Auditing

Year-end Examination 2017

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Question 1  
(40 marks : 60 minutes)  
One page only

You are the auditor of Edukate (Pty) Ltd, a supplier of educational CDs and DVDs, etc. You have been the auditor of the company for two years, during which time you found the company to have good internal controls and the audits were completed without any concerns. The financial statements were prepared in accordance with IFRS. Soon after the end of the prior audit, Edukate (Pty) Ltd was sold to a group of young entrepreneurs who were involved in the sale of educational and University text books. Whilst performing the audit of the company which produces and imports educational CDs and DVDs, you discovered that the company commenced selling X box and play station games (video games) during the year. Your trainees on the audit were amazed by the cheap prices of the video games that the company was selling as they were buying the same video games from other established retailers at nearly twice the price. Sales of these games have become a major part of Edukate (Pty) Ltd’s business.

Exercising professional skepticism, the engagement team investigated this anomaly (abnormality) only to discover that all the CDs and DVDs were being imported as educational material and consequently qualified for the zero import duties. The invoices from the foreign supplier listed all the educational and games CDs and DVDs as educational material and on the strength of this, no import duty was being levied. Video games are subject to import duties of 80% of the cost, which would push up the price significantly and bring them into line with other retailers.

On satisfying yourself that the scheme was an unlawful act, you sent a report to the IRBA “without delay” as required by Sec 45 of the Auditing Profession Act 2005. Two days after sending the report you met with the board of directors of Edukate (Pty) Ltd. At the meeting, having fully discussed the matter with them, the managing director disagreed with you pointing out that the games were up skilling the people using them, and were of an educational nature as they also developed concentration and imagination. He further argued that the invoice also stated that the DVDs were of an educational nature which he agreed with. You pointed out that the Import Duty Act specifically mentioned that video games were subject to a 80% import duty.

The managing director has made it very clear that he does not agree with you and was going to seek legal advice. The legal advice he received, differed from his interpretation. The managing director however insists that video games which educate should be exempt from import duties and has decided not to disclose the substantial additional import duties, penalties and interest which may arise if the video games are subject to import duties. He was going to get a second opinion on the matter from another attorney.

At the subsequent AGM of the company for which normal notice was given and which you attended, the directors who own a minority share of the shares in the company, proposed that you be removed as the auditor as you may cost the company a fortune because of your incorrect reporting that the video games are being imported without being subject to import duties. The 80% import duty if imposed, would also adversely affect sales and profits. It was also proposed that you withdraw your audit report. After a short debate during which you were prohibited by the managing director from speaking because you were not a shareholder, your removal and the withdrawal of the audit report were put to the vote and the motions accepted by a small majority of those who were present.

The requirements for this question will be handed out after the reading time.
Question 2

You recently were appointed as auditor to Green Solutions (Pty) Ltd, a company involved in environmental friendly products and which manufactures and sells anything from solar water heaters to enviro friendly packaging and is also involved in recycling. Abel Green the CEO of the company appointed your firm as he had heard that your firm was also concerned about environmental issues. The company has a 31 July year end.

Before you commenced with the audit, Malachi Jakobs the financial director pointed out that the company has spent a lot of money during the year, setting up the internal audit department and had recruited Kyk Weer an internal auditor with 15 years’ experience to lead it. The internal audit team has attended some training workshops and Kyk Weer had done some on-the-job training. During the year the internal auditors produced several reports on their assessment of business risk for the company, tested the systems and monitored the implementation of group policies at all the branches.

While busy with the audit, Abel Green the CEO of the company informed you that they were considering listing on the Namibian Stock Exchange but first needed to prepare the company for such a big step. Abel Green believes that the scope for environmental products is potentially massive and wants to prepare for the growth which will be financed most efficiently by the issue of shares to the public. One of the areas of concern is that the board realizes that the company needs to implement the provisions of King IV. Abel Green has asked you to assist him with this as he is not familiar with King IV.

By using a questionnaire and making inquiries of appropriate staff, you have ascertained the following:
The board of directors is made up of seven directors. Six are executive and one is non-executive. The members of the board are appointed by Abel Green as he feels he needs to work closely with the other directors and does not want anybody he cannot get on with and who does not pull his/her weight. The philosophy of the board is that the directors need to be “hands-on” and have a sufficient knowledge of the ins and outs of the business. The non-executive director is an ex director of Green Solutions (Pty) Ltd who retired two years ago. She was the financial director before she retired.

The board of directors presently consists of the following directors:
Abel Green – CEO and Chairman (MBA)
Malachi Jakobs – Financial director CA (SA)
Primrose Suni – Marketing director
Simon Makabele – Corporate director
Sisha Naidoo – HR director
Jim Brown – executive director
Getrude Groen – Non-executive director CA(SA)

The company does not have an audit committee or any other board committees as they do not have sufficient independent non-executive directors and believe that the efficient internal audit department performs basically the same function that an audit committee would. The head of internal audit reports directly to the CEO Abel Green who points out what work they should do. If the company decides that a committee is necessary for whatever purpose, then the CEO appoints the committee and chairs it.

Abel Green also determines the amounts directors should be paid and just recently awarded all directors an above inflation increase of 7% as well as a performance bonus of N$150 000 each for achieving record income and net profits.

The company presently prepares annual financial statements in terms of IFRS for the audit. The financial statements are only presented to directors and shareholders who attend the annual general meeting of the company and a copy is given to the Revenue Authorities when the tax return is submitted. A review of the financial statements for the prior year revealed that they contained a director’s report, a statement of financial position, a statement of profit or loss and comprehensive income, a statement of changes in equity, a statement of cash flows and notes.

The directors believe the company is a good corporate citizen as it is employing over 600 employees, makes good profits for its shareholders and pays substantial amounts of income tax.

The requirements for this question will be handed out after the reading time.
Question 3  

You are a member of the team on the audit of Ace (Pty) Ltd a company which purchases chemicals both locally and overseas and blends them to make adhesives. Ace (Pty) Ltd is required to be externally audited in terms of its public interest score. The company has its head office and warehouse in the industrial area of Windhoek.

You have been assigned to the audit of inventory.

To familiarize yourself with the inventory section, you obtained a copy of the previous years working papers as well as a copy of this year’s financial statements and inventory count sheets.

You noted that inventory was a material balance and that the accounting policy of the company for inventory was:

"Inventories are measured at the lower of cost and estimated selling price less the costs to complete and sell, on the first-in-first-out cost (FIFO) basis (including a proportion of production overheads in the case of finished goods). At the end of each reporting period an impairment loss is recognized for any inventories that are impaired: i.e. the carrying amount is not fully recoverable."

After reading the working papers and interviewing the warehouse manager you gathered the following information about the inventory:

Generally stocks of blended (mixed) goods are kept to a minimum as their shelf life is limited to about nine months. Every attempt is made to blend only against specific orders but, in order to maintain a satisfactory level of customer service, a minimum level of blended inventory is kept on hand. Blended inventories are packed in drums and the date of blending is marked clearly on the outside of the drums.

The unblended inventories are considered to have an almost indefinite life.

Perpetual inventory records are kept for both unblended and blended inventories. A physical inventory count was carried out on 31 July the last day of the financial year.

At the end of the prior year and beginning of this year, world-wide shortages of some of the chemicals resulted in stock outs of some products. Ace (Pty) Ltd imported large quantities of unblended chemicals in the middle of the financial year as a safeguard against the threat of further chemical shortages. These chemicals, however, became in plentiful supply towards the end of the year and their prices have dropped significantly. This drop in price is expected to last for at least two years. Although your client has not bought any chemicals at the new reduced prices, they have been obliged to drop the selling price of their blended products in order to compete with their competitors who have been able to take advantage of these reduced costs.

The requirements for this question will be handed out after the reading time.
REQUIREMENTS FOR QUESTIONS 1, 2 & 3

QUESTION 1

You are required to:

a. Discuss fully whether your decision to report the reportable irregularity to IRBA without delay, was justified at the time that you reported it.  
   (13 marks)

b. Draft the audit report assuming that you informed the IRBA in your second report to it, that a ‘reportable irregularity’ existed and was continuing and management had not taken any steps in response to your reporting a reportable irregularity. You are not required to include the paragraphs dealing with the directors’ and auditor’s responsibilities or other information.  
   (15 marks)

c. Discuss the legality of your removal from office as auditor.  
   ( 9 marks)

d. Comment on whether the shareholder are within their rights to insist that you withdraw your report.  
   ( 3 marks)

QUESTION 2

You are required to draft a report to Mr. Abel Green discussing Green Solutions (Pty) Ltd’s non-compliance with the recommendations of King IV based on the information supplied. Briefly include in your report, the committees which King IV recommends as well as the composition of those committees.  
   (40 marks)

QUESTION 3

You are required to:

a. Specify all the audit procedures you would perform to satisfy yourself that the company’s accounting policy for valuing inventory has been correctly applied.  
   (35 marks)

b. Describe the substantive audit procedures that you would conduct in respect of the completeness assertion for Ace (Pty) Ltd’s inventory at 31 July 2017.  
   ( 5 marks)

HAND YOUR ANSWERS TO ALL QUESTIONS IN AT 11H15