

Part (d) With reference to the background information, memo B and the sample of trade receivables in workpaper C01, draft the substantive audit procedures required to verify the following balances to be disclosed in the financial statements of Smart-Pack for FY2018: (i) Allowance for credit losses; and	Marks
1. General audit procedures	
1.1. Obtain the detailed allowance calculation for trade receivables from Christine Tlaka (Senior Sales and trade receivables accountant) and do the following:	
• Cast and cross cast the calculation.	½
• Agree the amount to the general ledger and trial balance.	½
1.2. Request from Alicia Florrick a management representation letter that addresses all the relevant assertions for the allowance for credit losses of R1 513 452 as at 31 December 2018.	½
1.3. Inspect minutes of management meetings for discussions relevant to the allowance for credit losses, such as the approval of the policy, debt incumbent etc.	½
2. Test of detail	
2.1. Ensure that the movement between the opening and closing balance has been recognised in profit and loss (P/L) by inspecting the P&L statement for inclusion of the movement.	1
2.2. Ensure, by inspection of the detailed calculations, that the simplified approach was used to calculate the allowance with reference to the lifetime expected credit loss	1
2.3. Obtain an understanding if the IFRS 9 was early adopted in the prior year.	1
2.4. Enquire from Peter and Alicia Florrick the distinguishing characteristics for all customer accounts. E.g. Distill Africa and BotAir are foreign customers with long outstanding debt to confirm/determine how the customers were grouped/segmented (by product type, geographically etc.)	1
2.5. Compare to the South African customer accounts which seem to pay more frequently (i.e. customers within the foreign and South African group seem to individually have similar loss patterns)	1
2.6. Consider the reasonableness of management current year estimates (default rate) by recalculating and comparing prior year expected default rate to actual bad debt written off in the current period.	1
2.7. Based on the distinguishing patterns and actual default rate from prior year, recalculate the current year default rate and compare to the rate used by management to determine the reasonability thereof.	1
2.8. Assess the forward-looking information used in the calculation for reasonableness by agreeing to supporting documentation where possible or discussion with Peter Florrick (CFO) and Christine Tlaka.	1
2.9. Recalculate the allowance based on the above/adjusted forward- looking information (i.e. the loss rate).	1
2.10. Inspect subsequent receipts from debtor for debt included in allowance for credit losses, to confirm reasonability of valuation.	1
2.11. Obtain permission from Peter Florrick to send out lawyer's letter.	1
2.12. Request confirmation from the lawyers regarding the recoverability of Silvia Packaging and Foodies Supplies.	1
2.13. Based on the response received from the lawyers, consider whether the amount should be provided for or written off and discuss this with management.	1
2.14. Enquire from Peter as to the status of the dispute with Distill Africa regarding the 15% VAT inclusion for a foreign customer.	1
2.15. Inspect the current year's draft financial statements to ensure that the disclosure related to the allowance for credit losses meets the requirements of IFRS 9	1
Available	17
Maximum	6
Total for part (d)(i)	6

Part (d) With reference to the background information, memo B and the sample of trade receivables in workpaper C01, draft the substantive audit procedures required to verify the following balances to be disclosed in the financial statements of Smart-Pack for FY2018: (ii) Gross trade receivables balance.	Marks
3. General audit procedures	
3.1. Obtain from Christine Tlaka the final year-end (31 December 2018) debtors age analysis that includes all Pack-Smart's debtors and do the following: • Cast and cross-cast the analysis; • Agree the closing balance to the final year-end (31 December 2018) balance in the general ledger and trial balance; and.	1/2 1/2
3.2. Request from Alicia Florrick a management representation letter that addresses all the relevant assertions for trade receivables of R14 612 100 as at 31 December 2018.	1/2
3.3. Obtain from Christine Tlaka a breakdown of the year-end balance of the debtors' general ledger account amounting to R14 612 100 and scrutinise the breakdown for journal entries and/or unusual transactions and agree to supporting documentation, i.e. approved journal entry requests, invoices, credit notes, etc.	1
3.4. Inspect minutes of management meetings for discussions relevant to the receivables	1/2
4. Analytical procedures	
4.1. Perform the following analytical procedures for the trade receivable amount as at 31 December 2018 (R14 612 100) and investigate and discuss any significant fluctuations or deviations from the expected balances with Christine Tlaka, Alicia and/or Peter Florrick:	1
4.2. Compare the current year's account balance with the prior year's balance for the movement in the balance.	1
4.3. Compare monthly sales by customer and/or product type for the current year with monthly sales for the prior year and the first few months subsequent to year end.	1
4.4. Compare the aging categories of the current year's trade receivables with that of the prior year and/or that of the manufacturing industry for medium- sized South African companies (companies similar to Smart-).	1
4.5. Calculate the following key ratios for the current year and compare it with the prior year:	
<ul style="list-style-type: none"> • Trade receivable turnover • (By dividing the new credit sales by the average accounts receivable for the period) • Days of sales in accounts receivables • (the number of days in the year, 360 or 365, divided by the trade receivable turnover ratio) • Gross profit margins • (by calculating the difference between sales and cost of sales divided by sales) • Inventory turnover. • (by dividing the cost of sales for a period by the average inventory for the period) 	1/2 1/2 1/2 1/2 1/2 1/2 1/2
5. Test of detail regarding the debtors selected in sample (WP C01) based on performance materiality	
5.1. Obtain a breakdown of the customer statements for the following customer accounts by requesting a printout of these debtors statements at 31 December 2018, and agreeing the balance to that on the age analysis: • Silva Packaging (R566 800) • Foodies Supplies (R292 604) • Thela Winery (R1 372 500) • Distill Africa (R4 165 900) • BotAir (R3 091 800)	1
5.2. Select a sample of sales transactions from the statements and do the following: • Recalculate the amount of the invoice and agree it to the customer's statement. • Agree the price on the invoice to the authorised price list of Smart Pack	1 1

<ul style="list-style-type: none"> • Agree the quantity on the invoice to the quantity on the order form and signed delivery note. 	1
<ul style="list-style-type: none"> • Recalculate the amount on the invoice and ensure that the VAT is correct (i.e. 14% up until 31 March 2018 thereafter 15% - South African Customers and 0% as it is a direct export). 	1
<ul style="list-style-type: none"> • Inspect the invoice for its date and ensure that the date on the invoice is within the 31 December 2018 year end. 	1
<ul style="list-style-type: none"> • Reperform the aging of the selected invoices to ensure correctly stated in age-analysis. 	1
<ul style="list-style-type: none"> • Obtain the average rates for the year and year end spot rates for Botswanan Pula (BWP), and Lesotho Loti (if Distill Africa is not in ZAR) from Invest bank (reputable source). 	1
<ul style="list-style-type: none"> • Recalculate the amount of the invoice according to the exchange rates above (either with reference to the average rate or rate on the day of the transaction) and agree it to the customer's applicable statement 	1
<ul style="list-style-type: none"> • Recalculate the year-end debtors balance for both Distill Africa and BotAir with reference to the year-end spot rate and do agree to amount on age-analysis 	1
5.3. A sample of cash payments reflected on the statement should be agreed to the bank statement to verify amount, date of receipt	1
5.4. and that it was allocated to the correct invoice.	1
5.5. A sample of credit notes reflected on debtor statements should be agreed to the details on the credit note (date, customer, amount, authorisation etc.)	1
5.6. Select a sample of invoices close to year end and inspecting the associated delivery note to verify the goods were delivered prior to year-end.	1
5.7. Inspect the bank statements after year end and identify payments from these customers agree the amount/invoices reflected applicable customer's statement	1
6. Debtors confirmation	
6.1. Obtain permission from Peter Florrick to send out debtors' confirmations.	1
6.2. Send out debtors' confirmations to the sample of debtors selected.	1
6.3. Send confirmations to the debtors selected, ensuring the confirmations are sent under the auditors' control, on the client's letterhead, with the auditors return address and are returned directly to the auditors and not through Peter or any other staff member of Smart-Pack.	1
6.4. Monitor all replies and for confirmations not yet received, follow up telephonically, sending of a second confirmation.	1
6.5. For replies received with discrepancies, follow up by inspecting relevant supporting documentation, and discussions with the relevant staff.	1
6.6. For debtors for which no response is received after follow-up, perform subsequent receipts testing.	1
7. Presentation and disclosure	
7.1. Inspect the financial statements to ensure that debtors are correctly classified and disclosed correctly in terms of IFRS.	1
	Available
	33
	Maximum for part (d) ii
	24
	<i>Communication skills – appropriate style</i>
	<i>1</i>
	Total for part (d)
	31

Part (e) With reference to memo A, draft an email to the management of Smart-Pack to be reviewed by the audit partner, in which you – <ul style="list-style-type: none"> • discuss any control deficiencies in memo A (excluding the preferential procurement arrangement); and • comment on the potential impact of each of these deficiencies on Smart-Pack. 	Marks
Email To: Ms Alicia Florrick/Management of Smart-Pack From: (Decker and Young Inc. – to be reviewed by the partner) Date: X January 2019 Subject: Reporting on control deficiencies Dear Ms Florrick This memorandum sets out the control deficiencies identified with regard to the ordering system used in the procurement of raw materials and the possible impact thereof for Smart-Pack during the financial year ended 31 December 2018.	
1. <u>Control weakness:</u> The fact that Xolani refuses help in the form of an additional ordering clerk in the procurement department to assist him is leading to a lack of segregation of duties/ Xolani has been doing this job since the inception of the company, which places him in a position of familiarity with suppliers	1
1.1. <u>Impact:</u> As Xolani has total control over the procurement function the possibility exists that he can engage in fraudulent activities such as placing orders with friends and family at inflated prices, or arrange kick-backs, or purchasing goods for himself on the company's accounts.	1
2. <u>Control weakness:</u> Smart-Pack has not instituted a perpetual inventory system, which provides a more accurate basis for ordering raw materials (e.g. type and quantity), re-order levels, and tracking inventory. They currently only ensure the accuracy and completeness of the inventory record with monthly stock counts.	1
2.1. <u>Impact:</u> The inventory levels are incorrect resulting in lost sales or production delays or inventory shortages / theft are concealed	1
3. <u>Control weakness:</u> These stock counts are also conducted by staff who work in the relevant departments and there is no external corroboration or confirmation of the inventory count (e.g. being done by other staff within the organisation or an internal audit department).	1
3.1. <u>Impact:</u> Inventory records could be inaccurate and only rectified on a monthly basis. – leading to Possible incorrect orders or missed business opportunities and unhappy clients.	1
3.2. <u>Impact:</u> A consequence of the weak control could be that inventory records could be purposefully misstated to cover up mistakes or theft of raw materials.	1
4. <u>Control weakness:</u> Xolani bases decisions on what he wants to order from which supplier on past trends of an Excel spreadsheet and not on current facts/business needs (e.g. re-order levels or pending customer orders).	1
4.1. <u>Impact:</u> The business could possibly stock raw materials not needed, thus tying up working capital. ock may be ordered to fulfil customer needs.	1
4.2. Insufficient stock may be ordered to fulfil customer needs	1
5. <u>Control weakness:</u>	1

Smart-Pack does not have an authorised list of pre-approved suppliers that are vetted (quality, reliability and pricing) from whom raw materials should be procured.	
5.1. Impact: Purchases could be made from suppliers that do not offer the best quality or prices or a reliable supply to Smart-Pack..	1
5.2. This could in turn lead to lower gross profit margins or unavailability of certain raw materials that could delay the production process and lead to client dissatisfaction	1
5.3. Impact: Allowing purchases of raw materials from any supplier the possibility exists that he can engage in fraudulent activities such as placing orders with friends and family at inflated prices, or arrange kick-backs, or purchasing goods for himself on the company's accounts	1
6. Control weakness: There is an insufficient number of copies of the order. The current order form is only issued in duplicate instead of at least triplicate. Currently only the supplier receives a copy and one copy is kept at the procurement department.	1
6.1. Impact: The business does not have a proper way to track which orders are going to be delivered at the warehouse or of conducting three-way matching with the delivery note, goods received note and invoice to ensure accurate quantities/prices of ordered goods.	1
7. Control weakness: The business does not keep track of goods ordered (except on an Excel spreadsheet); the pending order file is not reviewed regularly for long outstanding orders and followed up on/Pending order file is not updated with associated goods received notes/no reconciliations of order places to goods received performed.	1
7.1. Impact: The failure to follow up on missing orders/orders not placed could result in delays in production/dissatisfied customers in cases where the raw materials not be available when needed.	1
8. Control weakness: Orders/ Excel spreadsheets are not reviewed or authorised to ensure optimal pricing, supply requirements etc., which could lead to ineffective inventory management systems for Smart-Pack.	1
8.1. Impact: Purchases done by Xolani of raw materials, not reviewed or authorised the possibility exists that he can engage in fraudulent activities such as placing orders with friends and family at inflated prices, or arrange kick-backs, or purchasing goods for himself on the company's accounts.	1
8.2. This failure of review could also increase the risk of incorrect or unnecessary goods being purchased for the company. Placing unnecessary strain on the company's cash flows.	1
Please let me know should you have any queries regarding the contents of this memorandum. Kind regards ITC Candidate	
Available	21
<i>Communication skills – layout and structure</i>	<i>1</i>
Maximum for part (e)	13

Part (f) With reference to the background information and memo B – (i) discuss the factors that you would consider when assessing the risk of material misstatement relating to the inappropriate use of the going concern basis of accounting in the 2018 annual financial statements of Smart-Pack;	Marks
1. Factors that will increase risk of material misstatement	
1.1. Overall and from the following it appears as if Smart-Pack is experiencing cash-flow difficulties evidence by:	
1.1.1. The bank overdraft has significantly increased and is at the limit of the facilities provided by the company's banker.	1
1.1.2. The current working capital is not optimal and Smart-Pack is experiencing difficulties with paying its creditors in a timely manner (i.e. the balance outstanding appears to be well in excess of 30 days' purchases; large stock holding etc.).	1
1.1.3. Smart-Pack wants to apply for an increased overdraft to finance its working capital, which is in effect a very expensive form of financing and may be an example of a desperate attempt to secure cash inflows.	1
1.1.4. The company has an increased foreign exposure compared to the prior year.	1
1.2. The gross profit percentage has dropped from 30% to 21%.	1
1.3. There has been an increase in non-current liabilities and decline in production capacity with non-current assets declining.	1
1.4. Sales have increased significantly (almost doubled), but the trade receivables will take more than 60 days (R12 612 100/ R61 470 000 X 365) to settle their accounts – which points to recoverability problems (given the 30 days payment period).	1
1.1.1. If not recoverable, these amounts will have a negative impact on – <ul style="list-style-type: none"> • working capital and the current ratio, specifically with regard to the cash flow of Smart-Pack; and • the company's solvency, should it be necessary to write off these balances. 	1 1
1.5. The 'going green movement' could have a negative impact on businesses like Smart-Pack going forward as a result of legislation and/or loss in sales, especially if Smart-Pack does not investigate alternative products that are more environmentally friendly.	1
1.6. As at 31 December 2018 Smart-Pack was factually insolvent, as its liabilities exceeded its assets.	1
1.7. Should the control weaknesses over procurement (evident from part e)) not be addressed, it can further worsen the effective management of working capital regarding inventory and trade payables (control risk).	1
1.8. Sales to South African customers has reduced in the current year from R32 million to 25.6 million (20%). This reduction could negatively impact sustainability should this continue in management forecasts.	1
2. Factors that will decrease risk of material misstatement	
2.1. The sales in Lesotho and Botswana have grown significantly when compared to the prior year despite the decrease in South African sales (92% overall increase) and the growth is expected to continue, as expanding into neighbouring African countries seems promising/probable..	1
3. Overall assessment of risk of material misstatement	
3.1 Based on the factors identified and discussed the risk of material misstatement related to the inappropriate use of the going concern basis of accounting in the 2018 annual financial statements of Smart-Pack is assessed as HIGH	1
Available	16
Maximum	7
Total for part (f)(i)	7

Part (f) With reference to the background information and memo B – (ii) formulate the substantive audit procedures that should be performed to respond to the assessed risk of material misstatement.	Marks
Obtain a management representation letter in which management specifically deals with its ability to continue as a going concern.	1
Obtain a detailed evaluation for the going concern (including cash flow forecasts and budgets for FY2019) of Smart-Pack from the Board of Directors and perform the following:	1
1. Enquire who prepared the evaluations, and assess their experience and qualifications.	1
2. Enquire from the preparers the process and information used to determine the cash flow forecasts and budgets for FY2019	1
3. Compare the estimates previously made by the preparer(s) to the actual results, to assess their competence.	1
4. Compare the data used in the budgets and forecasts to the figures in the FY2018 financial records for accuracy.	1
5. Evaluate the reasonableness of any assumptions made by enquiry from management and inspection of relevant documentation.	1
6. Re-perform the clerical accuracy of the budgets/forecasts.	1
7. Inspect the minutes of the Board of Directors for the approval of the reasonableness of the budgets and forecasts, including any discussion regarding financial difficulties or going concern factors.	1
8. Assess the reasonability of the action plans/interventions to improve the working capital of Smart-Pack (i.e. to improve cash flows from sales) by discussion with management and other knowledgeable persons.	1
9. Compare the forecast to actual performance in January/ February 2019 to assess the accuracy of the forecast.	1
10. Enquire from management whether they have alternate plans to raise funding should Invest Bank not agree to provide the additional funding.	1
11. Enquire from management whether Invest Bank has indicated the level of security it will require on the increased funding and what impact this may have on the going concern of the entity.	1
12. Enquire from management whether Invest Bank has indicated what covenants it will require to be in place on the increased funding and whether it is likely that Smart-Pack will be able to meet those covenants.	1
13. Obtain confirmations from Invest bank regarding the possibility of future funding and the terms of the funding to assess whether they are in line with management's assumptions/ expectations.	1
14. Obtain and inspect letters of support from shareholders or subordination agreements with creditors.	1
15. Obtain permission from Peter Florrick to send out lawyer's letter.	1
16. Request confirmation from the lawyers regarding the recoverability and/or disputes other than those mentioned in part (d).	1
17. Perform subsequent events testing to determine if there is any further information that would impact on the going concern of Smart-Pack	1
Available	19
Maximum for part (f)(ii)	6
<i>Communication skills – logical argument</i>	<i>1</i>
Total for part (f)	14
TOTAL FOR PART II	58