainee</td>
<td>• Will be involved in the statutory audit of Billing4U</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• Will assist in the preparation of tax returns</td>
</tr>
</tbody>
</table>

The number of audit team members planned for the audit of Billing4U has decreased in comparison to that of prior years. During the financial year, Billing4U was able to gain control of three companies that are in the business of providing billing solutions to district and local municipalities. Billing4U is now your firm’s largest audit client in terms of revenue. The companies that Billing4U acquired have a 31 July year end. This resulted in Billing4U changing its year end from 31 March to 31 July. The three companies are located in various parts of South Africa and for their 31 July 2011 financial year end, they will be audited by their respective audit firms. None of these companies is an audit client of Motholo & Terblanche.

During February 2011, 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 2011, 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 2012. 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.

Julius Zille has informed the audit partner that the audited consolidated financial statements for the year ended 31 July 2011 are required a week after year end to enable the group to apply for a loan to cover the lawsuit instituted by the Mayor.

The shareholding of Billing4U was as follows on 31 July 2011:

<table>
<thead>
<tr>
<th>Shareholders</th>
<th>Percentage (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Juristic persons</td>
<td>32</td>
</tr>
<tr>
<td>Natural persons other than directors</td>
<td>39</td>
</tr>
<tr>
<td>Non-executive directors</td>
<td>9</td>
</tr>
<tr>
<td>Executive directors</td>
<td>20</td>
</tr>
</tbody>
</table>

The directors of Billing4U receive share options annually driven by profits for the year.

The following are working papers on gathering audit evidence:

- 2600 – 1 Administrative fee income
- 2700 – 1 Information relating to the Speedbill 9000 system
- 2800 – 1 Extract from procedures followed by Billing4U Ltd relating to the purchase and implementation of Speedbill 9000
- 2900 – 1 Extract from information relevant to disputed bills
Entity name: Billing4U Limited  
Year end: 31 July 2011  
Prepared by: J Naidoo  
Date: 20 May 2011  
Reviewed by: U Cliff  
Audit section: Administrative fee income

- A standard contract, setting out the terms, conditions, fee structure, etc, is entered into with the municipalities for the billing of the residents.

- Both the administrative fee income and the penalties structures were approved by management and were included in one of Billing4U’s policy documents.

- The billing to the various residents by Billing4U on behalf of the municipalities is based on a monthly data file received by the latest on the 20th of each month.

- This data file from the municipalities contains each resident’s unique account number as well as the movement in meter readings that has to be billed.

- An invoice is prepared at the end of each month for each municipality and contains the administrative fee, a penalty deduction (if necessary), VAT and the net administrative fee amount, all calculated in accordance with the standard contract.

- Administrative fee income is charged according to the number of residents appearing on the data files received from the respective municipalities. The standard contract with the municipalities contains the following administrative fee structure:

<table>
<thead>
<tr>
<th>Number of municipality residents billed for the month</th>
<th>Fee per resident per month (VAT Exclusive)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1 to 100 000</td>
<td>R20</td>
</tr>
<tr>
<td>100 001 to 250 000</td>
<td>R15</td>
</tr>
<tr>
<td>250 001 to 500 000</td>
<td>R10</td>
</tr>
<tr>
<td>500 001 and more</td>
<td>R5</td>
</tr>
</tbody>
</table>
There is also a penalty clause incorporated into the standard contract, which results in a reduction of Billing4U’s administrative fee income for complaints relating to incorrect billing. The total number of all billing complaints received by Billing4U in a month, which was due to their own fault and not due to an error on the data file they received from a municipality, is used to calculate the penalty based on the following sliding scale:

<table>
<thead>
<tr>
<th>Percentage reduction in administrative fees (penalty)</th>
<th>Number of complaints relating to incorrect billing</th>
</tr>
</thead>
<tbody>
<tr>
<td>1%</td>
<td>500 to 10 000</td>
</tr>
<tr>
<td>3%</td>
<td>10 001 to 50 000</td>
</tr>
<tr>
<td>5%</td>
<td>50 001 and more</td>
</tr>
</tbody>
</table>

The penalty percentage is multiplied with both the administrative fee that was raised in the previous month (to which the complaint relates) as well as the valid number of complaints received from residents. Therefore, a backdated provision will be raised for any disputes that will be lodged relating to the July 2011 administration fees, as the details will only be available in August 2011.

During the conversion process from the Billfast X200 system to the Speedbill 9000 system, a power outage occurred when master files of the City of Johannesburg were transferred. This resulted in an estimated 98 000 valid complaints from residents.

The number of valid complaints is derived from a list that is drawn from the “Disputes” module of the new Speedbill 9000 system.
<table>
<thead>
<tr>
<th>Entity name:</th>
<th>Billing4U Limited</th>
<th>Year end:</th>
<th>31 July 2011</th>
</tr>
</thead>
<tbody>
<tr>
<td>Prepared by:</td>
<td>J Naidoo</td>
<td>Date:</td>
<td>20 May 2011</td>
</tr>
<tr>
<td>Reviewed by:</td>
<td>U Cliff</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Audit section:</td>
<td>Information on the Speedbill 9000 system</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

- The Speedbill 9000 system was purchased on 10 December 2010 at an amount of €3 000 000 from an international supplier in Germany.

- Billing4U decided to take out a forward exchange contract (FEC) on the same day to cover it against major fluctuations in the exchange rate, as there were rumours in the market that a weakening of the rand could be expected at the beginning of 2011. The invoice was only payable in 2011 after the Speedbill 9000 system had been implemented and was fully operational.

- Costs directly attributable to the Speedbill 9000 systems (e.g. the feasibility study) were incurred by Billing4U and amounted to R250 000.

- Training was provided to the personnel of Billing4U by Mr Johnson, the information technology manager (IT manager), to operate the system effectively, and the cost thereof amounted to a further R500 000.

- After discussions with the international supplier and based on a feasibility study, it was concluded that the Speedbill 9000 system can be used without problems for a period of four years. Thereafter, Billing4U will need to consider updating the system for it to continue operating effectively. However, management decided to write the Speedbill 9000 system off over a period of six years.

- As this system was bought in the current year, management did not deem it necessary to do an impairment test on this system.
### Decision and approval to purchase the Speedbill 9000 system

- During August 2010, the IT director, Mrs Rosa, sent out a questionnaire to the staff members who would be performing billing functions in order to obtain an understanding of their specific needs and requirements in terms of the new billing system.

- Only Mr Johnson, the 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 2010. 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 2009.

- 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.
Conversion from the Billfast X200 system to the Speedbill 9000 system

- Mrs Rosa was assigned to oversee 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 assigned 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 2012.
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 regarding 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 that 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 them 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 of 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.
### QUESTION 2: Howzit (Pty) Ltd

50 marks

You are an audit senior at Storm Incorporated (Storm) a medium-sized audit firm in South Africa. Storm has offices in Cape Town, Durban and Bloemfontein, and the head office is situated in Johannesburg. Storm has a workforce of 800 employees, including 12 partners.

In March 2010, the board of directors of Howzit (Pty) Ltd (Howzit) awarded a tender to Storm for the audit of Howzit. Howzit is one of the largest mobile communication companies providing voice and data services in South Africa. Howzit will be the largest client of Storm in terms of fee revenue.

After completing the preliminary engagement activities, the audit partner requested one of the trainee accountants, assigned to the audit, to prepare a draft engagement letter to be issued to Howzit. The draft engagement letter has been included as **Annexure 1**.

#### BUSINESS BACKGROUND

Howzit is a wholly owned subsidiary of Dial-IT SA Limited (Dial-IT). Dial-IT supplies analogue residential phone lines with standard voice functionality. Dial-IT established Howzit three years ago with the intention to provide mobile communication in South Africa. Dial-IT is audited by one of the big four audit firms.
Both Dial-IT and Howzit have a 28 February financial year end.

Howzit’s head office is situated in the central business district of Johannesburg. Howzit has 250 sales and service outlets across South Africa. The call centres established to handle all customers’ queries are based in Johannesburg and Cape Town.

During the first months of the 2011 financial year, Howzit grew its operations to include networks in Lesotho, Botswana, Namibia and Mozambique. At year end, Howzit was providing its services to 1,1 million subscribers, in total, in these countries. Howzit plans to expand its infrastructure in these countries in order to have 7 million subscribers by 2012. To finance the infrastructure expansion, Howzit has applied for a bank loan. The approval of the loan is pending the audited 2011 financial statements.

In August 2010, the Competition Commission subpoenaed two executives of Howzit and executives of another mobile communication company for suspected price-fixing. It was difficult for the Competition Commission to prove the collusion, but Howzit agreed to lower the prices of the services it provides. The two executives, together with other senior executives, are set to receive share options in Howzit based on reported profits.

In November 2010, three key staff members in the accounting department went on maternity leave. Their posts were filled by temporary staff members who were on training for the first two months and were not performing at the optimal level during the period they were on training. The auditors of Dial-IT require the audited financial statements of Howzit a week after the year end in order to audit the consolidated results in time.

**Financial data**

The following accounts, among other things, were identified as significant accounts from the trial balance of Howzit:

- **Revenue**  
  R330 million

  Revenue comprises sale of airtime, data usage, and sale of handsets and accessories. Subscribers in foreign countries transact in their respective currencies. Revenue is recognised as follows:

  - Revenue on airtime and data is recognised on usage.
  - Monthly service revenue is recognised in the period in which the service is rendered.
  - Revenue on the handsets and accessories is recognised when delivery is made.

- **Inventory**  
  R210 million

  Inventory consists of merchandise such as handsets and accessories. The merchandise is purchased from foreign countries such as Finland, Canada and China. When the merchandise is purchased from foreign countries, Howzit is invoiced in the respective currencies of the foreign countries. Howzit takes out forward exchange contracts to protect itself against foreign currency fluctuations. Inventory from foreign countries takes at least three weeks before being delivered in South Africa. Inventory from foreign countries is purchased free on board (FOB). At year end, merchandise estimated at R9 million was in transit.
The Accountant
Howzit (Proprietary) Limited
PO Box 333
Johannesburg
2000

Dear Sir

AUDIT ENGAGEMENT LETTER

We have been requested to audit the annual financial statements of Howzit (Pty) Ltd, which comprises the statement of financial position at 28 February 2011, the statement of comprehensive income, the statement of changes in equity, the cash flow statement for the year then ended, the summary of significant accounting policies, other explanatory notes and the certificate issued by the company's directors. Our audit will be undertaken with the objective of expressing an opinion on the correct presentation of the financial statements.

We will conduct our audit in accordance with International Standards on Auditing, the Code of Professional Conduct of the South African Institute of Chartered Accountants, the King III Report and the Companies Act of 2008. The standards require that we plan and perform the audit to obtain assurance about whether the financial statements are free of material misstatements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or to error. An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements.

An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

In making our risk assessments, we consider internal controls relevant to the entity's preparation of the financial statements in order to design audit procedures that are appropriate in the circumstances. Our statutory audit will include the expression of an opinion on the effectiveness of the entity's internal control.
We remind you that the responsibility for the preparation of financial statements and their fair presentation is that of management of the company. This responsibility includes the maintenance of adequate accounting records and internal controls that management determine are necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or to error. We confirm our agreement to accept a management representation letter signed by the financial director as sufficient appropriate audit evidence on the revenue and inventory accounts.

We look forward to full cooperation from your staff, as the daughter of the financial director is included in the audit team. We trust that your staff will make available to us whatever records, documentation and other information we may request in connection with the audit.

Our audit fees, which will be billed as the work progresses, will be R1,6 million (including VAT and excluding disbursements) and will not be adjusted for a period of five years. The audit fee to be charged is 15% lower than the fee charged by the previous auditors.

In addition to the statutory audit, we will prepare calculations of current and deferred tax liabilities (or assets) for Howzit. The fee for these calculations will be charged at 10% of the resulting tax refund.

The maximum liability of Storm Incorporated for any claims resulting from any services rendered in terms of this engagement letter shall be limited to an amount equal to twice the fees billed.

This letter will be effective for future years unless the agreement is terminated or amended with our consent.

Yours faithfully

Alwyn le Roux CA(SA) Registered Auditor
Storm Incorporated

WE OFFER THE BEST AUDIT SERVICE IN TOWN!
YOU NOW HAVE 75 MINUTES TO ANSWER THIS QUESTION.

REQUIRED

<table>
<thead>
<tr>
<th>(a)</th>
<th>Critically discuss your concerns about the draft engagement letter prepared by the trainee accountant (see Annexure 1). Your answer should comprise the following:</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>1. the requirements in terms of ISA 210 (13)</td>
</tr>
<tr>
<td></td>
<td>2. the requirements in terms of the SAICA Code of Professional Conduct and the Auditing Profession Act of 2005. (13)</td>
</tr>
<tr>
<td></td>
<td>(PPE 2009 – adapted)</td>
</tr>
<tr>
<td>Marks</td>
<td>26</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>(b)</th>
<th>Describe the audit risk at the overall financial statement level of Howzit for the year ended 28 February 2011.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Marks</td>
<td>10</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>(c)</th>
<th>Conclude on the level of the audit risk at the overall financial statement level of Howzit and discuss the effect of your conclusion on the overall audit strategy.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Marks</td>
<td>8</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>(d)</th>
<th>Describe the risk at the assertion level for revenue and inventory of Howzit for the year ended 28 February 2011.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Marks</td>
<td>6</td>
</tr>
</tbody>
</table>

**Total** | **50**
---|---
(Unisa – Test 1, 2011)

**QUESTION 3: New-Age Taxi Corporation Ltd** 34 marks

**BACKGROUND INFORMATION**

You are a first-year trainee auditor forming part of the audit team assigned to the 2012 audit of SA New-Age Taxi Corporation Limited (SANATACO), a company operating in the taxi industry in South Africa. SANATACO appointed your firm in July 2011 after the previous auditors had issued a qualified ("except for") audit opinion in their audit report on the 2011 financial statements of the company. Management of SANATACO refused to make the necessary adjustments to the financial statements as a result of the misstatements identified by the previous auditors. Each of these misstatements was in excess of the materiality figure. SANATACO is listed on the JSE Ltd and its year end is 30 April.

For the past five years’, management of SANATACO have been planning to venture into the airline industry. In January 2011, SANATACO obtained South African Civil Aviation Authority approval as well as the Air Services Licence, allowing them to operate as an airline in South Africa. SANATACO have also confidently passed the relevant South African safety benchmarks, which are acknowledged as being among the most stringent in the world, for their aircraft.

On 1 November 2011, SANATACO launched a new low-cost airline to supplement its road service. The company decided to start its new flight service by operating two flights per day between Lanseria in Gauteng and Bisho in the Eastern Cape. Initial bookings proved this route to be extremely popular with customers who often made a 14-hour road trip for business and leisure travels to destinations in this part of the country. Being a low-cost airline, snacks and drinks are not included in the cost of flights but may be purchased during the flight or may be pre-ordered and paid for when booking a flight.
SANATA CO operates the acclaimed Boeing 737 series aircraft, which has been sourced from an international aircraft leasing company, Aergo. This modern plane has been arranged in a cost-effective 148-seater, all-economy class configuration. The Boeing 737 is currently the world’s most largely produced aircraft.

On 13 November 2011, SANATA CO gained control over two companies, Fuel-Up (Pty) Ltd (Fuel-Up), which supplies SANATA CO with fuel for its taxis and aircraft, and Snack-Attack (Pty) Ltd (Snack Attack), which supplies SANATA CO with the snacks and drinks it offers for sale on their flights. Fuel-Up and Snack-Attack each have a 30 April year end, and they will be audited by their respective audit firms for the 2012 financial year end.

During the interim audit, the financial manager of SANATA CO provided you with the following information on revenue.

<table>
<thead>
<tr>
<th></th>
<th>Actual 01/05/2011 to 31/12/2011</th>
<th>Prior period 01/05/2010 to 30/04/2011</th>
<th>Budgeted 01/05/2011 to 30/04/2012</th>
</tr>
</thead>
<tbody>
<tr>
<td>Revenue</td>
<td>R’000</td>
<td>R’000</td>
<td>R’000</td>
</tr>
<tr>
<td></td>
<td>157 850</td>
<td>178 000</td>
<td>308 560</td>
</tr>
</tbody>
</table>

**Nature of revenue**

Revenue consists of passenger airfare revenue, taxi fare revenue, and sale of snacks and drinks on flights.

The prior-period figures only include revenue on taxi fares. The budgeted figures were projected based on the shareholders’ perception of how lucrative the airline industry is.

**Accounting policy relating to revenue recognition**

Revenue arising from the provision of transportation services to passengers is recognised on an accrual basis in the period in which the services are rendered.

Revenue on sales of snacks and drinks is recognised at the fair value of consideration received.

**Sale of airline tickets**

SANATA CO entered into a service level agreement with GoodBuy (a grocery retail store) to sell passenger airline tickets to its customers. In terms of the service level agreement, GoodBuy outlets will be paid a flat rate as an administration fee plus a commission based on the number of tickets sold. SANATA CO prepares a schedule of the amount payable by GoodBuy outlets on a daily basis based on the daily airline ticket sales. The GoodBuy outlets check the schedules for their accuracy and, if satisfied, sign them and return them to SANATA CO. The payments are then made to SANATA CO by the GoodBuy outlets within 24 hours of receipt of the acknowledgement of the schedules. The payments are made net of administration fee and commission.

GoodBuy has outlets across South Africa, which are easily accessible to SANATA CO customers. Currently, SANATA CO airline tickets can only be purchased at a GoodBuy outlet.

When purchasing an airline ticket, a customer is required to present the cashier with an identity document or passport of the individual wishing to travel. The booking of the flight is done by the cashier on the computer which is linked to the SANATA CO system via a wide area network. Access to the computer, on which the purchase of airline tickets is made, is limited to authorised cashiers.
The cashier captures the customer’s name according to the identification document provided, date, time and place of departure, and destination. The computer automatically draws the ticket price from the airline tickets master file and checks the availability of seats. The computer numbers purchased tickets sequentially and also keeps a log of tickets purchased.

The airline tickets vary in price depending on when they are purchased. The ticket cost comprises the selling price, VAT, airport taxes and travel insurance.

Customers, who purchase their tickets at least three months in advance of the date of their travel, receive a discount on the price of the ticket purchased. Tickets purchased on discount can only be used for the flight specified when making the booking. If it is not used, the customer forfeits the amount paid.

There are also no cash refunds on tickets purchased at the normal price. If a customer does not wish to use the ticket purchased anymore, the customer may redeem the ticket value for a voucher that may be used in any of the GoodBuy outlets. Tickets are redeemable within seven days from the day the customer was due to travel.

The airline ticket price list is reviewed on a daily basis by the financial director and amended if necessary.

---

**YOU NOW HAVE 52 MINUTES TO ANSWER THIS QUESTION.**

<table>
<thead>
<tr>
<th>REQUIRED</th>
<th>Marks</th>
</tr>
</thead>
<tbody>
<tr>
<td>(a) Describe the significant audit risk of SANATACO and the SANATACO group at the overall financial statement level.</td>
<td>10</td>
</tr>
<tr>
<td>(b) Describe the risk of material misstatement for revenue on the sale of airline tickets at the assertion level for SANATACO.</td>
<td>4</td>
</tr>
<tr>
<td>(c) Describe how the assessment of the risk of material misstatement for revenue on the sale of airline tickets at the assertion level will affect the nature, timing and extent of the planned audit procedures for revenue.</td>
<td>9</td>
</tr>
<tr>
<td>(d) List the controls that SANATACO should implement to ensure the occurrence and accuracy of the airline tickets sales by GoodBuy outlets.</td>
<td>11</td>
</tr>
</tbody>
</table>

**Total 34**

(Source – Unisa test 1, 2012)
QUESTION 4: Cottonworth (Pty) Ltd

You are a first-year trainee accountant at Sakhile & Davids (S&D), a firm of registered auditors. S&D is a medium-sized audit firm in South Africa (SA) with offices in Cape Town, Durban, Mangaung and Johannesburg. In the past year, S&D won major tenders to be the statutory auditors of companies including SA’s biggest mobile operator, one of SA’s manufacturers and distributors of beer, and SA’s national airline. As a result, S&D increased its first-year trainee accountant intake for 2013 by 70% when compared to the prior year.

Shortly after joining S&D in January 2013, you were assigned to the audit team conducting the audit of Cottonworth. Cottonworth is an investment holding company and one of the top 100 companies listed on the JSE Ltd. Its core business is the provision of retail and financial services to upper- and middle-income groups mainly in South Africa, the United Kingdom (UK) and New Zealand. Cottonworth operates through the following subsidiaries:

- Cottonworth (Proprietary) Limited (hereafter referred to as CPL). CPL is a respected chain of over 350 retail stores, including franchise stores, and it offers a selected range of quality clothing, food, homeware, beauty and financial services (in partnership with ZAR Bank) under its own brand name in South Africa, other parts of Africa and the Middle East. CPL is audited by S&D.

- Farm Road Limited (hereafter referred to as FRD). FRD is based in the UK and offers apparel and homeware in its own retail stores and through concessions in major UK department stores. The functional currency of FRD is the pound. FRD is audited by an audit firm in the UK.

Cottonworth and its subsidiaries have a 28 February year end.

You are responsible for the audit of the following accounts of CPL for the year ended 28 February 2013:

<table>
<thead>
<tr>
<th>Details</th>
<th>2013 (Rm)</th>
<th>2012 (Rm)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Operating lease expense</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Land and buildings</td>
<td>1 839</td>
<td>1 569</td>
</tr>
<tr>
<td>Plant and equipment</td>
<td>21</td>
<td>16</td>
</tr>
<tr>
<td>Provision for onerous lease commitments</td>
<td>12</td>
<td>7</td>
</tr>
<tr>
<td>Total</td>
<td>1 872</td>
<td>1 592</td>
</tr>
</tbody>
</table>

Land and building rentals comprise rentals for all retail stores in the urban areas and shopping malls. Plant and equipment comprise mainly the rental of a factory and machinery used in the production of food products. Each of the lease contracts has its own lease terms; however, all the lease contracts require CPL to pay compensation should the contract be terminated prior to its termination date. CPL has terminated some contracts in the past prior to their termination date and has identified some contracts to be ended prior to their termination date in the 2014 financial year. The early termination of lease contracts is as a result of the development of new malls close to existing ones providing better lease terms. The provision for onerous lease commitments is recognised in respect of these early lease terminations.
Merchandise consists of clothing, food, homeware and beauty products. Most of the clothing products are purchased from suppliers in China and India. These suppliers’ accounts are settled in their respective currencies. Prior to yearend, a free-on-board (FOB) transaction was concluded with the Chinese supplier and this stock was at sea at year end. The cost of food products that are produced by the company is determined using standard costing. The majority of the allowance above is the mark-down of clothing merchandise at the end of seasons. The cost of raw material includes work in progress.

<table>
<thead>
<tr>
<th>Details</th>
<th>2013 (Rm)</th>
<th>2012 (Rm)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Inventories</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Merchandise</td>
<td>2 800</td>
<td>2 100</td>
</tr>
<tr>
<td>Allowance for shrinkage, obsolescence and mark-down of inventory</td>
<td>(75)</td>
<td>(68)</td>
</tr>
<tr>
<td>Consumables</td>
<td>3</td>
<td>2</td>
</tr>
<tr>
<td>Raw material</td>
<td>13</td>
<td>9</td>
</tr>
<tr>
<td>Total</td>
<td>2 741</td>
<td>2 043</td>
</tr>
</tbody>
</table>

Trade and other receivables comprise sales of merchandise on credit.

Prior to the merchandise being sold on credit, customers are required to open an account. Once the account has been approved (after performing the credit checks), a customer is allocated an account number and credit limit and is given a card in order to make purchases. The credit terms of sale of merchandise on credit are as follows:

- Settlement of debt (account) within six months – no interest is charged.
- Settlement of the account in over six months but within 12 months – interest is charged on the outstanding amount after six months at the prime rate.
- Settlement of the account in a period beyond 12 months – interest is charged at the prime rate plus 3% on the amount outstanding after 12 months. Interest is charged at the prime rate for any balance outstanding between 6 and 12 months.

The allowance for credit losses is calculated at 3% on merchandise sold on credit.

The applicable financial reporting framework of Cottonworth and its group is International Financial Reporting Standards.
YOU NOW HAVE 33 MINUTES TO ANSWER THIS QUESTION.

REQUIRED | MARKS
---|---
1. Describe the risks of material misstatement at the overall financial statement level of Cottonworth Holdings Limited and its group for the year ended 28 February 2013 | 7
2. Describe the risks of material misstatement at the assertion level for the year ended 28 February 2013 of Cottonworth (Proprietary) Limited on the following accounts:
   - Operating lease expense
   - Inventory
   - Trade and other receivables
   **Note:** Ignore the risks relating to presentation and disclosure.
   | 15

Total | 22

(Unisa test 1 – 2013)

QUESTION 5: Top-Electric (Pty) Ltd 30 marks

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 and provides 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”.

Top-Electric’s financial year end is 31 March 2011 and the financial director indicated that he would like to have the final audit report on 20 April 2011 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:

<table>
<thead>
<tr>
<th>Code</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>AA – 1</td>
<td>Information on the acquisition and payments cycle: Ordering of goods</td>
</tr>
<tr>
<td>BB – 1</td>
<td>Information on the acquisition and payments cycle: Receiving of goods</td>
</tr>
<tr>
<td>--------------------------</td>
<td>-----------------------</td>
</tr>
<tr>
<td><strong>Information on the acquisition and payments cycle: Ordering of goods</strong></td>
<td></td>
</tr>
</tbody>
</table>

**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) are established by Top-Electric's management, and should be followed 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 2008.

**Ordering of goods**

- Top-Electric's management believe that using the internet is the best way of doing 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.
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 are 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.

YOU NOW HAVE 45 MINUTES TO ANSWER THIS QUESTION.

REQUIRED

<table>
<thead>
<tr>
<th>Task Description</th>
<th>Marks</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. 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>
<td>20</td>
</tr>
<tr>
<td>2. Recommend in detail improvements to the current receiving of goods function of the company as described on working paper BB – 1.</td>
<td>10</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>30</strong></td>
</tr>
</tbody>
</table>

(Unisa test 2 – 2011, adapted)
QUESTION 6: Save-a-Rhino Pty (Ltd)  

YOU HAVE 5 MINUTES TO READ THIS QUESTION.

BACKGROUND INFORMATION

You are the audit senior at Green Auditors Inc responsible for the 30 September 2012 audit of Save-a-Rhino Pty (Ltd) (Save-a-Rhino). Save-a-Rhino has been a wholly owned subsidiary of South Africans Against Rhino Poaching Ltd (SAARP) since December 2010.

Despite increased public awareness, numerous donations and various tip-offs, 448 known cases of rhino poaching were reported during 2011. During 2012 (prior to April 2012), an alarming 162 cases were reported. The main purpose of Save-a-Rhino is to raise public awareness and support for the ongoing and ever-increasing war against rhino poaching in South Africa through an independent web-based platform. Save-a-Rhino’s objective is to

- convey the latest rhino poaching figures in South Africa;
- act as an online rhino poaching reporting system (with an online form for tip-offs that are routed directly to the South African Police Service); and
- collect donations from both private and corporate donors. (In the interest of transparency, information on all funding allocations is made available on the website.)

Donations are received from both local donors and international donors (both on an ad hoc and an ongoing basis). For all donations greater than R100 000, a logo of the donor company and a website link to the donor company’s website are placed on the Save-a-Rhino website. The website only allows once-off donations of up to R10 million. Thereafter, the donor is required to contact a Save-a-Rhino delegate personally to arrange payment. Donors making donations exceeding R10 million are referred to as VIP- (very important person) donors and are allowed to attend board meetings where the allocation of their donation is discussed.

For the year ending 30 September 2012, a total of approximately R64 million was received from private and corporate donors. Save-a-Rhino retains 5% of all donations for administrative purposes and also receives a monthly administration fee from SAARP of R200 000 to fulfil its duties (administration fees are mainly used to cover salary and wage expenses).

The board of Save-a-Rhino is responsible for allocating donations to various crucial initiatives. The initiatives are focused mainly on training and the purchase of vital equipment for rhino protection projects in provincial reserves. The board consists of six independent rhino specialists (with expertise in rhino management, research and security), the CEO (Chief Executive Officer) and the CFO (Chief Financial Officer) of both SAARP and Save-a-Rhino. The board meets once a month to decide on allocations of funds to initiatives.

Donations may be made by credit card, direct deposit or PayPal. A PayPal account is not a bank account, but a virtual wallet that may be used to securely and conveniently pay for goods and services online. PayPal protects the donor’s financial information with industry-leading security and fraud prevention systems. When a donor uses PayPal, his/her financial information is not shared with Save-a-Rhino. A payment notification should be sent by the donor directly after making the payment to Save-a-Rhino either via fax to 082 888 8888 or via e-mail to info@save-a-rhino.com.
For direct deposits, Save-a-Rhino’s banking details are provided on its website. An additional SWIFT code is given for international donors. A SWIFT code is a unique identification code for a particular bank. These codes are used for transferring money and messages between banks.

A link to www.paypal.com is given on the Save-a-Rhino website for any PayPal donations (with fields similar to the fields for credit card donations, but Save-a-Rhino will not be able to view this information).

The following is an extract from the Save-a-Rhino website, setting out the fields to be completed by a donor making an online credit card donation:

- Donation Amount (ZAR)
- Yes: Donate online using your credit card? (This box needs to be ticked by the donor if he/she wishes to donate through the use of a credit card.)
- Donor contract details
  - Title: Mr.
  - First name
  - Surname
  - E-mail address
  - Phone
  - City
  - State/Province
  - Country (with a list of possible countries to choose from)
- Payment information
  - Credit card type (with a list of possible credit cards)
  - Credit card number
  - CVV number (The CVV number is the special 3-digit code on the back of the donor’s credit card.)
  - Month and year of credit card expiry date
- The donor then has to agree to the terms and conditions (available on the website) by selecting the “I agree with the terms and conditions” option.
- A “register” option must be selected for the donor to be registered.
YOU NOW HAVE 23 MINUTES TO ANSWER THIS QUESTION.

<table>
<thead>
<tr>
<th>REQUIRED</th>
<th>Marks</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Discuss the business risks that Save-a-Rhino (Pty) Ltd faces when receiving donations and donors' personal information over the internet.</td>
<td>10</td>
</tr>
<tr>
<td>2. Describe the additional <strong>computerised (programmed) controls</strong> that should be implemented by Save-a-Rhino to ensure the <strong>accuracy</strong> of the online process for credit card donations.</td>
<td>5</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>15</strong></td>
</tr>
</tbody>
</table>

(Unisa test 4 – 2012)

QUESTION 7: Paparazzi (Pty) Ltd

YOU HAVE 10 MINUTES TO READ THIS QUESTION.

BACKGROUND INFORMATION

You are an audit partner at Motaung & Khoza Inc (Motaung & Khoza), a medium-sized auditing firm based in Southern Africa. You were promoted to partnership seven years ago, after being with the firm for 11 years.

The following working paper is made available:

**Description**

Working paper B1: New company website
New company website

Until recently, orders were placed via the call centre and by mail. The demand for the Paparazzi magazine has increased “as not only teenagers have shown interest in the lives of the celebrities but grown-ups as well”. To handle this increased demand and to ensure efficiency, Paparazzi established a website, www.paparazzi.co.za, for the placing of orders. Only South African retail outlets and magazine subscribers may place orders via the internet at this stage.

Paparazzi reached an agreement with a national courier company to deliver magazines ordered via the internet.

Paparazzi’s website was developed by GTEC Website Design Co, known to be the best in South Africa. Clients were able to place orders from the beginning of January 2009. The website has been well promoted and can easily be found using various search engines.

South African retail outlets and subscribers are required to register as users on the website prior to placing orders. When the user registers as a retail outlet, the company registration number and VAT number are required as mandatory fields. This enables Paparazzi to validate the entity. To access the website the users will have to log on using a username and password and the contact details they have chosen when registering as users on the website. Different prices are charged to retail outlets and individual subscribers; as a result, users are charged differently, depending on how they have registered.

Orders are dispatched from Cape Town, Durban or Johannesburg. Users are required to choose their nearest location when placing orders. Orders may be placed at any time of the day. Once an order is accepted as valid, instructions to dispatch the goods are automatically generated by the system. Delivery is made within 48 hours from the time the order has been placed.
YOU NOW HAVE 50 MINUTES TO ANSWER THIS QUESTION.

REQUIRED

(a) Regarding working paper B1 (New company website):

1. Describe the risks to Paparazzi of allowing access to its data and trading of its magazines via the internet, and the key control measures which should be implemented to counter these risks.

   Note: Present your answer in a table format as follows:

<table>
<thead>
<tr>
<th>Risk</th>
<th>Key control measure</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>(8)</td>
</tr>
<tr>
<td></td>
<td>(8)</td>
</tr>
</tbody>
</table>

2. Discuss, with regard to the Paparazzi website (www.paparazzi.co.za), the application controls that should be in place to ensure that only valid orders are accepted over the internet and that these are recorded completely.

   Total 33

(Unisa examination – 2009)

QUESTION 8: Express Railway Services Ltd 40 marks

YOU HAVE 12 MINUTES TO READ THIS QUESTION.

BACKGROUND INFORMATION

You are a first-year trainee accountant at Effortless Auditing Incorporated (EA), a medium-sized audit firm in Pretoria. The firm aims to be at the cutting edge of information technology and uses advanced information technology in its audit engagements. EA has recently been appointed as the auditors of Express Railway Services (ERS) Ltd. Mr DJ Wolf is the partner in charge of the audit engagement.

ERS is at the forefront of transforming South Africa’s railway transport services. ERS has two main sources of income: daily luxury express train services in the main business centres of the country and long distance inter-city rail services. Currently, ERS operates only within the borders of South Africa.

ERS has entered into various public-private partnerships with the South African government to upgrade railway infrastructures across the country. Increases in fuel prices over the last five years have led to an increased demand for alternative means of transport for the average South African consumer. ERS’s ability to provide affordable and reliable services has enabled them to show steady increases in their profits, and the company’s share price has responded positively. The share price of ERS currently trades at R41.40 per share on the JSE.

Information technology (IT) has been one of ERS’s cornerstones since its inception ten years ago. Significant investments are being made in developing IT systems. Currently 90% of its ticket sales take place via the internet.

ERS has a 28 February year end.
Upgrade of the internet-based reservation system

Owing to the excellent growth in revenue and passenger numbers over the years, internet traffic and system load have increased dramatically. ERS is in the process of upgrading its website and plans for the upgraded system to be operational by the end of April 2014. You have held discussions with the financial manager of ERS, Mrs Phutago, who is responsible for the systems upgrade. She mentioned that the company’s board of directors had basically given her an open cheque book and only wanted to receive feedback once the project has been signed off. She also mentioned that the Chief Information Officer (CIO), Mr T Kahal, reports directly to her office as the success of the upgrade will have a direct impact on the integrity of the financial reporting system.

The following user requirements were developed by ERS’s business analysts:

- A web page that allows customers to perform a search on the availability and costs of seats on the trains of their choice.
- A customer who identifies an available seat on a train is able to book the seat by providing his or her name, surname, ID or passport number, cell phone number, e-mail address and method of payment. Customers should also specify whether or not it is for a one-way or return ticket. A 2.5% discount is applicable to all bookings that are made on a return basis. Weekly and monthly coupons are offered at a 5% discount to passengers using the luxury express trains.

According to ERS’s policy, unaccompanied passengers of younger than 12 are not allowed to travel on any of its trains. The fares for passengers of younger than 12, accompanied by an adult, are 50% less than the normal fare.

Ticket fees are determined monthly by the Fees Committee and forwarded to the IT department on the last day of each month to ensure that it is effective from the first day of the following month. A railway levy has to be paid by every passenger and it must therefore be added to the train fare. These levies are calculated based on the stations of departure and arrival. For example, if the destination is Durban, the passenger has to pay the Durban station levy.

Once a customer confirms a booking on the website, he/she has 48 hours to pay for the ticket. Payment may be made either online by way of a credit card transaction (via a secure connection) or by an electronic funds transfer (EFT) when making the booking; proof of payment must be faxed to the head office. The customer may also pay directly at a kiosk at the train station, but only if the booking is done at the kiosk. The payment method at the kiosk is either cash or credit card. The ticket fee is recognised immediately as revenue at the time when payment is made by a customer. The database is updated immediately and the seat is reserved. The ticket is issued electronically via e-mail to the customer shortly after payment has been made. At the end of each day, the passenger transaction file (PTF) is updated to the general ledger.

Train tickets for long-distance routes may be cancelled by customers if ERS is notified of the cancellation in writing, at least two days prior to the departure date. A penalty amounting to 10% of the ticket fee is payable upon cancellation. The balance of the ticket fee is then refunded to the customer.

All the train stations on ERS routes are equipped with state-of-the-art electronic turnstiles. The system controlling the operation of the turnstiles is integrated with the IT systems of ERS. A customer may only board the train once he or she has presented a valid ticket at the turnstile, which then allows access to a secured platform where the passengers board the train.
The installation of the turnstiles was one of the public-private projects that ERS entered into with the Department of Transport. The turnstiles allow ERS to confirm the number of passengers that have departed from and arrived at the stations which they selected when booking. Five minutes before the train is scheduled to depart, the turnstile closes and a passenger list is generated by the system. This list contains the names of the passengers on board the train. The passenger list is transferred electronically via a secure direct link between ERS and the Department of Transport. The process was approved by both parties, as it would automatically calculate the station levy that is payable to the Department of Transport. This calculation is done by matching the passenger list with the PTF. Any difference should be followed up by management before payment can be processed.

An automatic EFT is generated by the system on a weekly basis. This EFT has to be authorised by Mrs Phutago after she has agreed the amount on the EFT voucher to the amount displayed on the system. The payment may only be released from a dedicated terminal and the financial director as well as the operations director should approve the EFT payment voucher electronically.

YOU NOW HAVE 60 MINUTES TO ANSWER THIS QUESTION.

<table>
<thead>
<tr>
<th>REQUIRED</th>
<th>Marks</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Discuss the risks of material misstatement at the overall financial statement level as well as the risk at the assertion level for ERS for the year ended 28 February 2014.</td>
<td>12</td>
</tr>
<tr>
<td>2. Write a memorandum to Mr Wolf, in which you:</td>
<td></td>
</tr>
<tr>
<td>(a) Discuss the specific application controls that relate to the accuracy and completeness of ERS’s internet reservation system. Note: Exclude application controls relevant to the payments and master file updates from your solution.</td>
<td>14</td>
</tr>
<tr>
<td>(b) Discuss the additional application controls that you would expect to be present in ERS’s processing of EFT payments to the Department of Transport, to consider the occurrence and authorisation thereof. Communication skills: Logical flow and layout</td>
<td>8</td>
</tr>
<tr>
<td>3. Discuss any weaknesses in the upgrade of the internet-based reservation system. Note: Limit your answer to the principles of governing information technology in terms of the King III Report.</td>
<td>4</td>
</tr>
<tr>
<td>Total</td>
<td>40</td>
</tr>
</tbody>
</table>

(UNISA test 2 – 2014)
QUESTION 9 Dynamic Food Limited

YOU HAVE 12 MINUTES TO READ THIS QUESTION.

BACKGROUND INFORMATION

You are the audit senior assigned to the audit of Dynamic Food Limited (Dynamic) for the year ended 28 February 2015. The audit firm where you work has been the auditor of Dynamic for the past three years and has been reappointed through a competitive tender process to complete the audit for the year ended 28 February 2015.

Dynamic will be your first client in the manufacturing industry and you are looking forward to learn more about the industry. During a meeting you had with Mr Rupert, one of the co-founders and Chief Executive Officer (CEO) of Dynamic, you made some notes regarding the company, which are attached as Appendix A.

You also came across the following article in the Pretoria News:

Dynamic Food Limited seeks help from court over excessive fine

*Dynamic Food is once again heading to court over the excessive fine imposed on the company.*

*Mr Rupert, CEO of Dynamic Food, said in an exclusive interview to Pretoria News that they are not appealing the verdict, which found them guilty, but are appealing the financial penalty of R46 million. They feel this amount is outrageous.*

“If we have to pay this amount we will have no other alternative than to let some of our personnel go. The court will just have to step in.”

*Dynamic Food has been fined earlier this month by the Competition Commission of South Africa after an investigation into collusion over tender contracts.*

*Mr Rupert claims that they are not in a position to pay the fine, as an anticipated loss is expected for the 2015 financial year. This will be the first time in the history of the company that they make a loss. The main reasons for the expected loss is the downturn in the economy, and a downturn in sales as a result of a new competitor that is manufacturing a more cost-effective product.*

The following appendix and working paper, relating to the audit of Dynamic Food, has been prepared by you:

<table>
<thead>
<tr>
<th>Reference number</th>
<th>Summary of the meeting held with Mr Rupert</th>
<th>Proposed changes to the current time recording and payroll application</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Appendix 1</td>
<td>Working Paper P1</td>
</tr>
</tbody>
</table>

After performing your risk assessment procedures, you have decided to follow a combined audit approach for the audit of inventory.
Summary of the meeting held with Mr Rupert 16 February 2015

Dynamic Food is a food manufacturing and distribution company listed on the JSE Ltd. Dynamic Food specialises in the manufacturing of various instant food products. All manufactured products are instant products, which means that only water or milk needs to be added.

The manufacturing department has been the cornerstone of the business since its inception 16 years ago when Mr Rupert and Dr Matsimela (in-house food scientist and operational director) started the food manufacturing company. The directors of Dynamic Food collectively own 20% of the company’s shares and performance bonuses are paid based on the financial results of the company.

The company has all the necessary committees as required by King III and the Companies Act. Mr Rupert is the chairman of the board of directors and Mr Matsimela has recently been appointed as the chairman of the audit committee.

Dynamic Food specialises in the manufacturing of instant porridges such as instant maize porridges, instant sorghum porridges and instant high-protein oats porridges. The company also manufactures powder for energy drinks such as high-protein shakes and powdered cold drinks. During the 2015 financial year, Dynamic Food also introduced its instant desserts range which includes custard powder and instant yogurts.

Dynamic Food provides food through tender manufacturing, which is predominantly government related through the National School Nutritional Programme, and through contract manufacturing for retail or wholesale customers such as Pick n Pay, Checkers and Dis-Chem.

Currently, Dynamic Food manufactures more than 200 various instant food products, some of which are manufactured exclusively for the Department of Education through the National School Nutritional Programme and the rest for retail or wholesale customers. Dynamic Food manufactured approximately 15 000 tons of food products for the 2015 financial year.

The manufacturing plant is situated in Centurion, Gauteng, with distribution warehouses in the Eastern Cape, Mpumalanga and Limpopo. Two more distribution warehouses will be opening in other provinces in the coming months.

Because the majority of instant food products have an adequate shelf life with expiry dates within 12 months of manufacture, there are a number of large contracts which involve the selling of these products on consignment. Dynamic Food has a policy to discard and destroy all unsold food products after the expiry date.

Inventory is the largest balance on the statement of financial position and consists of raw materials, work in progress and finished goods. Raw materials are purchased from both local and foreign suppliers. Dynamic Food takes out foreign exchange contracts to protect itself against adverse foreign currency fluctuations. Inventory from foreign suppliers is purchased free on board. Despite the favourable discount negotiations with retail and wholesale customers, there has been a reduction in the inventory turnover during the year and an increase in the number of customer complaints.

During February 2014, Dynamic Food launched its initiative of “going paperless”. Through this initiative, all functions within the company will be computerised in order to minimise the use of hard-copy documents.
On 1 March 2014 Dynamic Food installed a new fully computerised, integrated sales and purchases application. This has resulted in changes to both the general and the application information technology (IT) controls throughout the organisation. The internal audit department was involved in the conversion project and gave positive feedback on the implementation of the new IT controls. Mr Rupert requested us to also include the testing of the general and the application controls as part of our audit of inventory, as he would value our feedback.

The next step in the “going paperless” initiative will be the installation of a fully computerised, integrated time recording and payroll application.
The human resources department is under the control of Mrs Ontime, the human resources director. During the current financial year, many personnel problems were experienced in this department and Mrs Ontime was appointed in January 2015 to get things back on track. Mrs Ontime is responsible for all staff appointments and resignations. Dynamic Food has a labour force of 50 permanent employees and 350 hourly paid wage workers. Of the hourly paid wage workers, 250 are stationed at the Centurion manufacturing plant and 100 at the distribution warehouses. There are five plant supervisors at the manufacturing plant, each of whom is responsible for a team of wage workers and who report to the plant manager.

Presently, the time recording function for the 250 wage workers at the manufacturing plant is performed using properly designed clock cards, which are created for all wage workers in terms of the employee master file. New clock cards are printed on a Monday morning and are available at the entrance to the plant. The wage worker has to insert his/her clock card into a timing device to record times of entry or exit.

The normal and overtime hours worked per wage worker, per week, are manually calculated by the respective plant supervisors and approved by the plant manager. The payroll is prepared on a weekly basis and the wage workers receive their weekly wages through an electronic funds transfer (EFT) on a Friday afternoon.

As part of the “going paperless” initiative to computerise all functions within the company, Dynamic Food is in the process of buying a new computerised time recording and payroll application. It was one of Mrs Ontime’s responsibilities to investigate the possibilities of a new system and she came across the following article:

**Having problems with your current time recording system?**

**Try our new Iris Biometric Identification Scanner**

Iris scanners perform recognition detection of a person’s identity by mathematical analysis of the random patterns that are visible within the iris of an eye from some distance.

Iris scanning is an ideal way of biometric identification since the iris is an internal organ that is largely protected from damage and wear by the cornea. This type of identification is more attractive than fingerprint identification, as fingerprints can be difficult to recognise after several years of certain types of manual labour.

The Iris Identification Scanner is a time attendance system that tracks employee attendance, including when they clock in, when they clock out, and if they showed up when they were scheduled to work.
Mrs Ontime envisions that the new system will work as follows:

All permanent data, such as employee names, employee numbers and pay rates required for the preparation of the payroll, will be stored in the employee master file.

An Iris Biometric Identification Scanner will be installed at the entrance to the manufacturing plant.

Upon entering and leaving the plant, the wage worker will have to scan his iris with the biometric iris scanner.

The system will record the entry and exit times and at the end of the day, will automatically transfer the hours worked to the payroll application.

When the payroll is processed, the payroll application software automatically calculates the total hours worked for the week.

These calculated hours and the permanent data in the employee master file will be used by a dedicated payroll clerk to prepare the payroll.

The payment of the wages will still take place on a Friday afternoon via an EFT.
You are a senior audit manager at Brilliant Auditors Incorporated (Brilliant), an audit firm with offices across South Africa. Brilliant has recently accepted the appointment as external auditor of Shop and Pay Ltd (SnP). You have many years of experience in the retail industry and have been assigned to the audit of SnP for the year ending 29 February 2016.

Background information

SnP is one of South Africa's major retailers and has been in existence since 1966. The company listed on the Johannesburg Stock Exchange in 1977. SnP manages the sale of groceries, clothing, health and beauty products and general merchandise. The management of SnP is dedicated to the growth of the company and bonuses for directors and senior management are based on profitability. The company operates 1098 stores across South Africa, employs almost 40 000 people and products are supplied by more than 4 000 suppliers. Despite the competitive retail industry, SnP opened 55 new stores in the 2016 financial year.

SnP has thousands of sales transactions taking place daily and is therefore dependent on reliable information technology (IT) systems. As a result of the large amount of transactions, the growth experienced during the past few years as well a need to maintain a competitive advantage, the board of directors approved the implementation of a new accounting system during June 2015. A steering committee was formed to manage the conversion to the new system and after the performance of a feasibility study, it was decided to purchase a pre-developed accounting software package (off-the-shelf) rather than to develop the software in-house. The new system was implemented during November 2015. With the new accounting software all sales information are transmitted to the accounting system on a real time basis and as a result real time information for decision-making purposes is available.

To ensure a convenient and accessible shopping experience, SnP is planning to launch its internet shopping business in June 2016. This will provide customers with the opportunity to shop online from their homes and have their products delivered to their front door. Management is of opinion that revenue from internet sales will increase sales by at least 15%.

At the audit planning meeting it was agreed that the audit approach for the 2016-audit would be control based, with a focus on testing SnP's general and application controls. This will enable the audit team to obtain a thorough understanding of the entity, to comment on the operating effectiveness of the controls and to provide valuable feedback to the client. Mr Cadbury, the chief financial officer and main shareholder of SnP, requested your audit team to provide him with feedback regarding the proposed system description for the internet sales. The audit team prepared the following working paper for your attention.

<table>
<thead>
<tr>
<th>Working paper</th>
<th>Reference number</th>
</tr>
</thead>
<tbody>
<tr>
<td>Proposed system description for the internet sales</td>
<td>F100</td>
</tr>
</tbody>
</table>
Audit objective

To obtain an understanding of the proposed internet sales.

Registration as a new customer on SnP’s website
Customers wanting to shop online have to access SnP’s website using a computer and have to register on the website. Upon registration a customer profile is created with a unique username and password. The customer can select his/her own password which should be 8 characters long and should contain both numeric and alpha-numeric characters. As part of the registration process the customer is required to complete certain fields with personal information such as name, surname, identification number, cell phone number, e-mail address and physical address for deliveries. These fields are mandatory and registration cannot be completed without these required fields.

Placement of orders
Once a customer profile has been created the customer will be able to log into SnP’s website to browse through the catalogues. The catalogues show a picture of each of the available products as well as its on-line sales price. The customer can then select a number of products and add it to the on-line “shopping trolley”. After all the required products have been selected the customer clicks on the “checkout” button. Once the customer “checked out” he/she is required to review the products selected, the quantity selected, the price per product, the total amount owing and the delivery address. The customer then confirms that the order is correct by clicking on the “confirmation tick box” which automatically takes the customer to SnP’s secure payment website. At the secure payment website the customer has to complete his/her credit 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.

A confirmation e-mail with the customer’s invoice is send to the registered e-mail address. All invoice numbers are sequentially logged.

Before the products are delivered, the system confirms with the bank the customer’s available balance and that the credit card is not stolen or fraudulent. SnP is directly linked, via an Electronic Data Interchange (EDI) link, to all the South African Banks. Once the balance has been confirmed with the bank, the products will be delivered. If insufficient funds are available the products will not be delivered and the customer will be informed thereof. Upon delivery the customer are required to review the products and quantities and to acknowledge receipt thereof by signing the delivery note. The transaction will then be recorded in the accounting records and the outstanding amount requested from the bank. The debtors clerk reconciles the amount received from the bank with the invoice e-mailed to the customer and the amount recorded in the general ledger and follows up on any identified differences.

General
SnP uses the latest technology in its encryption techniques as well as firewalls. Logs of unauthorised access attempts and missing numbers in the sequence of invoice numbers are generated and reviewed by Mr Beacon, the IT manager. An exception report of deliveries made for which payment was not received is generated and reviewed on a weekly basis.
YOU NOW HAVE 60 MINUTES TO ANSWER THIS QUESTION.

<table>
<thead>
<tr>
<th>REQUIRED</th>
<th>Marks</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>(a)</strong></td>
<td></td>
</tr>
<tr>
<td>1. Describe the risk of material misstatement due to <strong>fraud</strong> at the overall financial statement level for Shop and Pay Ltd for the year ended 29 February 2016.</td>
<td>5</td>
</tr>
<tr>
<td>2. Describe the risk of material misstatement due to <strong>error</strong> at the overall financial statement level for Shop and Pay Ltd for the year ended 29 February 2016.</td>
<td>4</td>
</tr>
<tr>
<td><strong>(b)</strong></td>
<td></td>
</tr>
<tr>
<td>Discuss the advantages and disadvantages that Shop and Pay Ltd would have considered in their decision to purchase a pre-developed accounting software package instead of developing it in-house.</td>
<td>7</td>
</tr>
<tr>
<td><strong>(c)</strong></td>
<td></td>
</tr>
<tr>
<td>Write a memorandum to Mr Cadbury to discuss the business risks that Shop and Pay Ltd will be exposed to from the sale of their products via the internet.</td>
<td>13</td>
</tr>
<tr>
<td><em>Communication skills: Memorandum format and layout</em></td>
<td>1</td>
</tr>
<tr>
<td><strong>(d)</strong></td>
<td></td>
</tr>
<tr>
<td>With reference to working paper F100, identify the application controls that Shop and Pay Ltd are going to implement to ensure the occurrence of revenue from the internet sales.</td>
<td>9</td>
</tr>
<tr>
<td><em>Communication skills: Formulation of controls</em></td>
<td>1</td>
</tr>
</tbody>
</table>

(Unisa – Test 1, 2016)
SELF-ASSESSMENT – SUGGESTED SOLUTIONS

QUESTION 1: Billing4U Ltd

(a) (i) Factors that Motholo & Terblanche should have considered prior to accepting the reappointment as statutory auditors of Billing4U Limited

1. Independence
   1.1 The audit partner (Gareth Lewis) has been the partner in charge of the audit for a period of more than 10 years, which creates a familiarity threat to independence. (2)
   1.2 Gareth Lewis is in contravention of the Companies Act for having been the audit partner of Billing4U Ltd for a period of more than five years. (1)
   1.3 The safeguard that Motholo & Terblanche can apply is to rotate the audit partner. (1)
   1.4 Billing4U Ltd is the largest client of Motholo & Terblanche in terms of the revenue generated. This would create a self-interest threat to independence. (2)
   1.5 The rest of the audit team members (excluding the audit partner) will be involved in assisting Billing4U in the preparation of tax returns. (1)
   1.6 In terms of the CPC 290.183, the preparation of tax returns does not create a threat to independence if management take responsibility for the returns, including any significant judgements made. (1)

2. Client investigation and business risk
   2.1 The integrity of management is questionable, as the CEO, Julius Zille, intentionally provided the mayor with inaccurate information. (1)
   2.2 The business risk is increased due to non-adherence to King III, which indicates a possible lack of integrity. King III state that it is not good practice for non-executive directors to receive share options, as this could impair their independence. (1)
   2.3 This is further demonstrated by the fact that the audit committee is not complying with the Companies Act, as the re-appointment of auditors needs to be evaluated annually and not every 5 years. (1)

3. Skills, competence and resources
   3.1 Motholo & Terblanche does not appear to have adequate staff members to perform the audit of Billing4U. Only 4 members are planned for the audit client that has 8 metropolitan municipalities as clients. (1)
   3.2 The audit deadline is tight, as the audit report is required a week after year end, namely 31 July 2011. Therefore, more audit team members will be required on the audit. (1)
   3.3 Consider the need for an IT expert in the audit of the conversion from Billfast X200 to Speedbill 9000. (1)
   3.4 Motholo & Terblanche has been auditing Billing4U for a reasonable amount of time. Skills and competence do not appear to be a concern in this regard. (1)

4. Engagement letter
   4.1 The statutory engagement letter must be signed and it will highlight the following: the responsibility of the auditor to report a reportable irregularity if it exists as well as management’s overall responsibility for tax returns. (2)

5. Other matters
   5.1 Billing4U might be experiencing going concern problems and may not be able to settle the audit fee. However, Billing4U has enjoyed long association with
5.2 Motholo & Terblanche and recoverability of audit fees does not appear to have been a problem in the past. (2)
5.3 The fact that the auditors have to rely on work performed by other auditors should be taken into account, as Billing4U acquired 3 companies during the year. (2)
5.4 There is additional reliance by a third party, as Billing4U is going to apply for a loan based on its financial statements. (2)
5.5 The client’s reputation should be considered because the client is being sued by the mayor. (1)

(a) (ii) Risk of material misstatement at the overall financial statement level of Billing4U and at the group level

<table>
<thead>
<tr>
<th>Risk indicator</th>
<th>Description of risk</th>
</tr>
</thead>
</table>
| 1. Billing4U Ltd is listed on AltX of the JSE Ltd. | - The AFS may be materially misstated to enable Billing4U to meet the AltX listing requirements. (1)  
- The AFS may be materially misstated in order to meet the shareholders' expectation. (1) |
| 2. CEO Julius Zille deliberately provided the mayor incorrect information. | - The AFS may be materially misstated, as the control environment might be compromised by lack of integrity of the CEO/management. (1) |
| 3. Directors receive share options driven by the profit for the year and directors have a significant shareholding in the company. | - The AFS may be materially misstated by overstating revenue/income and understating expenses as well as manipulation of profits to increase the directors’ benefits. (1) |
| 4. Change in the financial year end. | - The AFS may be materially misstated, as the items in the financial statements might not be properly accounted for in the correct period. (1)  
- The AFS may be materially misstated, as the change in year end might not be done in compliance with the Companies Act requirements. (1) |
| 5. Going concern. | The financial statement may be inappropriately presented on the going concern basis because of the following:  
- loss of major client, resulting in loss of revenue (City of Johannesburg); (1)  
- not having enough cash to settle the lawsuit of R210 million; and (1)  
- going concern problems may give management the opportunity to manipulate the financial statements to show a favourable position. (1) |
| 6. Loan depends on the audited financial statements. | - The AFS may be materially misstated, as the assets/revenue might be overstated and liabilities/expenses understated in order to obtain the loan (fraudulent financial reporting). (1) |
| 7. Billing4U operates within a group. | - The AFS may be materially misstated, as the related party/intergroup relationships and transactions might not be properly accounted and disclosed in Billing4U's financial statements. (1)  
- The AFS may be materially misstated, as this is the first year consolidated financial statements will be prepared. (1)  
- The AFS may be materially misstated, as the controls might not be operating consistently throughout all the companies within the group. (1) |
<table>
<thead>
<tr>
<th>Risk indicator</th>
<th>Description of risk</th>
</tr>
</thead>
<tbody>
<tr>
<td>8. Billing4U acquired three entities during the year.</td>
<td>• The AFS might be materially misstated, as the acquisition of the three entities might not be accounted for in terms of IFRS3. (1)</td>
</tr>
<tr>
<td>9. Consolidations required.</td>
<td>• There is a risk that the intergroup party transactions might not be eliminated on consolidation. (1)</td>
</tr>
<tr>
<td></td>
<td>• The different companies in the group may use inconsistent accounting policies. (1)</td>
</tr>
<tr>
<td>10. Reliance on the component auditors.</td>
<td>• There is a risk that the component auditors might not possess the required independence, skills and expertise to audit the components, resulting in material misstatements in the group AFS. (1)</td>
</tr>
<tr>
<td>11. Financial statements are required a week after year end and the members of</td>
<td>• The tight audit timeframe for the audit team creates an opportunity for fraudulent reporting by management on the financial statements. (1)</td>
</tr>
<tr>
<td>the audit team have decreased.</td>
<td></td>
</tr>
</tbody>
</table>

**PART b**

(i) **Risk at the assertion level**

**Net administrative fee income**

1. There is a risk that administrative fee *income of the next period might be accounted for in the current period* to inflate profits *because* management have share options based on profits and there are going concern issues (occurrence, cut-off). (1)

2. There is a risk that *municipalities might be charged incorrect rates*, as the rates are driven by the number of residents billed per month and vary per month, and because various files are received from different municipalities (occurrence, accuracy, completeness). (1)

3. There is a risk that all the *complaints and resulting penalties are not taken into account* for calculation of the net administration fee (completeness). (1)

4. There is a risk that *VAT is subtracted* not from the *net fee income* (excluding the penalty charged) *but from the full fee income* (inclusive of the penalty charged) (accuracy). (1)

5. The administrative fee income could be calculated using the *incorrect penalty percentage* (1) / *original fee* (1) / *number of residents* (1) (accuracy). Max (3)

6. The *provision* for the *July penalties may be incorrectly calculated* due to the many problems that occurred during the year (accuracy). (1)

7. The *provision for the July penalties may not be included* in the *net fee income* (cut-off). (1)

8. There is a risk that the *net administrative fee* accounted for in the general ledger might be *inclusive of VAT and penalties charged* (accuracy). (1)
### Speedbill 9000

1. There is a risk that the costs may not be properly treated. (1)
   1.1 Costs capitalised to the intangible assets are not qualifying costs (e.g. training costs) (accuracy). (1)
   1.2 The costs qualifying to be capitalised (e.g. feasibility study costs) might not be capitalised (existence, completeness). (1)

2. There is a risk that the foreign invoice with regard to the purchase of Speedbill 9000 might not be translated at the correct exchange rate when the risks and rewards pass to Billing4U (valuation, accuracy). (1)

3. There is a risk that the translation of the FEC asset or liability might not be properly calculated (accuracy). (1)

4. There is a risk that FEC gains or losses might be incorrectly accounted for in the cost of the Speedbill 9000 (valuation, accuracy). (1)

5. There is a risk that the Speedbill 9000 might be amortised over the incorrect useful life (valuation). (1)

6. There is a risk that the intangible asset is not assessed for impairment as required by IAS 36, as management did not deem it necessary to do an impairment test, especially in view of the complaints received, which might be software related (valuation). (1)

**Presentation:** Language and logic (1)

<table>
<thead>
<tr>
<th>Available</th>
<th>Maximum</th>
</tr>
</thead>
<tbody>
<tr>
<td>19</td>
<td>11</td>
</tr>
</tbody>
</table>

### PART C

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></td>
</tr>
</tbody>
</table>
| • Mrs Rosa sent out a questionnaire to the staff members who would be performing billing functions on the new system to obtain an understanding of their specific needs and requirements in terms of this new billing system. | • Mrs Rosa sent out the questionnaire to staff members only who would be performing billing functions on the new system. Therefore, she did not take the needs and requirements of the following parties into account:  (1)
<p>|                                                                                 | – 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, for example input, procedures, calculations, output, reports, audit trails, etc. Have all of these issues been dealt with in the questionnaire? | (1) |</p>
<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>Only Mr Johnson, the IT manager replied to the questionnaire in terms of specific needs and requirements with regard 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 seriously affect assistance and support being offered by the supplier. (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 evaluate itself objectively. (1)</td>
</tr>
<tr>
<td>Mrs Rosa contacted one company abroad currently using the Speedbill 9000 system.</td>
<td>Mrs Rosa contacted one company abroad only that uses the Speedbill 9000 system and based her conclusion that the system would work for Billing4U on this company's experiences only. (1) This company is abroad and therefore may not experience the same problems that are unique to a South African company. (1)</td>
</tr>
<tr>
<td>The company abroad, which Mrs Rosa contacted, identified no problems; however, 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 no 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 provide for 1,2 million residents. (1)</td>
</tr>
</tbody>
</table>
### Information from the scenario to which the weakness relates (DOES NOT COUNT MARKS)

<table>
<thead>
<tr>
<th>Weaknesses</th>
</tr>
</thead>
<tbody>
<tr>
<td>• The purchase was authorised by management as well as the steering committee appointed by management to run the Speedbill 9000 project.</td>
</tr>
<tr>
<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)</td>
</tr>
<tr>
<td>• The board of directors did not authorise the purchase of the software, despite the major operational and financial impact that this system has. (Bonus)</td>
</tr>
</tbody>
</table>

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

<table>
<thead>
<tr>
<th>Weaknesses</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Management and the steering committee assigned Mrs Rosa to the conversion process. She was appointed as the only member of the “conversion project team”.</td>
</tr>
<tr>
<td>• 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)</td>
</tr>
<tr>
<td>• She was mainly responsible for</td>
</tr>
<tr>
<td>- deciding on an appropriate conversion method;</td>
</tr>
<tr>
<td>- setting deadline dates and cut-off points;</td>
</tr>
<tr>
<td>- setting time schedules for specific stages of the project;</td>
</tr>
<tr>
<td>- allocating specific tasks to appropriate staff members;</td>
</tr>
<tr>
<td>- giving clear guidance and support to these staff members as well as time schedules for completion of these tasks;</td>
</tr>
<tr>
<td>- regularly monitoring the progress of the process;</td>
</tr>
<tr>
<td>- identifying possible problems in the process; and</td>
</tr>
<tr>
<td>- reporting to the steering committee at regular intervals.</td>
</tr>
<tr>
<td>• Mrs Rosa was solely responsible for all the tasks allocated to her by the steering committee and there is lack of involvement/ownership by other people. She might not have had</td>
</tr>
<tr>
<td>- the required knowledge or experience to perform all these tasks; or (1)</td>
</tr>
<tr>
<td>- sufficient time to perform the tasks to the required standard. (1)</td>
</tr>
<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>
</tr>
<tr>
<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>Information from the scenario to which the weakness relates (DOES NOT COUNT MARKS)</td>
</tr>
<tr>
<td>---</td>
</tr>
</tbody>
</table>
| • 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. | • 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; only quick discussions were held. (1) |
| • Due to time constraints, he had brief discussions with management of each department. | • 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) |
| • Mr Johnson advised management that job descriptions would not have to be changed, as each person would still be responsible for the same tasks. | • Clearly defined and updated job descriptions were not used as part of the training exercise. (1) |
| • A power outage occurred during the conversion process. | • As a power outage occurred during the conversion process, the premises of Billing4U were clearly not adequately prepared for disaster recovery procedures, or something similar. (1)  
• There were no data recovery procedures. (1) |
| • 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. |

**Testing and post-implementation review**

| • Supervisors were appointed to oversee the conversion. | • Insufficient (or ineffective) supervision took place; otherwise, the conversion error would have been detected. (1) |
| • Backups were made of the new system. | • No backups were made of the old system prior to conversion. (1) |
Information from the scenario to which the weakness relates (DOES NOT COUNT MARKS) | Weaknesses
---|---
- A post-implementation review was scheduled for January 2012. | - The post-implementation review scheduled for January 2012 is probably too late, as numerous problems might have been experienced by then. (1)
- The compatibility of the new system for the new Billing4U subsidiaries was not considered. (Bonus)

PART D

The computerised (programmed) application controls you would expect to see to ensure the following:

(i and ii )The occurrence and authorisation (validity) as well as the completeness of the capturing of lodged complaints 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><strong>Occurrence and authorisation</strong></td>
<td><strong>Computerised access controls</strong></td>
</tr>
<tr>
<td>- Billing4U employed temporary clerks at each of the four care centres and 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 two months only (after this period, it should be automatically disabled). (1)</td>
</tr>
<tr>
<td>- Employment contracts valid for a period of two 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 and Speedbill 9000 system level should be in place. A CRUD (create, read only, update and/or delete) matrix could be used for this purpose. (1)</td>
</tr>
<tr>
<td>The system does not allow the clerks to delete residents' 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 captured the data using 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>The personal computer (PC) on which the clerk captures the data should shut down when an access violation takes place (e.g. incorrect user ID or password entered three times). (1)</td>
<td></td>
</tr>
<tr>
<td>The PC on which the clerk does the capturing should have a time-out facility after a certain period of inactivity. (1)</td>
<td></td>
</tr>
<tr>
<td>The user ID, date, time and nature of the activity performed on the PC should be logged by the computer. (1)</td>
<td></td>
</tr>
</tbody>
</table>
### Information from the scenario to which the application control relates (DOES NOT COUNT MARKS)

- 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.

### Computerised application control over input – occurrence and authorisation

- The following checks should be performed by the computer:
  - Limit check: For example, that the complaint is lodged within 30 days of invoice date. (1)
  - Range check: For example, the resident’s account number falls within the minimum and maximum ranges for a customer of one of the eight metropolitan municipalities. (1)
  - Verification check: For example, the computer should confirm 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. (1)
- The computer should give an error message if an error is noted during any of the above program checks. (1)
- 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. (1)
- There should be an alternative method of obtaining the resident’s account number, for example through a look-up facility. (Bonus)
- If another complaint already exists, that complaint should be opened or an exception report of multiple claims per month should automatically be generated. (Bonus)

- 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.

- A drop-down list should be available on the capturing screen for the clerk to choose from the various types of complaints. (1)
- There should be standardised fields for the capturing of additional information, depending on the type of dispute selected. (Bonus)

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Available 14
Maximum 11
<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).</td>
</tr>
<tr>
<td>• Each clerk was allocated a personal computer on which the clerk captured the resident’s number, the date of lodging the dispute, the nature of the dispute, etc, directly using 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, for example the resident’s number and the drop-down box for the nature of the dispute should be present and completed before a reference number is allocated.</td>
</tr>
</tbody>
</table>

Available 2
Maximum 2
Presentation: Layout (table) (1)
- Part c (1)
- Part d (1)

**MARKERS’ COMMENTS**

**General**
- Some students wrote their answers in paragraphs instead of providing the answers in bullet form. This resulted in them losing presentation marks.
- It was evident that many students did not read the "required" section properly in order to identify what exactly was expected of them.
- Some students were in a rush to write their answers down without proper planning. This resulted in students rambling, wasting time, and losing marks.

**Part (a)(i)**
- Students performed generally very well in this part of the "required" section.
- Many students did not apply the theory to the scenario and merely listed generic considerations without making it relevant to the scenario, despite the fact that the "required" section clearly requested a discussion.
- Some students considered the long association (period of more than 5 years) a Companies Act contravention by the audit firm. This is incorrect, as the long association is only a contravention of The Companies Act if the audit partner has been serving for a period of more than 5 years.
- Students would identify that there were threats to independence (such as the large portion of revenue that the audit firm was receiving from the client), but would fail to identify the specific threat that was applicable (i.e. self-interest threat). Some students also listed all the independence threats, which demonstrated that the student was unsure about the specific applicable threat.
- Students wrongly identified the fact that the auditors assisted with the completion of tax returns, as a self-review threat. This is not necessarily a self-review threat in accordance with the CPC (please refer to paragraph 290.183 of the CPC).
Some students lost easy mark by failing to comment on the fact that an engagement letter needed to be prepared.

There were students that made the mistake of stating that the auditors should contact the previous auditors. This is not correct, as this is not a new audit engagement but a recurring engagement for Motholo & Terblanche.

Part (a)(ii)

Students struggled with differentiating between risks at overall financial statement level and risks at assertion level.

Most students included audit risks in their solutions. This was not required. For instance, if the risk indicator is that the financial statements will be used to apply for a loan, the risk of the auditor’s third party liability is an audit risk, and not a risk of material misstatement. The correct risk of material misstatement in this example would be that management might be inclined to overstate income/assets and understate expenses/liabilities, in order to show a favourable financial position to the loan providers.

Some students did not word the risks properly, and tended to write audit objectives or a list of suggestions. The correct manner is to identify the risk indicator from the scenario, and then to explain properly why this specific indicator is a risk of material misstatement by explaining how the financial statements might be misstated due to this specific indicator.

Most students stated the risk in relation to change of software. This is incorrect, as this is not a risk at the overall financial statement level. The change of software only applied to the billing of residents; it was not the software used to process the financial statements.

Part (b)(i)

Students performed average with regard to this "required" section.

Many students struggled to identify the assertion level risks.

Once again, students tended to write audit objectives or a list of suggestions, without explaining what the risk is. Some students formulated their risks in a very vague manner by for instance writing that cut-off is a risk, without explaining why it is a risk, or linking it to the scenario.

Most students did not seem to have understood the scenario very well. Students listed the risks in relation to meter readings as part of describing the risk for the net administrative fee. This is incorrect, as the administrative fee is not derived from the meter reading and electricity charged for residents by Billing4U, but is charged for the service it provides for municipalities in relation to the number of residents.

The specific account balance (e.g. admin fee income) should be used to describe the risk. Most candidates resorted to stating generic assertion level risks.

The assertions level risks relating to the Speedbill 9000 system were generally answered well.

Part (c)

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 (d)

- Students recommended many manual controls, despite being asked for computerised controls.
- Many students listed input control terms without applying them to the case study.
- The input control terms 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 whereby information is received telephonically. Therefore, they reverted to generic manual controls according to the standard transaction cycles.
- Students struggled with the part on master files and the application thereof.
- Students did not seem to understand the risks involved in the case study and the effect thereof on the specific applicable controls.
- Many students formulated audit procedures to test the system controls, rather than writing down the recommended controls.

QUESTION 2: Howzit (Pty) Ltd

(a) Concerns about the draft engagement letter prepared by the trainee accountant

1. Terms of International Standards on Auditing

1.1 The engagement letter is addressed to the Accountant of Howzit (Pty) Ltd, rather than to the company’s board of directors (ISA 210.9) (1)

1.1.1 Although ISA 210 allows for the engagement letter to be addressed to an appropriate member of management or those charged with governance, the purpose of establishing the terms of the engagement is negated as, for example, management’s commitment to meeting their responsibilities to the audit are confirmed. (1)

1.1.2 Even if the accountant formally accepted the terms of the engagement letter, it is doubtful that the company would be bound by it, should he not have been given the authority by the board of directors to contract on behalf of the company. (1)

1.2 It is a concern that the engagement letter states that an audit of the financial statements will include the certificate by the company’s directors and that it will be audited. (1)

1.3 The engagement letter incorrectly states that the objective of an audit is to express an opinion on the correct presentation of financial statements. (1)

1.4 The engagement letter indicated that the audit is to be conducted in accordance with the CPC and King III. This is incorrect, as they contain guidelines on ethics and principles and the audit should be conducted using International Standards on Auditing. (1)

1.5 The level of assurance to be obtained about the financial statements is not specified, for instance, reasonable assurance. (1)

1.6 The paragraph outlining the inherent limitation of an audit has been omitted, which should indicate that there is always a risk that some material misstatements may remain undiscovered. (1)
1.7 The engagement letter incorrectly states that an opinion on the effectiveness of internal controls will be expressed as part of the statutory audit. (Note that significant deficiencies in internal controls should be documented and reported to management.)

1.8 Stating in an engagement letter that a management representation is appropriate audit evidence for revenue and inventory is a concern.

1.9 The engagement letter does not contain a section allowing for client acceptance/signature.

1.9.1 If the client does not sign the engagement letter, there will be no contractual relationship between the Storm and Howzit.

1.10 The statement that the engagement letter will be effective for future years, unless terminated or amended, is a concern.

1.11 The engagement letter does not refer to the accounting framework used to prepare the financial statements to be audited.

1.12 It is a concern that the provision for non-assurance work (calculation of current and deferred tax liabilities/assets) is included in a statutory audit engagement letter.

1.13 There is no reference to the form and content of the auditor's report.

1.14 There is no indication that there is unrestricted access to persons within Howzit, who are determined necessary to obtain audit evidence.

2. Terms of the Code of Professional Conduct of SAICA and the Auditing Profession Act, 2005 (APA)

2.1 The sentence highlighting that the financial director's daughter will be part of the audit team is a concern.

2.1.1 The inclusion of the financial director's daughter in the audit team will create a familiarly threat/intimidation threat.

2.2 The fact that the auditor has agreed to a fixed fee for five years is a concern.

2.2.1 With the fixed fee, any subsequent change to the client's size or complexity of the audit is likely to result in the fee being inappropriate, as the fee will not be a fair reflection of the value of the professional service undertaken.

2.2.2 An increase in the size/complexity of the client may result in pressure to perform less work than is required to express an audit opinion in accordance with the professional standards (i.e. the fee may indicate a limitation of scope).

2.3 Given the fact that Howzit is expanding, quotation of the fee at 15% lower than what the previous auditors had quoted will result in a self-interest threat.

2.4 Preparation for the calculation of current and deferred tax liabilities (or assets) for Howzit will result in a self-review threat (CPC 290.184).

2.5 The fee for non-assurance service may be considered a contingent fee, as the fee is based on 10% of tax refundable (outcome).

2.5.1 Contingent fees may create threats to non-compliance with the fundamental principles (CPC 240.3).
2.5.2 The charging of a contingent fee to Howzit will result in a self-interest threat (CPC 290.285), also considering that Howzit is the biggest client of Storm in terms of revenue. (1)

2.6 A paragraph purporting to limit the registered auditor’s liability for any services rendered (including a statutory audit) is included in the engagement letter. (1)
   2.6.1 The limitation of liability for audit services is specifically prohibited by section 46 of the APA. (1)

2.7 The “locking-in” of an audit client into a five-year contract, whereby the client may not appoint another registered auditor, is not considered consistent with the fundamental principles of professional behaviour. (1)
   2.7.1 Clients have a right to choose their professional advisers and to change them should they so desire. (1)

2.8 The slogan, “We offer the best audit service in town”, is not considered to be in good taste (CPC 250) and as such, it contravenes the CPC. (1)
   2.8.1 This slogan appears to belittle the service of others, which is contrary to the requirements of the CPC. (1)

2.9 The engagement letter did not highlight the duty to report a reportable irregularity to IRBA as required by the APA. (1)

(b) Audit risk at the overall financial statement level of Howzit for the year ended 28 February 2011

1. Howzit is a new client (nature of the industry is complicated).
   1.1 There is a risk that opening balances might be materially misstated. (1)
   1.2 There is a risk that material misstatements could go undetected, as we are not familiar with the client. (1)

2. Howzit’s operation is decentralised.
   2.1 The AFS may be materially misstated, as the control environment might not be effective throughout all centres and regions/data from branches might not be completely included in the financial records. (1)

3. Howzit operates in foreign countries.
   3.1 The AFS may be materially misstated, as Howzit might not comply with rules and regulations of these countries, resulting in hefty penalties that might not be properly accounted for. (1)

4. Approval of the loan is pending the audited financial statements.
   4.1 The AFS may be materially misstated, as management might manipulate the financial results in order to stand a better chance of obtaining the loan. (1)

5. The Competition Commission subpoenaed two senior executives of Howzit for suspected price-fixing.
   5.1 The AFS may be materially misstated, as managements’ integrity is questionable and this might lead to a poor control environment. (1)
5.2 There is a risk of a reportable irregularity, which will result in modification of our audit opinion. (1)

6. Two senior managers receive share options based on the profit reported.
   6.1 The AFS might be materially misstated, as the senior managers might engage in fraudulent financial reporting in order to reflect better profits to receive the share options. (1)

7. Temporary staff filling key positions in the accounting department were not performing at the optimum level for the first two months.
   7.1 The AFS may be materially misstated, as there might be errors in the financial records due to these staff members lacking the required knowledge. (1)

8. Tight audit deadline: The group auditors require the audited financial statements a week after year end.
   8.1 The AFS might be materially misstated, as management might not have enough time to complete the financial statements and properly identify and disclose the subsequent events. (1)
   8.2 There is a risk that the auditor might express an inappropriate audit opinion, as very limited post-reporting date information will be available. (1)

9. Howzit is experiencing rapid growth.
   9.1 The AFS might be materially misstated to reflect the results anticipated by the investors. (1)
   9.2 The AFS might be materially misstated, as the control environment could be compromised. (1)

(c) Evaluation of audit risk and the effect on the overall audit strategy

1. Based on the above audit risks identified at Howzit, the audit risk is assessed as high. (1)

   As a result, the effect will be as follows on the overall audit strategy:

2. Engage more experienced staff, also considering the fact that Howzit operates in a very complex industry. (1)

3. Exercise professional scepticism. (1)

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

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

6. Incorporate an element of unpredictability in performing audit procedures. (1)

7. Perform more substantive procedures with more test of detail and fewer analytical procedures. (Place less reliance on test of control.) (1)

8. Place less reliance on management’s representation given the fact that their integrity is questionable. (1)
9. Consider the use of an expert in areas where you don’t possess the required skills as auditors.  
   
10. Perform procedures close to year end.  

(d) Risk at the assertion level

1. Revenue

1.1 There is a risk that revenue from foreign countries might not be properly translated (converted) into rand in the financial statements of Howzit (accuracy).  

1.2 There is risk that revenue on airtime might not be recognised on usage but on purchase of airtime by subscribers (cut-off).  

1.3 There is a risk that revenue on monthly services is recognised up-front instead of when the service is rendered (cut-off).  

1.4 There is a risk that revenue on products such as handsets are recognised prior to risks and rewards associated with the products are transferred to the customer (cut-off).  

2. Inventory

2.1 There is risk that merchandise purchased from foreign countries might not be translated (converted) at the correct rate at year end (valuation).  

2.2 There is a risk the profit or loss on the FEC is not properly accounted for, resulting in misstatement of inventory (valuation).  

2.3 There is a risk that the airtime not used at year end might be accounted for as inventory.  

2.4 There is a risk that merchandise in transit purchased FOB might not be included in the inventory balance at year end (completeness).  

2.5 There is a risk that the cost for imports that do not qualify to be capitalised might be capitalised (valuation).  

MARKERS’ COMMENTS

(a) 1. Concerns about the engagement letter prepared by the trainee accountant in terms of ISA 210

- It seems that most students did not use the engagement letter as contained in ISA 210, Appendix 1, as a form of guidance for answering this part of the question. It appears that students are not aware that an example of the engagement letter is included in ISA 210.
- Most students raised the fact that the engagement letter is prepared by the trainee accountant as a concern. This is not a concern as an engagement letter can be prepared by any member of the audit team. The only important aspect is that it needs to be signed by the engagement partner.
Some students even raised the fact that the engagement letter was not signed by the engagement partner as a concern. This is not a concern, as the engagement letter was still in draft format and had not been sent to the client.

(a) 2 Concerns about the engagement letter prepared by the trainee accountant in terms of the CPC and APA
- Most students wrote very little for the 10 marks allocated for this part of the question.
- The CPC and the APA are some of the easiest parts of the auditing syllabus. Some students don't seem to have studied this at all. Students also had the APA and the CPC available as part of the open-book policy with them.

(a) 2. Some students identified the concerns without discussing them in detail, as the "required" section stated.
- Bonus marks were awarded to students who spoke about lack of independence of the financial director's daughter. Please note that the CPC as issued by SAICA is applicable to CAs only. Trainee Accounts are subject to the Training Regulations which do not form part of your syllabus.

General (a)
- Some students discussed concerns relating to (a)(2) in (a)(1) and this resulted in them losing marks, as they did not deal with what was required.
- Some students did not split sections (a)(1) and (a)(2) (in the "required" part) in their solutions. This resulted in 2 marks being deducted from the total marks obtained by students. Correct and detailed numbering of answers is extremely important when answering questions in tests and examinations, in order to score maximum marks.

(b) Audit risk at the overall financial statement level
- Most students battled to formulate the risk at the overall financial statement level. This is a concern, as there is a table on how risk should be described included in Tutorial Letter 102. The exact words used in this table of Tutorial Letter 102 on risk description are the ones you need to use. This table will assist you in describing risks properly and earning the marks you deserve.
- Some students just wrote the risk indicators down without describing the risks themselves, as they had been required to do.
- Some students still confused risk at the overall financial statement level and risk at the assertion level. Please refer to Tutorial Letter 102.

(c) Evaluation of audit risk and the effect on the overall audit strategy
- Students who studied the relevant study material, that is, the tutorial letter and prescribed texts, did very well in this part of the question and obtained maximum marks.
- Some student raised the fact that the engagement letter was not signed by the engagement partner as a concern. This is not a concern, as the engagement letter was still in draft format and had not been sent to the client.

(d) 2. Concerns about the engagement letter prepared by the trainee accountant in terms of CPC and APA
- Most students wrote very little for the 10 marks allocated for this part of the question.
- The CPC and the APA are some of the easiest parts of the auditing syllabus. Some students don't seem to have studied this at all. Students also had the APA and the CPC with them as part of the open-book policy.
- Some students identified the concerns without discussing them in detail, as the "required" section stated.
- Bonus marks were awarded to students who spoke about lack of independence of the financial director's daughter. Please note that the CPC as issued by SAICA is applicable to CAs only. Trainee accountants are subject to Training Regulations which do not form part of your syllabus.

General (a)
- Some students discussed concerns relating to (a)(2) in (a)(1) and this resulted in them losing marks as they were not adhering to the "required" section.
- Some students did not split section (a)(1) and (a)(2) of the "required" part in their solutions. This resulted in 2 marks being deducted from the total marks obtained by students. Correct and detailed numbering of answers is extremely important when answering questions in tests and examinations, in order to score maximum marks.

(e) Audit risk at the overall financial statement level
- Most students battled to formulate the risk at the overall financial statement level. This is a concern, as there is a table on how risk should be described included in Tutorial Letter 102. The exact words used in this table of Tutorial Letter 102 on risk description are the ones you need to use. This table will assist you in describing risks properly and earning the marks you deserve.
- Some students just wrote the risk indicators down without describing the risks themselves as they had been required to do.
- Some students still confused risk at the overall financial statement level and risk at the assertion level. Please refer to Tutorial Letter 102.

(f) Evaluation of audit risk and the effect on the overall audit strategy
- Students who studied the relevant study material, that is, the tutorial letter and prescribed texts, did very well in this part of the question and obtained maximum marks.
- There are students who were indecisive when they answered this part of the question. These students stated that the assessed risk is moderate to high. This does not earn you any mark. You should decide as to whether the risk is high, moderate or low.
- Most students just explained the definition of the assertion. For instance, students wrote: Revenue – accuracy, there is a risk that revenue is not accurate. This is incorrect, because you are not dealing with what was required of you, using the given scenario.

(g) Risk at the assertion level
- Refer to the suggested solution to see how you were supposed to discuss risk at the assertion level.
- Some students’ explanations of risks are incorrect. For example, they mentioned that there is a risk with which the requirements of an IAS do not comply. This is incorrect, because the IAS has a number of requirements, but you should discuss the ones specific to the question. Such general comments did not earn you marks.
General
It is clear that many students either did not study their tutorial letters thoroughly, or did not work through enough questions to prepare for the test.

This test was very fair and you should really put more effort into the preparation for the remaining three tests. Going forward, you will have to study more complex topics and therefore you will find the tests more difficult if you don’t work harder.

QUESTION 3: New-Age Taxi Corporation Ltd

(a) Audit risk of SANATAKO and the SANATAKO group at the overall financial statement level

1. New client – appointed in July 2011
   • The AFS may be materially misstated, as the opening balances might be incorrect since we were not the auditors in prior years and management of SANATAKO did not adjust prior-year misstatements above materiality. (1)
   • The AFS may be materially misstated, as material misstatements could go undetected since we are not familiar with the client. (1)
   • The AFS may be intentional misstated by management who are aware of the new auditors and their limited knowledge of SANATAKO. (1)

2. Venturing into a new industry (airline industry)
   • The AFS may be materially misstated, as management of SANATAKO might not be familiar and not complying with the relevant laws and regulations. (1)
   • There could be a risk of SANATAKO not being a going concern should the airline industry incur major losses that could also affect the current taxi industry. (1)

3. Management’s integrity is questionable, as they refused to adjust misstatements above materiality.
   • The AFS may be materially misstated, as the control environment might be compromised by management who lack integrity. (1)
   • The AFS might be materially misstated, as the refusal by SANTACO management to adjust misstatements above materiality might indicate a possibility of the existence of a reportable irregularity. (1)

4. SANATAKO is listed on the JSE.
   • The AFS might be materially misstated, as the company might not comply with JSE regulations, resulting in the delisting of the company and the going concern of the company being affected. (1)

5. SANATAKO gained control over two companies during the current financial year.
   • The AFS may be materially misstated, as IFRS 3 might not be properly accounted for. (1)
   • The AFS may be materially misstated, as related-party transactions and relationships might not be identified, accounted for and disclosed properly in terms of IAS 24. (1)

6. SANATAKO is required to produce consolidated financial statements for the group.
   • The AFS may be materially misstated, as related parties might not be eliminated on consolidation. (1)
   • The AFS may be materially misstated if accounting policies are not applied consistently by all companies in the group. (1)
7. Reliance on third parties: Subsidiaries will be audited by their respective audit firms for the 2012 financial year end.
   - The AFS may be materially misstated, as the other audit firms might not be competent and/or independent in performing the work required for audit evidence. (1)

(b) Risks of material misstatements relating to revenue on the sale of airline tickets

1. There is a risk that management might recognise fictitious sales in order to meet shareholders' expectations because of the JSE listing/lack of integrity (occurrence). (1)
2. There is a risk that revenue on tickets sold in the current year to be used by the customer in the following financial year might be recognised incorrectly in the current year (cut-off and occurrence). (1)
3. There is a risk that revenue on tickets 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 airline ticket price master file not be updated with the most recent price list (accuracy). (1)
5. There is a risk that revenue might not be recognised net of VAT, airport taxes, insurance and the administration fee (accuracy). (1)
6. There is a risk that revenue is not completely recognised, as the sale is captured by the GoodBuy store cashier initially (completeness). (1)
7. There is a risk that tickets exchanged for vouchers might be recognised incorrectly as revenue from airline ticket sales (accuracy). (1)
8. There is a risk of overstatement of revenue in order to meet budget (occurrence). (1)
9. There is a risk that revenue might not be presented correctly in the notes to the financial statements, that is, service rendered (airline tickets and taxi fares) and sale of goods (snacks and drinks) (presentation and disclosure). (1)

(c) The effect of the assessment of risks of material misstatements on the audit plan for revenue

Nature

1. Revenue is considered to have a fraud element in terms of ISA 240 (shareholders' expectations, airline industry being lucrative, creates risk for fraud). (1)
2. As a result, a combined audit approach will be followed, which will include
   2.1 testing of controls to assess the operating effectiveness and performance of substantive procedures; and
   2.2 substantive procedures entailing tests of detail and analytical procedures. (1)
3. A combined approach may not be considered appropriate if no controls are in place or if controls are considered poor. The auditor will, however, document this fact. (1)
4. SANATACO appears to have controls in place; therefore, the combined audit approach will be considered appropriate. (1)
5. Incorporate the use of CAATS in performing the audit procedures. (1)
6. Consider engaging the IT expert to test the internal controls surrounding the sales and receipt cycle. (1)

Timing
1. Audit procedures (tests of controls and substantive procedure) will be performed during interim audit and at and after year end. (1)
2. Early verification tests, such as vouching sales transaction from the accounting records to invoices (test of detail) will be performed prior to year end and roll forward at year end. (1)
3. The auditor has to incorporate an element of unpredictability of timing in performing audit procedures to gather audit evidence. (1)

Extent
1. Increase the sample size of the items to be tested from the revenue account as follows:
   a. More tests of controls will be performed with less substantive procedures. (1)
   b. Substantive procedures will entail more analytical procedures with fewer tests of detail. (1)

Presentation
Available 15
Maximum 9

(d) Controls implemented to ensure occurrence and accuracy of tickets sold

1. **Occurrence**
   1.1 Access to the SANATACO airline ticket sales application should be restricted by using a valid outlet number (or cashier unique username) and unique password. (1)
   1.2 Password controls: Passwords should not be obvious, be kept secret and changed monthly, etc. (1)
   1.3 Access to the computer must be restricted to the authorised cashier (access tables). (1)
   1.4 After three unsuccessful attempts to log on to the airline ticket sales application, the computer should deny access. (1)
   1.5 All unsuccessful attempts to log in must be logged and followed up by management. (1)
   1.6 At the GoodBuy stores, there should be limited number of PCs with the function/application to sell tickets. (1)
   1.7 Flight bookings by the outlets should be limited to the operating hours of the outlet. (1)
   1.8 An error message must be displayed on the screen where invalid travelling time, departures or destination venues are provided, for instance. (1)
   1.9 All the source documents (logs generated) should be pre-numbered to avoid duplications. (1)

2. **Accuracy**
   2.1 The following examples of edit checks must be performed:
      2.1.1 Reasonableness test, to confirm that bookings are not made that exceeds the capacity of the aircraft. (1)
      2.1.2 Range/limit checks, to confirm that the ticket sales prices are within the range of prices contained in the price master file. (1)
      2.1.3 Sign checks, to confirm that prices not negative. (1)
      2.1.4 Limited input fields, where cashiers can capture details and drop-down menus. (1)
3. Computerised controls should be in place to ensure that the airline ticket sales take into account VAT, airport taxes and travel insurance when invoicing clients. (1)

4. Changes to the airline tickets price masterfile should be authorised by the financial director. (1)

5. Reconciliation between a daily schedule of the amount payable by the GoodBuy store and the daily amount recorded in the general ledger. (1)

**MARKERS’ COMMENTS**

**PART (a)**

This part of the question required students to describe significant audit risk at the overall financial statement level.
- Most students listed the risk indicator without describing the risk. For instance, students wrote, "There is a risk relating to the new client". This is inadequate, as the correct description of the risk is that opening balances might be incorrect because we were not the auditors in the prior year and management did not adjust the misstatements, identified by the previous auditors, above materiality.
- Some students’ descriptions of the risks were incorrect. For instance, students wrote, "There is risk with opening balances". The wording of this type of risk description is not correct, and it should have read as follows: The AFS might be materially misstated, as there might be errors in the opening balances.
- We have included a table in Tutorial Letter 102 on how to describe risk correctly. We recommend that you study this table in detail.
- Some students seem to have crammed similar questions in the tutorial letter and performed a “memory dump” of the information in their solutions. For instance, students identified a tight audit deadline as a risk and described the risk accordingly. This is incorrect, as the scenario did not make any reference to a tight audit deadline.

**PART (b)**

This part of the question related to the risk of material misstatement at the assertion level for revenue.
- Most students merely turned the assertion into a risk without applying it to the scenario. For instance, some students wrote, "There is a risk that revenue did not occur (occurrence)". This is a generic statement without application. We suggest that you revisit the suggested solution in this regard to see how risk at the assertion level should be described.
- Most students did not provide enough points for the available marks. It appears that students were not able to identify all the risks as provided for in the scenario. We recommend that you do more questions on risk at the assertion level to master the technique. You will note that for you to provide the risk, you will need the information we have provided in the scenario.

**PART (c)**

This part of the question related to the audit plan for the revenue account.
- Most students did a “memory dump” in this instance as well, without application to the scenario given.
- Some students appear to not have understood the required. Please revisit this part of the question and see how you were supposed to answer it.

**PART (d)**

This part of the question required you to describe the controls to ensure occurrence and accuracy of revenue relating to tickets sales.

- Most students confused this part of the "required" section with tests of controls. Tests of controls are audit procedures. In this question, you were required to **describe** the controls without testing them.
- Most students still seem unsure about controls that deal with specific audit objectives. *Sequential numbering* of source documents does not confirm occurrence but completeness. The *pre-numbering* of documents, however, ensures that there is no duplication and confirms occurrence. If you battle with this distinction, please contact us.
- For accuracy, students listed the edit checks without giving examples relating to the scenario. This resulted in students losing easy marks.
- Please revisit the suggested solution to see how you could have better answered this question.

### QUESTION 4: Cottonworth (Pty) Ltd

1. **Risks of material misstatement at the overall financial statement level of Cottonworth Holdings Limited and its group for the year ended 28 February 2013**

   2.1 The AFS may be materially misstated, as Cottonworth might not comply with stringent JSE Ltd regulations. (1)

   2.2 The AFS may be materially misstated, as Cottonworth operates in other countries, and non-compliance with the applicable rules and regulations of these countries might result in a loss of customers/market share, affecting the going concern principle of the company. (1)

   2.3 The AFS may be materially misstated, as the related-party transactions might not be accounted for at arm’s length. (1)

   2.4 The AFS might be materially misstated, as the control environment might not be consistent and operating effectively in all the regions and countries in which Cottonworth operates. (1)

   2.5 The AFS of FRD might be materially misstated, as we have to rely on the work of other auditors who might not be independent and/or competent. (1)

   2.6 The group AFS may be materially misstated, as the consolidation working might contain errors due to the following:
   - 2.6.1 intergroup transactions not being eliminated; (1)
   - 2.6.2 FRD financial statements not properly translated; and (1)
   - 2.6.3 group companies applying different accounting policies. (1)

   2.7 The group AFS may be materially misstated, as the related-party relationships and transactions might not be disclosed. (1)

   **Available** 9 **Maximum** 7
2. Risks of material misstatement at the assertion level for the year ended 28 February 2013

2.1 Operating lease expense

2.1.1 There is a risk that the operating lease expense is not recorded net of VAT (accuracy).

2.1.2 There is a risk that not all the leases are accounted for, given the high volume of lease contracts/transactions (completeness).

2.1.3 There is a risk that leases might be recognised for leases that are not yet effective, or leases that have come to an end, given the high volume of lease contracts transactions entered into (occurrence, cut-off).

2.1.4 There is a risk that the operating leases are not properly calculated in terms of IAS 17, that is, equalising the lease payments (accuracy).

2.1.5 There is a risk that the leases, which qualify as finance leases, are incorrectly classified as operating leases (classification). This risk is relevant to machinery used in production of food.

2.1.6 There is a risk that the operating lease expenses are not recognised in the correct period, given that the leases have different lease terms (cut-off, accuracy).

2.1.7 There is a risk that the provision for onerous lease commitments is misstated (over-/understated), given the fact that assumptions are used in determining the estimate (accuracy).

2.1.8 There is a risk that the provision for onerous lease commitments is recognised incorrectly, as the provision might not meet the requirements of a provision in terms of IAS 37 (occurrence).

2.2 Inventories

2.2.1 There is a risk that the value of inventory includes merchandise that does not exist (existence). CPL merchandise is susceptible to theft.

2.2.2 There is a risk that not all the inventory is accounted for, given the high volume of transactions (completeness).

2.2.3 There is a risk that the inventories purchased from foreign suppliers are not translated at the correct rate (valuation).

2.2.4 There is a risk that the inventory purchased FOB is still at sea at year end and might not be included in the year end balance of the inventory (rights and obligation, completeness).

2.2.5 There is a risk that the cost of food products is not determined correctly, given that standard costing is complex to account for (valuation).

2.2.6 There is a risk that the allowance for writing down inventory is calculated incorrectly, given the different product types (valuation).

2.2.7 There is a risk that not all costs for inventories purchased from foreign suppliers are included (e.g. import duties, transport and insurance).

2.2.8 There is a risk that the value of raw materials is incorrect, as the determination of work in progress involves a complex calculation (valuation).

2.2.9 There is a risk that inventory is not valued at the lower of cost or net releasable value (valuation).

2.3 Trade and other receivables

2.3.1 There is a risk that an incorrect interest rate is charged on outstanding balances, resulting in over-/understatement of the debtors account (valuation).

2.3.2 There is a risk that the interest charged on the outstanding balances is expensed instead of capitalised to the debtors account (valuation, completeness).

2.3.3 There is a risk that the allowance for credit losses is calculated incorrectly, resulting in the misstatement of debtors (valuation).

2.3.4 There is a risk that the debtors have been ceased/factored (rights and obligation).
MARKERS’ COMMENTS

General comments

- It was evident that some students did not study enough for this test. Studying for Auditing implies working out questions under examination conditions and spending time in marking your own work.
- Most students failed to interpret the requirement correctly, resulting in a loss of easy marks.
- Some students demonstrated poor time management, as they did not attempt to answer all parts of the "required" section.
  - In order to be successful in Auditing at CTA level, you will need to manage your time well and attempt answering all parts of the "required" section. Time management is a skill you will acquire gradually when you attempt answering all the questions included in the tutorial letter under examination conditions.
- Most students wrote generic answers and did not apply the theory to the scenario given.
  - At CTA level, you will not be awarded a mark for memory dumping. At CTA level, you are being assessed on your competence to apply the theory you have learnt to different situations.

Comments relating to specific subsections

Requirement 1

- This part of the "required" section dealt with risks of material misstatement at the overall financial statement level. Most students did very well in this part of the requirement and the risks were discussed properly.
- However, some students did not understand the difference between risks of material misstatement at the overall financial statement level and at the assertion level.
  - The distinction between risks of material misstatement at the overall financial statement level and at the assertion level is explained in Tutorial Letter 102. Students who battle with this distinction need to revisit the tutorial letter.
- Most students mentioned the risk relating to the integrity of management. There is nothing in the scenario that suggests that management’s integrity is questionable. In fact, the integrity of the auditor is questionable and not that of management.

Requirement 2

- This part of the "required" section dealt with risk at the assertion level. Most students battled to generate enough points to earn marks for this part of the requirement.
- Some students discussed the risk relating to presentation and disclosure, although the requirement was specific that students should not discuss this risk.
- The majority of students listed the assertion, that is, there is a risk that inventory is not valued correctly. Students listed this statement without giving the reason. This resulted in no marks being awarded to them. Students would have earned a mark if they correctly stated that there is a risk that inventory is not valued correctly due to foreign exchange rates.
**QUESTION 5: Top-Electric (Pty) Ltd**

1. **Weaknesses and the 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>• Only 7 of the 15 retail stores were aware of the Standardised Procedures Manual.</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.</td>
</tr>
<tr>
<td>• 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).</td>
<td>(1)</td>
</tr>
<tr>
<td>• The mark-up percentages were last updated in 2008.</td>
<td>• Should the mark-up percentages not be updated at regular intervals, there is a potential risk that these percentages are outdated and sales could be made at incorrect prices.</td>
</tr>
<tr>
<td>• Only 7 of the 15 retail stores would be able to use the mark-up percentage as stipulated in the Standardised Procedures Manual.</td>
<td>(1)</td>
</tr>
<tr>
<td>The order clerks place orders without receiving an authorised requisition based on pre-set reorder levels or reorder quantities (inventory levels are not checked first).</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.</td>
</tr>
<tr>
<td></td>
<td>• The other 8 retail stores are therefore pricing goods incorrectly (not according to company policy).</td>
</tr>
<tr>
<td></td>
<td>• This could have severe financial implications for the entity.</td>
</tr>
<tr>
<td>Numerous orders could be placed by various order clerks for the same product.</td>
<td>• This could result in large amounts of unnecessary goods, which could lead to liquidity problems (as the company might purchase goods which they want to see first) and wastage for the entity.</td>
</tr>
<tr>
<td></td>
<td>When purchasing goods, an order clerk could perceive something to be a “bargain” when it is not.</td>
</tr>
<tr>
<td></td>
<td>• No formal/authorised price lists are available for the order clerks to use when purchasing goods from suppliers.</td>
</tr>
<tr>
<td></td>
<td>(1)</td>
</tr>
<tr>
<td>Each order clerk has the authority to place an order with the relevant supplier immediately without prior approval of a supervisor or senior.</td>
<td>• Order forms could be misused, for example for placing orders for private purchases. The company could suffer financially, as goods that could have been sold to the general public are stolen.</td>
</tr>
<tr>
<td></td>
<td>(1)</td>
</tr>
<tr>
<td>There is no list of authorised suppliers from which to purchase goods.</td>
<td>• Orders could be placed with unsuitable/unreliable suppliers leading to problems with</td>
</tr>
<tr>
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<td>(1)</td>
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<td></td>
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</tr>
<tr>
<td>(1)</td>
<td>(Max 2)</td>
</tr>
</tbody>
</table>
### Weaknesses | Potential risks
--- | ---
There is no isolation of responsibilities, as the order clerks placing the orders do not sign the order confirmation documents. (1) | • Without proper isolation of responsibility, it will be difficult or impossible for management to pinpoint responsibility for orders placed, and it will make it easier for order clerks to place orders for private purposes without being caught. This could lead to losses for the entity. (1) |
No internal (sequentially numbered) order forms are used. (1) | • 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) |
No one follows up on orders placed, for example, there is no reconciliation of orders placed with order confirmation documents. (1) | • 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 have a negative impact on the financial position or reputation of the entity. (1)  
• Should no one follow up on orders placed, goods 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) |
The order confirmation is kept with the order clerk and is not filed centrally. (1) | • Order confirmations could be misfiled or lost, making it impossible for the company to reconcile orders placed with goods received. (1) |

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

- All the retail stores’ goods receiving departments and warehouses should be physically secured and access controlled, for example by obtaining/doing the following: (1)  
  - security cameras;  
  - locked warehouses; and  
  - 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)  
- A goods receiving clerk should always be available to receive goods (possible time tables). (1)  
- 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 information on 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 thereof; (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)
- ensure that two people are present to receive each delivery/check each other/counter sign delivery notes and goods received notes; and (1)
- on transfer of the goods from the goods receiving area to the warehouse, follow the following procedure:
  - the goods receiving clerk should sign the goods out on the goods received note that accompanies the goods to the warehouse; and (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.

Available 17
Maximum 10

MARKERS’ COMMENTS

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

- Weaknesses and risks were specifically addressed in Tutorial Letter 102 under examination technique: internal control related questions. Specifically, the difference between a weakness and a risk was described with examples of both. In Tutorial Letter 102, the following was highlighted:
  - Weakness: ➔ Here, you merely state
    - whether an existing control is being performed incorrectly, and/or
    - if a key control (relevant to the scenario) is not being performed at all.
  - Risk: ➔ The risk is the potential consequence of the weakness mentioned above. This is normally what management and we as the 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.

- 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 overemphasising 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 have a poor attitude towards internal control).
  - The weaknesses did not always correspond to the risk 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 to how it influences the business, that is, it will lead to a financial loss for the entity.
- Many students only expanded further on the weakness in the risk column without discussing the potential consequence, that is, 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, for example 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 spent too much time of their allocated time for part 1 and therefore did not have sufficient time left for parts 2 and 3.

QUESTION 6: Save-a-Rhino (Pty) Ltd

PART 1

1. Save-a-Rhino has to comply with the Electronic Communications and Transactions Act (designed to protect consumers). Should it not comply with this Act, it could face potential lawsuits and incur liabilities. (1)

2. There is a risk of unauthorised access (internal as well as external [hackers]) to Save-a-Rhino's computer systems, as use of the internet to receive donations and donors' personal information creates a channel or link to the outside world. This could lead to
   (a) intentional service disruption of the website, resulting in a loss of potential donors; (1)
   (b) virus contamination of the website; (1)
   (c) data destruction or corruption of donors' personal information and/or donation amounts; and (1)
   (d) loss of confidential personal information relating to donors. (1)

3. Personal information and banking details completed by the donor might be invalid, inaccurate or incomplete, which could result in donor dissatisfaction and possible lost donations. (1)

4. Potential donors could be lost if Save-a-Rhino does not look like a legitimate business with a legitimate website. Should potential donors not feel comfortable with the website and have concerns that their donations will not be used in a legitimate manner, they may not make donations. (2)

5. Unavailability of the Save-a-Rhino website could lead to lost donations and might damage Save-a-Rhino's reputation. (1)

6. There is a possibility of user repudiation (donor denying having made donations) or the donor claiming to have made donations when he/she did not. Inadequate audit trails could make it difficult for Save-a-Rhino to defend itself against these claims. (2)
PART 2

1. The following **screen aid** should be in place:
   (a) The website should restrict the donor to **keying in the minimum information**, for example if the donor has made donations in the past, he/she should only give a first name and surname (which should then automatically retrieve all standing data for that donor from the master file).

2. **Screen dialogue and prompts.** For example, there could be a prompt to confirm that the donor wants to donate that specific amount before the donation is registered (“Are you sure?”).

3. **Mandatory fields and missing data checks.** Completion of the donation process will not be allowed unless all mandatory fields (e.g. donation amount) have been completed. Screen prompts should be given when certain fields are missing.

4. **Alpha-numeric checks.** If certain fields are incorrectly completed (e.g. numeric fields such as the donation amount entered as alphabetic or alpha-numeric fields such as surname entered as numeric), there should be a prompt on the website making the donor aware of this and that it should be corrected. This check is in place to either prevent or detect these errors.

5. **Limit checks.** Donations on the website are restricted to R10 million. Limit checks should detect donation amounts exceeding this limit.

6. **Size checks.** Certain fields should contain size checks to detect when the field does not conform to pre-set size limits (e.g. the surname may have a size limit of 20 characters).

7. **Sign checks.** Certain fields should only contain either a positive or a negative value (e.g. a donation may only have a positive rand value.)

8. A **help function** should be available on the website to guide donors when they encounter certain problems.

**Available**: 8  **Maximum**: 5

QUESTION 7: Paparazzi (Pty) Ltd

(b) 1. **Risks and key controls for trading via the internet**

<table>
<thead>
<tr>
<th>Risk</th>
<th>Key control measure</th>
</tr>
</thead>
<tbody>
<tr>
<td>Loss of information or modification to user data may occur during transaction processing, because messages and information can be modified during transmission.</td>
<td>Data encryption techniques and edit checks should be employed. (1)</td>
</tr>
<tr>
<td>Paparazzi may be liable for damages if its subscribers suffer losses due to confidential information being made available across the internet or security being compromised.</td>
<td>Encryption of data and limited access to information by users should be maintained. (1)</td>
</tr>
<tr>
<td>By connecting to the internet, Paparazzi creates a channel or link which could facilitate unauthorised access to the system. Hackers may impersonate legitimate users and create unauthorised transactions.</td>
<td>Authentication tests for users (including the use of digital certification) should be built into the hardware and software. (1)</td>
</tr>
<tr>
<td>Risk</td>
<td>Key control measure</td>
</tr>
<tr>
<td>----------------------------------------------------------------------</td>
<td>--------------------------------------------------------------------------------------</td>
</tr>
<tr>
<td>By connecting to the internet, Paparazzi could contract viruses and</td>
<td>Paparazzi must install firewalls, other access control features and antivirus</td>
</tr>
<tr>
<td>&quot;worms&quot;, resulting in the loss/destruction of data.</td>
<td>software.</td>
</tr>
<tr>
<td></td>
<td>Paparazzi should make regular backups of information and store it off-site.</td>
</tr>
<tr>
<td>Contractual agreements with the subscribers may not adequately</td>
<td>Detailed review (with assistance of Paparazzi legal advisors) of all contracts</td>
</tr>
<tr>
<td>limit its liability in respect of transactions, information and</td>
<td>should be done to ensure all rights and responsibilities are clearly stated.</td>
</tr>
<tr>
<td>money flow across the internet.</td>
<td></td>
</tr>
<tr>
<td>Dishonest employees of the Paparazzi may provide information over</td>
<td>Contracts as well as disclaimers on the website should clearly state the limitations</td>
</tr>
<tr>
<td>the internet that purports to be authorised by the company, but</td>
<td>of liability.</td>
</tr>
<tr>
<td>does in fact reflect their own personal views. This may increase the</td>
<td></td>
</tr>
<tr>
<td>risk of lawsuits.</td>
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<tr>
<td>Internet-based systems have inadequate audit trails. This may result</td>
<td>Detailed procedures and transaction logs should be kept and reviewed to identify</td>
</tr>
<tr>
<td>in the inability of Paparazzi to defend itself against legitimate</td>
<td>unusual transactions.</td>
</tr>
<tr>
<td>or fictitious claims or queries pertaining to a transaction.</td>
<td></td>
</tr>
<tr>
<td>Orders may be taken from customers and filed where the customers</td>
<td>Detailed checks should be performed to ensure that transactions are done on valid</td>
</tr>
<tr>
<td>may be unable to pay (creditworthiness).</td>
<td>credit cards only or with creditworthy clients through normal credit checks as well</td>
</tr>
<tr>
<td></td>
<td>as through the implementation of SET by major credit card companies.</td>
</tr>
<tr>
<td>Paparazzi now becomes a 24x7x365 business, which means that any</td>
<td>Employ knowledgeable and experienced IT staff to manage downtime and system failures.</td>
</tr>
<tr>
<td>lack of availability to or functioning of the website will affect</td>
<td>Provide an opportunity for customers to complain or raise concerns with follow-up</td>
</tr>
<tr>
<td>sales negatively and may affect the company’s image. For example,</td>
<td>procedures.</td>
</tr>
<tr>
<td>if the website is down, customers (including retailers) may take</td>
<td>A proper disaster recovery plan must be in place.</td>
</tr>
<tr>
<td>their business elsewhere, leading to loss of income.</td>
<td>Install a generator in the case of power failures.</td>
</tr>
<tr>
<td></td>
<td>Paparazzi must see to regular maintenance.</td>
</tr>
<tr>
<td>Purchases over the internet may not be timeously delivered. If the</td>
<td>Implement a proper system with sufficient control for timely delivery of magazines.</td>
</tr>
<tr>
<td>delivery method does not meet customer satisfaction require-</td>
<td>Tailor the system for exception reports for delivery failures.</td>
</tr>
<tr>
<td>ments, that is, delivered within 48 hours, the business will suffer</td>
<td>Provide an opportunity for customers to complain or raise concerns, with follow-up</td>
</tr>
<tr>
<td>a loss of sales.</td>
<td>procedures.</td>
</tr>
<tr>
<td>The company may not comply with relevant legal aspects relating to</td>
<td>The website must be designed in accordance with all legal aspects.</td>
</tr>
<tr>
<td>customer protection as well as tax and vat implications. This could</td>
<td></td>
</tr>
<tr>
<td>affect the image of the business and may also result in liability.</td>
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<tr>
<td>Total</td>
<td>Total</td>
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<tr>
<td>12</td>
<td>20</td>
</tr>
<tr>
<td>Maximum</td>
<td>Maximum</td>
</tr>
<tr>
<td>8</td>
<td>8</td>
</tr>
</tbody>
</table>
2. Application controls to ensure validity and completeness of orders

1. Validity of orders

Identification and authentication of subscribers and retailers should be done before the order is accepted. This can be achieved as follows:

For subscriptions
- Obtain personal details about the subscribers over the internet, for example, identity numbers and credit card numbers which can be authenticated. (1)
- Provide the subscribers with a PIN/password which they must use when they log in to the website to identify and authenticate the subscribers. (1)
- Supplement the above by a response procedure or one-time password. (1)
- Restrict the method of payment to valid credit card holders only. For example, the system should, by using accepted algorithms, confirm with the bank that the account is current and that the credit card is not stolen or fraudulent prior to any delivery taking place. (2)

For sales to retailers
- Retail customers should have a separate log-on based on existing customer details. (1)
- After initial investigation of the customers’ standing based on the registration number and VAT number, the retail customer should be supplied with a unique company code and password to gain access to the site. (1)
- Retail customers should log in to a separate portal area on the site. (1)
- A programmed credit check is conducted on the retailer’s account before the order is accepted. The credit check should take into account both physical and online orders. (1)

2. Completeness of transactions

The inclusion and enabling of transport layer security techniques are essential, for example secure socket layer or network transmission protocol, which
- encrypts sensitive data; (1)
- implements checking to ensure data integrity and completeness; (1)
- confirms the subscription/order by displaying it back to the subscribers/retailer from the sales system for final acceptance (which requires a button click); (1)
- could also be done by e-mail confirmation; (1)
- produces transaction logs and transmission logs; (1)
- are kept and reviewed by an appropriate person to ensure all transactions sent were received; (1)
- produces error logs in case of transmission errors, and reviews these by an appropriate person; (1)
- automatically allocates a designated number to the subscription/order in sequence; (1)
- performs sequence checks on subscription/orders and prints exception reports which are reviewed by management; and (1)
- performs missing data checks. (1)

Implement the following checks to ensure validity and accuracy of data:
- screen formatting;
- alphanumeric tests;
- limit tests;
- mandatory field check; and
- any other valid checks. Maximum (4)
3. **General user controls such as**
   - segregation of duties, for example the IT department should be entirely separate from user departments and transactions should not be authorised by members of the IT department; (2)
   - training staff to operate the system and database administrators having the specialised skills to develop, maintain and manage the online database; (1)
   - management review of audit trails (listing) of transactions, overriding logs and exception reports; and (1)
   - log of unauthorised attempts. (1)

**MARKERS’ COMMENTS**

Part (a) (1)
- This part of the question dealt with risks and controls for trading over the internet.
- As is always the case with students who struggle with risk-type questions, the risks were poorly worded. Many students also discussed generic risks here (e.g. delivery note not signed, goods dispatched not invoiced, etc) and not risks only relating to internet trading.
- Students repeated many of the same points.
- Some students failed to identify the proper measure to implement. For example, students wrote that proper security measures should be implemented, but they did not mention that data should be encrypted.
- Students included many of the factors that were asked in part d (2) in this subsection of the question.
- However, some students did fairly well in this part of the question.

Part (a) (2)
- This part of the question dealt with application controls on trading over the internet.
- General controls were mentioned instead of application controls.
- General application controls were also mentioned by students without relating them to the scenario given.
- Several factors that were asked in part d (1) of the question were included in the answers students supplied to this subsection of the question.
- Students did not write much in this subsection, even though it accounted for quite a substantial portion of the marks for part d.

**QUESTION 8: Express Railway Services Ltd**

1. Discuss the risks of material misstatement at the overall financial statement level as well as the risk of the recognition of revenue at the assertion level for ERS for the year ended 28 February 2014.

**RISK AT OVERALL FINANCIAL STATEMENT LEVEL**

- **New audit client**
  The AFS may be materially misstated due to the opening balances containing errors. (1)

- **Listed on JSE Ltd**
  The AFS may be materially misstated, as management may engage in **fraudulent financial reporting** to manipulate the share price. (1)
The AFS may be materially misstated, as the company might not comply with the JSE Ltd regulations, resulting in the delisting of the company and affecting the going concern of the company. (1)

☐ Non-compliance with King III
The AFS may be materially misstated, as management integrity might be lacking, which is evident from the poor implementation of corporate governance principles. (1)
The AFS may be material misstated due to a weak control environment evident from the poor implementation of corporate governance principles. (1)

☐ Heavy reliance on technology and online trading
The AFS may be materially misstated because of losing clients during down-time affecting the going concern. (1)
The AFS may be materially misstated if the website upgrading is not done properly, resulting in errors in the financial statements. (1)

☐ Increased clientele
The going concern risk is decreased because the clientele of ERS has increased due to the fuel price increases. (1)

☐ The new website and internet sales system hold the risk of
  ▪ loss of data; (1)
  ▪ continuity problems if the system does not function effectively; (1)
  ▪ risk of unauthorised access if firewalls are not effective; (1)
  ▪ risk of errors if staff are not properly trained; and (1)
  ▪ changes in technology. (1)
The facts above could increase the risk of the company not being able to operate at full capacity, which will affect the going concern assumption, which in turn, would lead to the AFS being materially misstated.

☐ The company is being sued
There is a risk of reputational damage, which could lead to possible client loss should the company be at fault. (1)

RISK AT ASSERTION LEVEL

☐ There is a risk that revenue is recognised before commuters travel since revenue is recognised when payment is made instead of at the journey date. (occurrence). (1)

☐ There is a risk that revenue is recognised in the wrong period because the travel dates are spread over the year end (e.g. weekly coupon) (cut-off). (1)

☐ There is a risk that revenue is recognised in full on cancellation instead of at a 10% penalty (occurrence and accuracy). (1)

☐ There is a risk that sales might not be accurately accounted for as a result of station levies and discount not properly accounted for as well as paid over to the respective parties (accuracy). (1)

☐ There is a risk that not all ticket sales or commuters are accounted for due to possible inefficiencies in the system, for example system down-time (completeness). (1)

☐ There is a risk that revenue on adults accompanying minors below the age of 12 is recognised at normal prices instead of at a fee less than 50% of the normal fare (accuracy). (1)
2. Write a memorandum to Mr Wolf in which you:
   (a) Discuss the specific application controls that describe the accuracy and completeness of the internet reservation system at ERS. 
       Note: Exclude application controls relevant to payments and masterfile updates from your solution.
   (b) Describe the additional application controls that you would expect to be present in ERS’s processing of EFT payments to the Department of Transport’s treasury department to deal with occurrence and authorisation of transactions.

Memorandum:
To: Mr DJ Wolf
From: You
Date: Date of test
Subject: Specific application controls that should be in place to deal with the accuracy and completeness of the internet reservation system at ERS

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)
   Destinations
   o One-way/return/weekly/monthly coupons
   o Dates (providing a calendar)
   o Times
   Max (1)

☐ 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 the passenger is entitled to a discount; (1)
   o ID number test for the age of the passengers to confirm that there are no unaccompanied passengers below 12; (1)
   o field presence on all compulsory fields; (1)
   o limit test based on total seats available per train; (1)
   o size check on ID numbers for 13 digits/passport number; (1)
   o reasonability tests to ensure the total number of booked seats does not exceed the available seats on the train; (1)
   o arithmetic accuracy checks on the train fee and station levies; and (1)
   o sign test to ensure that the amount payable is positive. (1)

Error messages should pop up when the customer has input information incorrectly or incompletely. This may also be in the form of screen dialogue and prompts. (1)

☐ Prices must be retrieved automatically from the price masterfile and displayed on the screen with no customer access to the price field, that is, a verification check. (1)

☐ A summary of the fare details and selections made as well as the full pricing calculation, including discounts and station levies, should be displayed on the screen as a final quotation so that the customer may check it for correctness. (1)

☐ All bookings should be allocated a sequence number to identify missing bookings. (1)
Additional application controls that should be in place in ERS’s processing of EFT payments to the Department of Transport’s treasury department to deal with occurrence and authorisation of transactions

Preventive

- A unique transaction number should be allocated and emailed/SMSed to the customer once the booking has been made. (1)

- **Available 18**
  **Maximum 14**

- User IDs, PINs and passwords should be subjected to sound password controls. (1)

- The PIN and password should be kept strictly confidential and the financial manager should not leave his cell phone about. (1)

- A limit on the amount, which may be transferred in a single 24-hour period or in a single EFT payment, should be agreed on with the bank. (1)

- The terminal should shut down after three (3) unsuccessful attempts to access the bank account/EFT facility. (1)

- Payments should be limited to office hours (08:00–16:00). (1)

- Data may be encrypted. (1)

- An arrangement may be made with the bank to transfer the money from the company’s main bank account to another clearing account and then to transfer it to the Department of Transport. (1)

Detective

- Confirmation of all EFT payments sent by the bank should be printed, matched to the EFT payment voucher, and attached to it. (1)

- The audit trial should be independently reviewed by a senior official and payments randomly checked against source documentation. (1)

- Security violations should be logged and followed up. (1)
The cash book reconciliation should be carried out regularly, and by someone independent of the payment process. (1)

Communication skills: Correct memo format (2)

3. Describe any weaknesses in the upgrade of the internet-based reservation system. Limit your answers to the principles of corporate governance as contained in the King III report.

- Principle 5.1: The board should be responsible for IT governance and principle 5.3: The board should delegate to management the responsibility for the implementation of an IT governance framework. (1)
  
  Application
  Although the board is allowed to delegate its functions in terms of the governance of IT, it seems that the financial manager has taken full responsibility for the implementation of the upgrades to the booking system and not the board of the company. (1)

- Principle 5.4: The board should monitor and evaluate significant IT investments and expenditure. (1)
  
  Application
  By giving an open cheque book to the financial manager and only expecting a report after the implementation of a project, the board will not be able to monitor the significant expenditure on the upgrade of IT systems. (1)

- Principle 5.5: IT should form an integral part of the company’s risk management. (1)
  
  Application
  Further to the evidence provided above, risk will not be managed if all authority is given to a member of management and no monitoring of progress is made on a continuous basis. (1)

MARKERS’ COMMENTS

Part 1
Students displayed poor examination technique by NOT differentiating between the risk at the overall financial statement level and the risk at the assertion level.

Students still tended to include risks at assertion level under the risk at the overall financial statement level. Remember to ask yourself the question of whether the risk you have identified affects one or a few balances/transactions? If the answer is YES, you are dealing with a risk at the assertion level.

Students struggle to link the identified risks to the information in the scenario.

Some students were not able to identify all the risks from the scenario. Some obvious risks were not identified, for example “new client – risk of opening balances misstated”.

Part 2

The majority of students presented their answers in the format of a memorandum, but unfortunately, some students lost easy marks by not doing so.
In many cases, students listed the objective of the control: “A control should be in place that ensures...” but they failed to describe the actual control adequately.

Some obvious controls were not identified, for example the list of edit checks, which indicates a lack of theoretical knowledge.

**Part 3**

Poor examination technique: It is always advisable that a candidate indicates the principle from King III and then the application to the scenario.

Not all issues identified from the open-book text – indicates a lack of preparation (answering questions under examination conditions).

**QUESTION 9**

(a) **Describe the risks of material misstatement at the overall financial statement level for Dynamic Food Limited evident from the information provided in the scenario.**

1. The company is listed on the JSE Ltd.
   - Management might fraudulently manipulate the financial statements in order to meet the stringent JSE Ltd listing requirements. (1)
   - Management might fraudulently manipulate the financial statements in order to increase the company's share price. (1)

2. The annual financial statements of Dynamic might be misstated, as the company might not be in compliance with the JSE Ltd requirements, resulting in possible delisting of the company, which could affect the going concern. (1)

3. There is non-compliance with KING III regarding the composition of the board and the audit committee, as Mr Rupert and Mr Matsimela are chairman of the board and the audit committee, respectively, but they are not independent. Management’s integrity is questionable, which increases the risk of fraudulent financial reporting at a management level. (1)

4. There is non-compliance with KING III regarding the suitability of Mr Matsimela as a member of the audit committee, as he is a food scientist and does not have any financial background. Management’s integrity is questionable, which increases the risk of fraudulent financial reporting at management level. (1)

5. Dynamic has been fined for collusion over tender contracts.
   - Management’s integrity is questionable and this might affect the control environment, as the tone at the top does not create a good control environment. (1)
   - Management’s integrity is questionable and there may be non-compliance with all Acts relating to the food industry (National Health Act, Consumer Protection Act, etc), as the company is in the food manufacturing industry, which increases the risk of a reportable irregularity. This may result in a modification of our audit opinion. (1)
   - There is possible non-compliance with other laws and regulations throughout the business, which increases the risk of a reportable irregularity. This will result in a modification of our audit opinion. (1)
   - The going concern principle might not be appropriately addressed in the financial statements, as Dynamic is not in a position to pay the fine. (1)
6. Dynamic's operations is decentralised (distributed warehouses around the country), which may create opportunities for fraudulent transactions and errors in the financial statements, as the controls might not be functioning properly and consistently at the various warehouses.  

(1)

7. The directors own 20% of the company's shares. The directors of Dynamic have an incentive to engage in fraudulent financial reporting in order to overstate the net asset value and profits.  

(1)

8. The directors receive bonuses based on financial results. The directors of Dynamic have an incentive to engage in fraudulent financial reporting in order to overstate the net asset value and profits.  

(1)

9. Complex accounting requirements increase the risk that errors may occur in the financial statements due to, for example, IAS 2 – Inventory, IAS 21 – Foreign exchange and IAS 39 – Hedging.  

(1)

10. The company's net profit has decreased and losses are anticipated for the year under review, which increases the risk of fraudulent financial reporting (a potential overstatement of assets and understatement of liabilities).  

(1)

11. The company's net profit has decreased and losses are anticipated for the year under review, which indicates that the going concern basis may be inappropriate for the preparation of the annual financial statements.  

(1)

12. Dynamic implemented a new computerised system.  
   - There is an increased risk for errors in the financial statements, as the general and application controls changed during the year.  
     (1)  
   - There is an increased risk for errors/loss of data/duplication of data due to the conversion from the old to the new system  
     (1)

Available 17  
Maximum 10

(b) Describe the risks at assertion level relating to the existence and valuation of inventory for Dynamic Foods Limited.  
(Note to markers: It was not required from the students to present their answer per assertion.)

There is a risk that the inventory included in the annual financial statements might not exist due to the following:

1. Inventories are distributed from warehouses around the country and it could therefore be double counted.  
   (1)

2. Inventories are out on consignment. Inventory could be double counted or sold inventory could still be included in the balance.  
   (1)

3. Some inventory is imported from overseas and is purchased free on board; this might result in problems in identifying when ownership has passed (also rights and obligations).  
   (1)

4. The company discards all unused or unsold food products after their expiry date, and some of these discarded inventory items might still be included in the inventory balance at year end.  
   (1)
There is a risk that inventory included in the annual financial statements might be valued incorrectly due to the following:

5. The importation of raw materials might not be converted at the correct spot rate at year end. (1)

6. The appropriate accounting for all costs to get inventory into the country also presents a problem, that is, transport, insurance and import duty costs. (1)

7. As the company is a manufacturer, there are risks relating to misallocating all costs of manufacture to finished products. (1)

8. The inappropriate treatment of transportation costs between Centurion, where the goods are manufactured, and the warehousing facilities elsewhere. (1)

9. The company produces food items with 12-month expiry dates; thus, inventory may not be recorded at the lower of cost and net realisable value. (1)

10. The profit or loss on the forward exchange contract may be incorrectly accounted for, resulting in an incorrect valuation of inventory. (1)

11. The valuation calculation may possibly be complex due to the extensive (200) product range. (1)

12. There is a risk that inventory might not be recorded net of VAT and discount. (1)

There is a risk that inventory included in the annual financial statements might not exist or be valued incorrectly due to the following:

13. The conversion to the new purchases system may result in errors in the inventory balance. (1)

14. There is an increased risk of food obsolescence because of the reduced inventory turnover, new competitors, and increase in customer complaints. (1)

(c) Discuss the reasons why you have decided on a combined audit approach for the audit of inventory. Also, discuss the timing and extent of the planned audit procedures for inventory.

General

By deciding on a combined approach, I would include the use of tests of controls and substantive procedures. (1)

Test of controls

I would want to test (necessity) the controls in the new integrated applications because of the following:

- The new system is highly complex; therefore, it is not possible to perform substantive procedures only (ISA 315, par A141 and ISA 330, par A24). (1)

- It is a highly automated system and therefore I would want to test the system to obtain an understanding thereof (ISA 315, par 30). (1)
• Changes in the controls were caused by the replacement of the system at the beginning of the financial year (ISA 330, par 14(a)). (1)

• There is a going-paperless initiative which minimises the use of hard copy documents (ISA 315, par A141). (1)

• We, as external auditors, were not involved in testing the conversion process. (1)

*It is possible to test the controls as*

• the report from the internal audit department states that the controls can be relied upon. (1)

*It is desirable to test the controls for the following reasons:*

• Mr Rupert requested us to give feedback on the controls, and therefore, I could provide Mr Rupert with value-added comments; (1)

• As we are appointed annually through a tender process, adding value-added comments could increase our chances of being re-appointed. (1)

• If the controls are tested in the current financial year and it is concluded that we can rely on it, it might decrease our audit work in the following financial year. (1)

**Substantive procedures**

*I should perform* (necessity) substantive procedures, as inventory can be considered as a material balance (ISA 330, par 18 – *Irrespective of the risk of material misstatement, the auditor shall design and perform substantive procedures for each material class of account balance*). (1)

**Extent of audit procedures**

• This is a manufacturing company and inventory is a *material amount*. The more material, the larger the extent of testing. (1)

• The extent of testing of computerised controls will not increase because of the consistency in the performance of the automated controls (ISA 330, par A29). (1)

• As the controls can be relied upon, as according to the internal auditor’s report, the reliance on analytical procedures will be increased. (1)

• As controls can be relied upon, as according to the internal audit report, test of details will be decreased. (1)

**Timing of audit procedures**

☐ Tests of controls will be performed at year end, for example controls over the physical inventory count, as well as for the whole period under review. (2)

☐ The substantive tests of detail will be performed at year end, for example stock count. (1)

☐ The substantive analytical procedures will be performed at year end. (1)

Communication skills: Logical argument (1)

(Note to markers: The communication mark is for the students’ motivation of *why* the auditor should follow a combined approach.)
Describe the application controls that you would expect to be present in the new proposed computerised time recording and payroll application to ensure that the hours worked, as recorded in the payroll, are complete, accurate and valid.

(Note to marker: Please remember that application controls are manual and automated controls – ISA 315, par A105.)

Controls over time recording

1. Employees’ iris scan should be removed from the employee master file upon termination of their employment (validity).

2. The entry and exit point to the manufacturing plant should be limited to preferably one (validity).

3. The entry and exit point to the manufacturing plant should be supervised by the supervisor during entry and exit times (validity).

4. Upon scanning of the iris, a validity check should be performed to ensure that the iris print matches the iris print stored on the employee master file (permanent data).
   - If not, a red light should be lit and the employee should be required to scan his iris again/turnstile should not open.
   - Should the problem persist, the supervisor should investigate and resolve the problem.

5. Total hours worked should automatically be split between normal and overtime hours (accuracy).

6. The need to work overtime should be authorised by the supervisor before overtime is worked (validity).

7. The application should contain the following edit checks:
   - A limit test on the amount of normal-time hours that may be worked, for example 40 hours; and
   - A reasonability test on the amount of overtime hours that may be worked per week.

8. The weekly log of overtime worked should be authorised by the supervisor before processing of the payroll. (This log should be inspected for hours in excess of the normal hours and high overtime hours as well as low normal hours.) (validity)

9. Exception reports should be generated reflecting abnormal items such as (all assertions)
   - hours more than a set limit for normal and overtime worked (as a result of a limit check or reasonability check performed by the program); (1)
   - staff with hours worked but who did not scan in; (1)
   - staff who clocked/scanned in but did not scan out, and vice versa; (1)
   - staff with no hours worked; and (1)
   - absent employees, late arrivals, or unexplained exits from the workplace. (Max 3)

10. These reports should be distributed to supervisors for investigation, review and approval before actual processing of the payroll (all assertions).

Controls over payroll preparation

11. The payroll clerk should gain access to the application by using a valid user ID and password (occurrence and authorisation).
12. The payroll clerk should not have write access to the permanent data and the hours worked (should not be able to change this data) (all assertions). (1)

13. Reconciliations should be performed between the hours worked from one week to the next. The financial (or operations) manager should review these reconciliations on a weekly basis. (1)

14. Any other valid mark. (1)

Communication skills (use of appropriate verbs when making a recommendation, eg should or must) (1)

Available 20
Maximum 11

MARKERS’ COMMENTS

Part (a)

Describe the risks of material misstatement at the overall financial statement level for Dynamic Food Limited, which are evident from the information provided

Students performed well in this part of the question. Some students only identified the indicator from the scenario and did not relate it to its effect on the financial statements. Please remember that you have to link the indicator to the risk of material misstatement at the overall financial statement level. Material misstatement may be due to fraud or error. It is therefore important that you should link your indicator to either fraudulent financial reporting or error.

Part (b)

Describe the risks at assertion level relating to the existence and valuation of inventory for Dynamic Food Limited.

Students performed well in this part of the question. However, some of the students did not limit the risks to only the existence and valuation of inventory. This has caused them to waste valuable time.

Part (c)

Discuss the reasons why you would have decided on a combined audit approach for the audit of inventory. Also, discuss the timing and extent of the planned audit procedures for inventory.

Students did not perform well in this part of the question. Most students did not write enough to obtain the maximum marks. Please work through the solution, especially the references (as indicated on the memorandum) to ISA 330. Students only focused on whether the controls are functioning as intended or not. There are, however, more things that the auditor should consider when deciding on an appropriate audit approach than only the functioning of the controls.

Students did not receive the maximum marks with regard to the timing and extent of the audit procedures. Please note that when the auditor is performing a combined approach, the auditor should consider the timing and extent of test of controls, tests of details and substantive analytical procedures separately.
Part (d)

Describe the application controls that you would expect to be present in the new, proposed computerised time recording and payroll application to ensure that the hours worked, as recorded in the payroll, are complete, accurate and valid.

Students did not perform well in this part of the question. Students only discussed computerised controls. Please remember that application controls are **manual as well as automated procedures** in terms of ISA 315, paragraph A105. Students who did discuss the manual controls performed well. Please attempt this question again in your preparation for the examinations.

QUESTION 10

(a) 1. Discuss the risks of material misstatement due to fraud at the overall financial statement level for the year ended 29 February 2016.
   1.1 This is a new audit engagement and management might manipulate (fraudulently) the financial statements as they know that the auditors have limited knowledge of the entity. (1)
   1.2 SnP is listed on the JSE
       • There could be pressure on management to fraudulently overstate profits in order to present favourable results to the public (increase its share price). (1)
       • Management might fraudulently manipulate the financial statements in order to meet the stringent listing requirements. (1)
   1.3 The directors and senior management receive performance bonuses based on profitability and they therefore have an incentive to engage in fraudulent financial reporting in order to overstate profits to increase their bonuses. (1)
   1.4 SnP operates in the food retail industry which is much regulated (National Health act, consumer protection act), non-compliance to any laws could be and indicator of fraud. (1)
   1.5 Mr Cadbury is the chief financial officer and main shareholder. He might engage in fraudulent financial reporting in order to overstate the profits. (1)
   1.6 SnP's operations are geographically wide spread and they also expanded during the year, which could lead to manipulation of the financial statements as control over operations at each of the stores is difficult. (1)

2. Discuss the risks of material misstatement due to error at the overall financial statement level for the year ended 29 February 2016.
   2.1 The new accounting system is being updated on a real time basis, and if the system is not operating correctly it could cause errors in the financial information. (1)
   2.2 SnP's operations are geographically wide spread and they also expanded during the year, which could lead to errors in the financial statements as control over operations at each of the stores is difficult. (1)
   2.3 SnP converted to a new accounting system
       • There is a risk for errors in the financial statements as the general and application controls changed during the year. (1)
       • There is a risk for errors in the financial statements as the conversion to the new system increases the risk for errors/loss of data/duplication of data. (1)
   2.4 Complex accounting treatment in the financial statements increases the risk of errors in the financial statements for example IAS 2- Inventory, IFRS 15- Revenue. (1)

Available 5
Maximum 4

HJB
(b) Discuss the advantages and disadvantages that Shop and Pay Ltd would have considered in their decision to purchase a pre-developed accounting software package instead of developing it in-house.

SnP would have considered the following advantages:

1. The cost involved of the pre-developed software package is usually much lower than to develop it in-house. (1)
2. The development project is completed far quicker because the development and testing have been done on the software by the developers. (1)
3. The pre-developed package can be demonstrated up front, so IT personnel and users can see what the package “can do”. (1)
4. Technical support (by phone or over the internet) is more readily available from individuals who are very skilled and knowledgeable about the specific package. (1)
5. Comprehensive manuals are available and supplied. (1)
6. Software companies usually upgrade the packages on an ongoing basis. (1)
7. The software development industry is highly competitive and as a result the packages are usually of a high quality, fully debugged and reliable. (1)

SnP would have considered the following disadvantages:

1. The package may not meet the company’s requirements as it is designed to meet the generic requirements for lots of users with similar needs. (1)
2. Some of the developed packages (especially if it is developed overseas) might not satisfy South African tax or financial reporting requirements. (1)
3. SnP will not be able to make any changes to the software. (1)

(c) Write a memorandum to discuss the business risks that Shop and Pay Ltd will be exposed to from the sale of their products via the internet.

TO: Mr Cadbury
FROM: Senior audit manager
SUBJECT: Business risks
DATE: 15 February 2016

The discussion below describes the business risks that Shop and Pay Ltd will be exposed to from the sale of their products via the internet.

1. SnP might not comply with the Electronic Communications and Transactions Act which is designed to protect customers. Failure to comply with this act could result in legal liability. (1)
2. By connecting to the internet, the company creates a channel or link to the outside world which could facilitate unauthorised access to the company's computer system. (1)
3. As a result of unauthorised access SnP are exposed to:
   - Intentional service disruption; (1)
   - Virus contamination; (1)
   - Data destruction or corruption of customers personal information; and (1)
   - Loss of confidential information (personal information and bank account details). (1)

4. Potential internet sales could be lost if SnP’s customers are not satisfied that the website is a legitimate website and the company a legitimate business. (1)

5. SnP might fail to employ IT experts to ensure that the website is up to date and user friendly. If the website design is not user friendly it could lead to loss of sales. (1)

6. By selling over the internet, SnP becomes a 24x7x365 business. This means that the lack of availability or functioning of the site will result in loss sales and may affect SnP’s reputation. (1)

7. As the internet sales are a growing business there is a risk that the system and webpage cannot handle the volume of transactions. (1)

8. Products sold via the internet may be delivered to customers without payment being received from the customer. This will result in losses. (1)

9. Received orders might not be acted upon or delivered which could result in negative publicity and dissatisfied customers. (1)

10. Information keyed in by the customer may be inaccurate or incomplete (for example the customer does not indicate the quantity required) resulting in customer dissatisfaction and loss of future sales. (1)

11. The prices of SnP’s products are more readily available to competitors, resulting in more competition. (1)

12. As SnP sell its products via the internet and retail outlets it may be in competition with itself. If the internet price is more favourable than the retail price the retail sales could be compromised. (1)

13. The true cost of trading over the internet (e.g. delivery cost) should be considered, otherwise the selling price of internet products could be too low and the overall profitability could be compromised. (1)

14. The website should restrict the geographical areas to which internet sales can be made, otherwise it might lead to orders from remote areas which could not be fulfilled. (1)

15. An inadequate audit trail may result in the company being unable to defend itself against legitimate or fictitious claims or queries pertaining to a transaction. (1)

Communication skills: Memorandum Format and layout (1)
Available 19
Maximum 14
(d) Identify the application controls that Shop and Pay are going to implement to ensure the occurrence of revenue from the internet sales.

1. The customer will make use of a **user ID** and a **password** for login purposes.  
   
2. There will be password controls in place as the password should contain numerical and alpha-numerical characters.  
   
3. SnP will make use of a log to monitor any unauthorised access attempts.  
   
4. The customer will be required to review the order and total amount outstanding and confirm it by clicking on the confirmation tick box.  
   
5. The customer’s available bank balance will be confirmed with the relevant bank before delivery of the goods and if there is insufficient funds the goods will not be delivered.  
   
6. The validity of the credit card will be confirmed with the bank to ensure that the card is not stolen or fraudulent.  
   
7. The customer has to sign the delivery note to acknowledge receipt of the goods.  
   
8. SnP will make use of the latest **firewall** and **encryption** techniques in order to prevent unauthorised access.  
   
9. The accounts receivable clerk will reconcile the amount received from the bank with the invoice sent and the amount recorded in the general ledger and will follow up on any identified differences.  
   
10. Customers have to register mandatory personal details such as bank account details and delivery address and registration will not continue if valid information is not provided.  
   
11. An exception report of deliveries made for which payment was not received will be generated and reviewed on a weekly basis.

Communication skills: Formulation of controls  
Available 14  
Maximum 10