

QUESTION

100 marks

Dlamini, Naidoo & Anderson Inc. ('DNA') is an audit firm based in Durban that focuses on providing assurance services to medium-sized private companies and small listed companies in KwaZulu-Natal. DNA also provides taxation advisory services to both audit and non-audit clients. The directors and shareholders of DNA are Ms Faith Dlamini, Mr Virat Naidoo and Mr George Anderson, all CAs(SA) and registered auditors (RAs). Virat and George focus on performing audits and Faith manages the firm's taxation advisory division.

It has been a very challenging past few years for DNA. The audit profession's reputation has been tarnished by the accounting scandals at a number of listed companies. DNA's audit clients are increasingly questioning the quality control systems in place at the firm, as well as its independence. In addition, clients are generally reluctant to agree to audit fee increases due to the prevailing economic conditions.

DNA generates revenue by rendering professional services to clients, billed at an hourly rate for the time spent by its staff on various engagements. The rates vary per employee category.

The responsibilities of the various employee categories in the audit division can be summarised as follows:

- The directors take final responsibility for client audit engagements and sign off the audit reports.
- Managers take responsibility for planning audit engagements and for reviewing of audit workpapers.
- Trainee accountants (trainees) are eligible to be appointed as seniors in the third year of their training contracts. Seniors are responsible for managing the day-to-day activities of the audit teams and for providing guidance to junior staff.

The responsibilities of the various employee categories in the tax division are similar to those of the audit division except that they do not issue audit opinions but rather provide advice and written opinions for clients on tax matters.

DNA's audit manual, developed to form part of the firm's quality control system, contains the following 'general audit procedures' that have to be performed by an audit team for all material classes of transactions and account balances in a client's annual financial statements:

- 1 Obtain client schedules supporting the classes of transactions and account balances.
- 2 Re-perform the casts and cross-casts on these schedules.
- 3 Agree the closing balance of these schedules to the amounts in the general ledger, trial balance and annual financial statements.
- 4 If applicable, agree the opening balance of these schedules to the prior-year working papers/audited financial statements.
- 5 Inspect the schedules and general ledger accounts for any unusual entries (e.g. negative, zero, large and round numbers, and back-dated journals) and follow up with management.
- 6 Perform overall analytical review procedures (e.g. by comparing current to prior year, budget, similar industries, etc.) and follow up on discrepancies by enquiry from management and inspecting supporting documentation.
- 7 Inspect the financial statements for adequate financial disclosures in relation to the International Financial Reporting Standards or the relevant accounting framework.
- 8 Obtain a signed management representation letter relating to all assertions regarding the classes of transactions and account balances being audited.

- 9 Consider the effectiveness of internal controls regarding classes of transactions or account balances and its impact on the nature, timing and extent of the substantive procedures.

1 Draft budget for FY2020

The financial manager of DNA has prepared the following draft budget for the year ending 31 December 2020 (FY2020) (the amounts have been cast correctly):

Abridged budget for the year ending 31 December 2020	Audit division	Tax division	Total for the firm
	R	R	R
Budgeted revenue – billings	43 186 250	15 740 000	58 926 250
Directors	5 592 000	4 800 000	10 392 000
Managers	6 116 250	5 960 000	12 076 250
Seniors	9 134 000	1 900 000	11 034 000
Other third-year trainees	3 019 500	–	3 019 500
Second-year trainees	9 787 500	1 190 000	10 977 500
First-year trainees	9 537 000	1 890 000	11 427 000
Professional employee costs	(21 490 000)	(7 350 000)	(28 840 000)
Directors	(5 000 000)	(2 750 000)	(7 750 000)
Managers	(3 600 000)	(3 000 000)	(6 600 000)
Seniors	(3 850 000)	(600 000)	(4 450 000)
Other third-year trainees	(1 440 000)	–	(1 440 000)
Second-year trainees	(4 000 000)	(400 000)	(4 400 000)
First-year trainees	(3 600 000)	(600 000)	(4 200 000)
Other operating costs	(22 284 091)	(4 215 909)	(26 500 000)
EBITDA	(587 841)	4 174 091	3 586 250

The budget has been drafted based on the following assumptions:

1.1 Employee numbers

Employee category	Audit division	Tax division
Directors	2	1
Managers	3	2
Seniors	7	1
Other third-year trainees	3	0
Second-year trainees	10	1
First-year trainees	12	2

1.2 Available hours per employee

The budgeted available number of hours per employee per annum amount to 1 864 hours (233 days x 8 hours). No overtime has been budgeted for FY2020 as clients are reluctant to pay the higher hourly charge-out rates associated with overtime.

Per employee for both divisions	Days in FY2020
Total working days	260
Public holidays	(12)
Leave days	(15)
Days available to work	233

1.3 Utilisation per employee category

The utilisation per employee category is calculated as forecast hours (hours worked on client-related matters) divided by total available hours per employee.

Employees cannot work on client-related matters for 100% of their available time as they also need to spend time on continuing professional development (CPD). They are also entitled to study, sick and family responsibility leave, if applicable, in any financial year.

Directors also spend time on managing their divisions and developing relationships with prospective and existing clients, resulting in lower utilisation.

Utilisation per employee category	Audit division	Tax division
	%	%
Directors	50,0	64,4
Managers	62,5	79,9
Seniors	70,0	81,5
Other third-year trainees	60,0	–
Second-year trainees	70,0	75,1
First-year trainees	71,1	72,4

1.4 Charge-out rates

Rate per hour per employee category	Audit division	Tax division
	R	R
Directors	3 000	4 000
Managers	1 750	2 000
Seniors	1 000	1 250
Other third-year trainees	900	1 000
Second-year trainees	750	850
First-year trainees	600	700

The tax division's hourly charge-out rates are higher than those of the audit division due to the perceived higher value added and the complexity of the advisory services that are rendered. The hourly charge-out rates of the audit and tax division employees are budgeted to increase by 3% on average in FY2020 compared to FY2019.

1.5 Professional employee costs

The average annual salary increases in the audit division in FY2020 are budgeted to be 5%, while it is 7% for the tax division.

DNA uses *PayBuddy* as its payroll system. *PayBuddy* records the following information per employee each month:

- Basic salary;
- Bonus, if applicable;
- Benefits, which include a cell phone allowance of R350 per employee, and a travel allowance;
- Amount of income tax deducted;
- Amount of Unemployment Insurance Fund contributions deducted;
- Medical aid scheme contributions;
- Provident fund contributions; and
- Net remuneration (amount paid into the employee's bank account).

Any changes to any of the input fields above on the monthly payslip (such as an increase in basic salary) have to be approved by one of the firm's directors.

An annual performance bonus is paid to employees who have exceeded their budgeted utilisation rates by more than 10%, and where no negative quality-related issues have been identified. The bonus is calculated as 15% of the employee's annual basic salary. This payment is calculated two months after DNA's financial year end and presented to the directors by the human resources department for approval. Once approved, each employee's bonus is paid out at the end of the first quarter after the financial year end. In any financial year a material amount is paid in respect of performance bonuses.

1.6 Other operating costs

Other operating costs include property rental costs, costs of finance and support staff, information technology costs, marketing and advertising costs, entertainment expenses, training and CPD costs. These costs are allocated to the audit and tax divisions based on the number of employees in each division.

2 Initial commentary on the FY2020 budget by the audit directors

Virat and George met to discuss the draft FY2020 budget and were very concerned that the FY2020 budget forecast an operating loss for the audit division. If the budget proves to be accurate, this would be the first time in DNA's history that the audit division incurred a loss.

They proposed the following actions to restore the division to profitability in FY2020:

- One manager and one audit senior should be retrenched;
- The intake of first-year trainees for FY2020 must be reduced from 12 to 10 trainees;
- Underperforming audit staff must be encouraged to leave the employ of DNA;
- The budgeted other operating costs of R26,5 million should be reduced by 10%;
- Marketing and entertainment expenditure should be reduced; and
- There should not be any expenditure on training and CPD.

The audit directors further objected to the allocation of other operating costs based on the number of employees in the audit and tax divisions. Their view is that the tax division derives the majority of its revenue from the provision of tax advisory services to DNA's audit clients. Therefore, the allocation of other operating costs should be based on the relative revenue of the audit and tax divisions.

3 Potential new audit client: Pharmasave (Pty) Ltd ('Pharmasave')

For the past three months George has been in discussions with the directors and shareholders of Pharmasave regarding the potential appointment of DNA as the independent auditor of the company, to replace the existing auditor. Pharmasave is a retailer of health and pharmaceutical products that trades in 75 stores nationwide. The company is renowned in the industry for tough negotiations with suppliers and disregarding healthcare regulations. Pharmasave has changed auditors three times in the past five years.

George's sister-in-law, Ms Pam Nel, is the marketing director of Pharmasave. George does not believe that this will pose a threat to DNA's independence as Virat could be appointed as the audit director who signs off the audit report of Pharmasave. George further undertook to have no contact with the other directors of Pharmasave if DNA were appointed as auditor.

The current auditor's proposed total audit fee of R10 million for the forthcoming financial year is based on an expected 9 300 hours for the audit of Parmasave. George has indicated to the directors and shareholders of Pharmasave that DNA could perform the audit for 10% less than the current auditor's proposed total audit fee.

4 Potential litigation: Zinkwazi Sugar Corporation (Pty) Ltd ('Zinkwazi')

DNA was the independent auditor of Zinkwazi from 2000 to 2019. Zinkwazi was a privately-owned sugarcane-growing business based in northern KwaZulu-Natal. The company was liquidated in September 2019 following the withdrawal of its banking facilities by a major South African bank.

Zinkwazi had struggled financially in its last few years due to droughts and a lower demand for sugar. The company resorted to creative accounting practices to artificially inflate profits in 2017 and 2018. The Chief Financial Officer (CFO) of Zinkwazi revalued the company's sugarcane at each of the 2017 and 2018 financial year ends to levels above the fair value. The resultant fair value changes contributed a significant percentage to reported profits. The DNA team agreed the resultant fair value to management's valuation and concluded that no further procedures were required as it had received a specific management representation with regard to this matter.

The liquidators of Zinkwazi have informed DNA that they intend suing the firm for damages because DNA failed to perform its duties as auditor with the degree of skill expected of RAs. The liquidators claim the creative accounting practices employed by Zinkwazi were fraudulent and DNA should have detected these during its audit of the company.

George was the RA responsible for signing off on the Zinkwazi annual financial statements. George is not concerned about the potential litigation as, in his opinion, it would be very difficult to prove any negligence on the part of DNA in a court of law.

INITIAL TEST OF COMPETENCE, JANUARY 2020

PROFESSIONAL PAPER 2

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

PART I – REQUIRED		Marks	
		Sub-total	Total
(a)	Draft a memo to the financial manager of DNA in which you – <ul style="list-style-type: none"> critically discuss, with supporting calculations where relevant, the draft budget and related information; and include any questions you may have for the financial manager. <i>Calculation marks limited to 8 marks</i> <i>Communication skills – layout and structure; logical argument</i>	30	
		2	32
(b)	Comment on the method of allocating other operating costs to the audit and tax divisions, and recommend alternatives where appropriate.	10	10
(c)	Critically evaluate the actions proposed by Virat and George to restore the audit division to profitability.	10	10
(d)	Describe the business risks faced by DNA, based on the information in the scenario.	10	
	<i>Communication skills – appropriate style</i>	1	11
Total for part I			63

INITIAL TEST OF COMPETENCE, JANUARY 2020

PROFESSIONAL PAPER 2

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

PART II – REQUIRED		Marks	
		Sub-total	Total
(e)	Discuss any ethical concerns you might have with regard to Pharmasave, the potential new client, with reference to the SAICA Code of Professional Conduct. <i>Communication skills – logical argument</i>	13 1	 14
(f)	Describe the substantive audit procedures to audit DNA’s payroll expenses, on the assumption that you are DNA’s external auditor. <ul style="list-style-type: none"> • Exclude all the ‘general audit procedures’ that are listed in DNA’s audit manual; • Exclude procedures on presentation and disclosure; and • Assume you have audit software available for the execution of CAAT procedures. <i>Communication skills – clarity of expression</i>	16 1	 17
(g)	Discuss, with reference to the audit of Zinkwazi, whether the audit work performed on the fair value gains is likely to result in any adverse consequences for DNA and its directors.	6	6
Total for part II			37
Total for the question			100