



ZIMBABWE EZEKIEL GUTI UNIVERSITY

FACULTY OF BUSINESS, ECONOMICS AND ACCOUNTING

DEPARTMENT OF ACCOUNTING AND FINANCE

EXAMINATION PAPER

COURSE CODE : CAC404
COURSE TITLE : ADVANCED AUDITING THEORY AND
PRACTICE OF AUDITING I
DURATION : 3 Hours
DATE : 28 May 2019

INSTRUCTIONS TO CANDIDATES:

1. No cell phones are allowed in the examination venue.
2. Use of silent, non-programmable calculators is allowed.
3. Answer **ALL** questions.
4. Begin each question on a new page.
5. The number of marks for each question or part question is shown in brackets []

Question One

You are the head of the internal audit department of Charlie Rue Ltd, a company whose main business is the operation of a smelting plant that produces steel from iron ore, which is then sold to other businesses. The financial year-end of the company is 31 March.

Background to the business

The company was founded a few years ago by the managing director, Mr. Tinso, who is also the majority shareholder, to exploit business opportunities arising from the popularity of steel furniture. Since inception the company has experienced exceptional growth and it intends listing on the JSE Ltd within the next year. The company intends to develop the appropriate systems of corporate governance prior to listing. Until recently the company has had a very low gearing.

The compound annual growth in company earnings over the last three years has exceed 20% per annum and forecast earnings growth for the year ending 31 March 2018 is in excess of 30%. This is as a result of the company securing some profitable contracts to supply a local manufacturer with quality steel furniture.

In addition to earnings-based management bonuses, share options are awarded annually to all senior management, based on the extent to which profit targets have been exceeded.

During the current year Charlie Rue Ltd acquired 100% of the shares in a company situated in Argentina.

This company manufactures steel products that are sold in its local markets. The purchase was financed by means of a \$3 million loan from a bank in the United States of America. The loan is repayable in five equal instalments, commencing on 1 January 2018. The financial year-end of this company is 30 June.

Charlie Rue Ltd is also currently involved in litigation concerning the payment of royalties to a foreign company for the use of a brand name. The claim against Charlie Rue Ltd is that it has underpaid royalties and inappropriately used the brand name of a lower quality product than was envisaged.

A fully computerised accounting system was installed two months ago. Certain problems are being experienced with the new system, with the result that data have been lost and significant delays

have occurred in data processing. A major advantage of the new system is that it is web-enabled, which allows the company to advertise its products globally and to conduct business through the internet.

All manufacturing processes make use of a standard costing system. Management accounts, which are used by management for planning and control purpose, are produced on a monthly basis.

System description for scrap metal

Scrap metal is produced as a by-product of the operations. Mr. Simbi Ngoo was appointed to control and manage the sale of scrap metal. The metal is sold on a weekly basis to a local merchant with whom Mr. Ngoo had previously entered into a verbal agreement. The merchant collects all the scrap metal on a weekly basis.

No formal records of scrap metal are maintained as Mr. Ngoo is of the opinion that it is too time consuming. Mr. Ngoo issues a clearing note to the merchant which allows him to leave the premises without being hassled by the security personnel at the gate. Mr. Ngoo invoices the merchant once a month and payment is made to the debtor's department of Charlie Rue Ltd.

Capital expenditure

Capital expenditure is handled by the administrations department. The requirement is that three quotes are obtained for all expenditure in excess of R500 000; these are submitted to a tender committee, which then awards the contract. Tenders in excess of R4 million must be approved by the board of directors. A quorum for any director's meeting is that three of the five directors must be present.

One of the contracts you have reviewed indicated that no alternative quotes have been obtained. In addition, no documents could be produced to support the awarding of the contract. The R4,5 million contracts awarded to Big Builders (Pvt) Ltd concerned the construction of a site office at the Durban plant.

You directed an enquiry to the financial director, who is a CA (Z), and he referred you to the minutes of the director's meeting during which the contract was approved. The minutes reflect that the financial director and two of the other directors were present. However, an accounting clerk

has told you that Big Builders (Pvt) Ltd is controlled by die financial director's wife because she is the majority shareholder in the company

Required:

Discuss, with reasons, the main risks currently facing Charlie Rue Ltd and the possible impact of these risks on the operations of the company and make recommendations to management on possible actions to address these risks.

[Total: 30 marks]

Question Two

You have been appointed as group financial director of Samaringa Ltd, a company which started as a family business and was soon transformed from a small sausage and cheese shop into an international food and dairy concern.

A large percentage of sales are done through fellow subsidiaries and other family owned businesses, as well as off-shore companies. Samaringa Ltd was listed in 2001 and in the same year appointed a medium sized audit firm in Johannesburg to perform both the internal and external audit work. Previously Samaringa Ltd used one of the "big four" audit firms.

Because the company deals with national as well as international clients, original documents are destroyed once they are scanned, using an optical scanning system. Many other documents exist only in electronically transmitted format. Debtors are collected by Samaringa's various subsidiaries and branches throughout the world. Surplus cash is then electronically transferred to the head office in Johannesburg. Samaringa's business is currently booming. The Namibian subsidiary, Ruet (Pvt) Ltd has sold 1 800 million litres of milk in the previous year. Huge stock levels have been built up during the past two years to support the ever-growing increase in sales. Debtors in off-shores companies have nearly doubled during this period. To finance this tremendous sales growth the company regularly issues bonds, and periodically entertains large company. Samaringa Ltd also regularly takes over smaller companies in the food and dairy industry to strengthen its market share. Most of the executive directors of Samaringa Ltd are members of the Mapara family that started the company. The company issues two different types

of shares: “A” shares that have 100 votes per share and “B” shares that have one vote per share. *Most of the “A” share were and still are issued by the Mapara family by way of share incentives, when certain sales targets are met. The “B” shares are issued to all other investors.*

Required:

List the possible risks that you as the new group financial director identify in the above scenario and explain why these are risks.

[Total: 20 marks]

Question Three

Nash Pvt Ltd assembles fridges, microwaves, washing machines and other similar domestic appliances from parts procured from a large number of suppliers. As part of the interim audit work two weeks prior to the company year-end, you are testing the procurement and purchases systems and attending the inventory count.

Procurement and purchases system

Parts inventory is monitored by the stores manager. When the quantity of a particular part falls below re-order level, an e-mail is sent to the procurement department detailing the part required and the quantity to order. A copy of the e-mail is filed on the store manager’s computer.

Staff in the procurement department check the e-mail, allocate the order to an authorised supplier and send the order to that supplier using Electronic Data Interchange (EDI). A copy of the EDI order is filed in the order database by the computer system. The order is identified by a unique order number.

When goods are received at Nash, the stores clerk confirms that the inventory agrees to the delivery note and checks the order database to ensure that the inventory were in fact ordered by Nash. (Delivery is refused where goods do not have a delivery note.)

The order in the order database is updated to confirm receipt of goods, and the perpetual inventory system updated to show the receipt of inventory. The physical goods are added to the parts store

and the paper delivery note is stamped with the order number and is filed in the goods inwards department.

The supplier sends a purchase invoice to Nash using EDI; invoices are automatically routed to the accounts department. On receipt of the invoice, the accounts clerk checks the order database, matches the invoice details with the database and updates the database to confirm receipt of invoice. The invoice is added to the purchases database, where the purchase day book (PDB) and suppliers individual account in the payables ledger are automatically updated.

Required:

- (a) List six audit procedures that an auditor would normally carry out on the purchases system at Nash Pvt Ltd, explaining the reason for each procedure. **(12 marks)**
- (b) List four audit procedures that an auditor will normally perform prior to attending the client's premises on the day of the inventory count. **(2 marks)**
- (c) On the day of the inventory count, you attended depot nine at Nash Pvt Ltd. You observed the following activities:
- Pre-numbered count sheets were being issued to client's staff carrying out the count. The count sheets showed the inventory ledger balances for checking against physical inventory.
 - All count staff were drawn from the inventory warehouse and were counting in teams of two.
 - Three counting teams were allocated to each area of the stores to count, although the teams were allowed to decide which pair of staff counted which inventory within each area. Staff was warned that they had to remember which inventory had been counted.
 - Information was recorded on the count sheets in pencil so amendments could be made easily as required.
 - Any inventory not located on the pre-numbered inventory sheets was recorded on separate

inventory sheets – which were numbered by staff as they were used.

- At the end of the count, all count sheets were collected and the numeric sequence of the sheets checked; the sheets were not signed.

Required:

- List the weaknesses in the control system for counting inventory at depot nine. **(3 marks)**
- For each weakness, explain why it is a weakness and state how that weakness can be overcome. **(9 marks)**

(d)

- State the aim of a test of control and the aim of a substantive procedure. **(2 marks)**
- In respect of your attendance at Nash Pvt Ltd's inventory count, state one test of control and one substantive procedure that you should perform. **(4 marks)**

[Total: 30 marks]

Question Four

The Nyaks Railways (NR) faces a real threat of collapse in the face of a growing negative net capital and ballooning operating losses, shareholders heard on Wednesday.

A report presented before the board by the Public Accounts Committee, after examining NR accounts, shows the giant company is in dire straits — weighed down by poor business performance, an ageing fleet and dilapidated railway infrastructure as well as arrears running into millions of dollars to different creditors.

Presenting the findings, the Board Chairman said while the report covers the company's accounts for the year ended December 31, 2011, the challenges facing NR continue to persist. He cited that NR operations had been deteriorating for years due to lack of recapitalisation.

"Both the rail infrastructure and the wagons have outlived their planned lifespan resulting in huge maintenance costs and the requirement for high manning levels.

"With such high inbuilt costs, it means NR would therefore; charge more for its transportation services to a level where it can't compete with other modes of transportation such as road, hence the depressed business levels experienced over the years," said the Finance Director.

"Given the current depressed economic environment, the committee concluded that it will be very difficult to attract a foreign investor to partner with NR under the public/private partnership." He said the committee stressed the strategic importance of a rail system to the development of the country's economy and recommended urgent steps to rescue the troubled firm.

"The audit observed a negative net working capital position and the company continued to incur operating losses. The government, therefore, does not have many options but to recapitalise NR if it were to continue as a going concern," the Board Chairman added. NR requires up to \$700 million to restore normal operations and is banking on a \$450 million rescue package being negotiated by the company and the Development Bank of Southern Africa.

The Finance Director said in 2011 the current liabilities of NR exceeded current assets by almost \$17 million. He said net loss incurred worsened from about \$24 million in 2010 to \$46 million in 2011 resulting in the company accumulating losses of up to \$105.5 million.

The committee expressed concern at the continued existence of the company as a going concern given such a weak financial position. Substantial financial injection by the government to recapitalise the company would be the major solution to the company's perennial woes, the committee recommended.

The giant company is struggling to meet its salary bill, service loans, meet statutory obligations to the National Social Security Authority (NSSA), Zimbabwe Revenue Authority (Zimra), the Environmental Management Authority (EMA) and also the medical insurance for its workers.

The committee registered concern at the low production as a result of an ageing infrastructure which has outlived its planned lifespan of 25 years. Most of the company's equipment was purchased in the 1960s and the latest around 1989.

"Such old equipment experiences frequent breakdowns hence high maintenance costs. Because the technology is too old and to a greater extent entails manual processes, it also requires high labour manning levels hence an unsustainable wage bill. Against such background, it became obvious that NR was operating below the break-even point," said Board Chairman. To break even, the company needs to move five million tonnes in terms of volumes that require rail transportation.

However, tonnage had considerably gone down from as high as 9.6 million tonnes that was moved annually during the turn of the millennium, to as low as 2.6 million tonnes in 2009. Some slight improvements were recorded in 2013 when NR moved about 3.71 tonnes.

Out of about 70 diesel locomotives, only 25 were operational while 15 electrical locomotives were not in use following decommissioning of the Harare-Gweru section after electric cables were vandalised. Out of 73 shunting locomotives, 35 were still serviceable but were 45 years old, which is way beyond the lifespan of 25 years.

Board Chairman said the rail infrastructure needed total replacement as well as the signal system, which has seen the company resort to a manual system for operating trains. At the time (2011) NR had 6,520 workers, which resulted in a monthly salary bill of about \$6.1 million, accounting for 67 percent of the monthly revenue.

“At the time of hearing the evidence, management informed the committee that the company had accumulated \$55 million in salary arrears, covering a period of nine months,” said the Board Chairman. According to the report, Zimra alone was owed \$43,478 million in PAYE and VAT taxes, NSSA \$4,1 million, RailMed \$1,2 million and \$1,6 million for Standard Development Levy.

Required:

From the case above, analyse the going concern issues, citing some remedies where necessary to rescue the company.

[Total: 20 marks]

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