

Background information

Smart-Pack (Pty) Ltd ('Smart-Pack') was incorporated in January 2010 by Alicia Florrick and her husband, Peter Florrick. Smart-Pack is a privately owned South African company, with Alicia as the Chief Executive Officer and Peter as the Chief Financial Officer. Neither Alicia nor Peter are chartered accountants, but both have extensive experience in running successful businesses. The company has three non-executive directors on the Board of Directors. The company's head office is situated in the Waterfall Business Park in Johannesburg, with a manufacturing plant and warehouse in the neighbouring city of Germiston.

Over the years, Smart-Pack has grown rapidly to become a medium-sized manufacturing company that supplies various forms of packaging solutions such as plastic shopping bags, cardboard boxes, crates and polystyrene bases to its wide and established customer base. To aggressively grow sales, Smart-Pack successfully expanded its business into sub-Saharan Africa (predominantly Lesotho and Botswana) during January 2018. Smart-Pack is registered for value-added tax (VAT) as a category C vendor.

The previous auditor resigned on 16 November 2018 with immediate effect, due to irreconcilable differences between the engagement partner and the Smart-Pack Board. This related to the audit fees that were charged. Accordingly, Decker and Young Inc. ('Decker and Young') was appointed as the new independent external auditor on 30 November 2018, for the 31 December 2018 year-end audit. Decker and Young is a medium-sized auditing, tax and advisory firm. The previous auditors did make prior-year working papers available to Decker and Young and based thereon the new engagement partner is satisfied that reliance can be placed on all opening balances for the current financial year audit.

Smart-Pack is currently experiencing cash flow difficulties and is operating at the limit of its overdraft facilities. Therefore Alicia requested that the signed audited financial statements be available by 4 February 2019, as Smart-Pack wants to apply for increased bank overdraft facilities from Invest Bank. Invest Bank requires audited financial statements that comply with International Financial Reporting Standards (IFRSs). The company's poor cash flow position is largely due to poor working capital management. The poor working capital management was first noticed in the South African operations, but has been worsened by the increased production needs to service the new Lesotho and Botswana business lines.

You are a first-year trainee accountant in the audit and assurance division of Decker and Young focusing on manufacturing enterprises. In addition to the above information, you have received the following:

Documentation reference	Description
Memo A	Notes from a meeting with the company buyer
Memo B	Planning notes on trade receivables and related items
Workpaper C01	Sample of trade receivables selected for detailed testing
Workpaper T05	Tax allowances for trade receivables

1 Staffing

The procurement department of Smart-Pack consists only of Xolani Gwebe, the company buyer, who has been with Smart-Pack since the inception of the company. Although he is extremely busy, he has on more than one occasion declined management's offer to appoint an ordering clerk to assist him in the procurement department.

The raw materials warehouse manager, Julius Sibanda, has three warehouse assistants, who are collectively responsible for receiving raw materials from suppliers and selecting and issuing raw materials for the production process. After completion of the production process, the final products are stored in the finished goods warehouse, which is managed by Bob Martins and two warehouse assistants.

2 Ordering

Xolani is responsible for placing orders with suppliers. He bases decisions on which items and quantities to procure on an Excel spreadsheet, on which he tracks his orders and the quantities previously ordered as well as details of supplier promotional sales and special offers.

Xolani uses a procurement system to generate a pre-numbered order in duplicate. The original order is sent to the supplier via email and a copy is retained in a pending-order file. Prices on the orders can be updated and changed by Xolani as necessary, depending on the current prices negotiated with the suppliers.

Smart-Pack does not maintain a perpetual inventory system. Monthly stock counts are conducted in the raw materials warehouse by Julius and in the finished goods warehouse by Bob.

3 Preferential procurement of inventory

The following information regarding preferential procurement was obtained from discussions with Xolani:

In view of the anticipated increase in sales from the Botswana and Lesotho business lines, Alicia signed a guaranteed supply contract with Paper & Plastics (Pty) Ltd ('P&P') on 1 January 2018. P&P is a South African company that supplies raw materials such as plastic, paper and wood to manufacturing companies in South Africa. Alicia's father is the majority shareholder of P&P.

In terms of the contract, P&P will prioritise the supply of raw materials to Smart-Pack. A facilitation fee was paid in addition to the documented contract price to ensure P&P prioritises supplies of inventory to Smart-Pack. This additional facilitation fee, amounting to R2 800 000, was only discussed in face-to-face meetings between Smart-Pack's management and P&P and has not been documented in the contract. Smart-Pack's management decided to account for the payment as part of the cost of sales line item, as they believe this facilitation fee to be essential for securing Smart-Pack's inventory supply. Alicia also reasoned that including the facilitation fee in the cost of sales line item would ensure that it did not receive too much attention from the auditors, as cost of sales is the largest cost line item in the company's statement of profit and loss.

MEMO B PLANNING NOTES ON TRADE RECEIVABLES AND RELATED ITEMS

Christine Tlaka is the senior sales and trade receivables accountant with extensive relevant experience. She is not a chartered accountant but has a Bachelor’s Degree in Accounting Sciences. She is assisted by John Mzini, a part-time, third-year accounting student.

All Smart-Pack’s sales transactions are on 30 days’ credit from date of invoice and subject to terms and conditions. Smart-Pack currently does not have written sales agreements with their customers. All invoices are accompanied by delivery notes, which are signed by the relevant customer upon delivery.

When customers place orders (usually telephonically), Christine issues invoices with reference to the price list that Peter approves on a monthly basis.

Smart-Pack’s expansion of its business into Lesotho and Botswana has been a great success. There is potential for significant growth in both these countries, as well as other African countries. As a result, Smart-Pack sales have grown significantly compared to the prior year. Sales to customers in Lesotho and Botswana are invoiced in the applicable foreign currency and delivered directly to the customers.

Smart-Pack currently does not perform reconciliations on any of their customer accounts, but does send monthly statements to all customers via email. Payments received from a specific customer are allocated to that customer’s longest outstanding invoice first.

The following is an extract from the financial reporting system:

	Notes	2018	2017
		R	R
Sales in South Africa		25 630 000	32 000 000
Sales in Lesotho		17 440 000	–
Sales in Botswana		18 400 000	–
Total sales		61 470 000	32 000 000
Cost of sales	B1	(48 258 500)	(22 500 000)
Gross profit		13 211 500	9 500 000
Net profit / (loss)		(47 750)	(1 425 450)

Note

B1 The R2 800 000 facilitation fee paid to P&P to ensure preferential procurement is included in FY2018’s cost of sales figure.

Description	Notes	2018	2017
		R	R
Total trade receivables		14 612 100	5 752 000
Customers from South Africa		5 460 100	5 752 000
Customers from Lesotho		4 352 000	–
Customers from Botswana		4 800 000	–
Allowance for credit losses	B2	(1 513 452)	(1 162 800)
Net trade receivables		13 098 648	4 589 200

Description (cont.)	Notes	2018	2017
		R	R
Total inventory		7 612 500	3 170 000
Trade payables	B3	(7 785 671)	(3 432 860)
Bank overdraft		(5 650 700)	(2 838 600)
Total other non-current liabilities		(14 286 094)	(12 994 946)
Total other non-current assets		6 670 989	7 565 280
Shareholders' equity and reserves		2 826 876	2 779 126

Notes

- B2 The detailed calculation for the allowance for credit losses is available from Peter. Trade receivables contain no significant financing component. Smart-Pack uses the provision matrix as the practical expedient as suggested by IFRS 9, *Financial Instruments*.
- B3 All purchases of raw materials used for manufacturing are on credit, payable within 30 days from date of invoice.

Workpaper			C01		
Customer: Smart-Pack (Pty) Ltd		Prepared by: ONP		Date prepared: 3/1/2019	
Year end: 31/12/2018		Reviewed by:		Date reviewed:	
Subject: Sample of trade receivables selected for detailed testing					

The performance materiality figure of R285 000 resulted in the following sample of trade receivables being selected for detailed testing:

Customer number	Description	Country	Notes	Days outstanding					
				120+	90+	60+	30+	Current	Balance
				R	R	R	R	R	R
DA001	Silva Packaging	South Africa		110 000	–	–	75 800	381 000	566 800
GF008	Foodies Supplies	South Africa	C1	–	–	142 750	38 880	110 974	292 604
TW010	Thela Winery	South Africa		–	–	–	27 000	1 345 500	1 372 500
AD035	Distill Africa	Lesotho	C2	925 000	525 300	800 000	415 600	1 500 000	4 165 900
AB041	BotAir	Botswana		–	–	551 800	650 000	1 890 000	3 091 800
Total				1 035 000	525 300	1 494 550	1 207 280	5 227 474	9 489 604

Notes, based on discussions with Christine

- C1 The balance of R142 750 in the 60 days outstanding column has been handed over to the Smart-Pack lawyers for collection, as there is a dispute about the amount owing.
- C2 The total balance of this account is currently in dispute because VAT was charged at 15% to the customer with a stated foreign address on the invoice. Upon enquiry, it transpired that Peter had never declared the output VAT on the VAT201 return. He instead included the VAT amount in his sales figures.

Workpaper		T05
Customer: Smart-Pack (Pty) Ltd	Prepared by: KLM	Date prepared: 15/1/2019
Year end: 31/12/2018	Reviewed by:	Date reviewed:
Subject: Tax allowances for trade receivables		

Sample selected from bad debts written off:

Customer account	Description	R (including VAT)
DW044 Pet World	Notified on 10 January 2019 that the customer has been declared insolvent. Amount relates to Invoice 31240 issued on 27 August 2018	419 750
WB063 We-Pack	After a long dispute, the customer is still refusing to pay the outstanding Invoice 43187, issued on 31 July 2018	73 370

Sample of items included in the allowance for credit losses as at 31 December 2018:

Customer account	R (including VAT)
FS081 Mr Street Allowance relating to an advance to a staff member who was later dismissed	81 500
LG113 Lucky Gin Distillery Relating to Invoice 49001 issued on 30 September 2018	250 000
BS064 Bespoke Packets Relating to Invoice 49052 issued on 5 October 2018	160 200
Total	491 700

The Commissioner of the South African Revenue Service has approved a 25% allowance for credit losses.

INITIAL TEST OF COMPETENCE, JUNE 2019

PROFESSIONAL PAPER 4

This question consists of two parts. Answer each part in a separate answer book.

PAPER 4 PART I REQUIRED		Marks	
		Sub-total	Total
(a)	Discuss, with regard to the R2 800 000 facilitation fee paid to P&P and the VAT treatment on sales to Distill Africa, any concerns that you might have regarding the management of Smart-Pack's ethical and corporate governance practices. <i>Communication skills – appropriate style</i>	14 1	 15
(b)	With reference to the background information and workpaper C01, draft a memorandum to Alicia in which you critically analyse the factors that influenced the effective management of Smart-Pack's working capital for FY2018. Include recommendations to address the factors identified. <i>Communication skills – layout and structure</i>	15 1	 16
(c)	With reference to workpaper T05, advise Alicia on the tax implications for Smart-Pack for the 2018 and 2019 years of assessment. Support your advice with calculations. <i>Communication skills – clarity of expression</i>	10 1	 11
Total for part I			42

INITIAL TEST OF COMPETENCE, JUNE 2019

PROFESSIONAL PAPER 4

This question consists of two parts. Answer each part in a separate answer book.

PAPER 4 PART II REQUIRED		Marks	
		Sub-total	Total
(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 (ii) Gross trade receivables balance. <i>Communication skills – appropriate style</i>	6 24 1	 31
(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 – • discuss any internal control deficiencies in memo A (excluding the preferential procurement arrangement); and • comment on the potential impact of each of these deficiencies on Smart-Pack. <i>Communication skills – layout and structure</i>	 12 1	 13
(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; and (ii) formulate the substantive audit procedures that should be performed to respond to the assessed risk of material misstatement. <i>Communication skills – logical argument</i>	 7 6 1	 14
Total for part II			58
TOTAL FOR THE QUESTION			100