



Initial Test of Competence Professional Paper 2

JANUARY 2015

TOTAL MARKS – 100
READING TIME – 30 minutes
WRITING TIME – 150 minutes

INSTRUCTIONS TO CANDIDATES

- 1 Enter your examination number on the front of the answer book. Your name must not appear anywhere.
- 2 You are reminded that answers may **NOT** be written in pencil.
- 3 The marks shown against the requirement(s) for each question should be taken as an indication of the expected length and the required depth of the answer.
 - **Even if it is not explicitly required, you should show workings and cross-reference them to your answer.**
 - Marks are awarded for appropriate arrangement and layout, clarity of explanation, logical argument and clear and concise language.

Disclaimer clause: All names of persons, places and business entities mentioned in this examination paper are fictitious and any resemblance to real persons, living or dead, places and business entities are purely coincidental.

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NOTES

- 1 The questions in this paper are not intended to reflect the reality of the Zimbabwean economy. Hence reference to exchange rates, interest rates, return on capital, etc., are to be taken at face value and there is an assumption that financial instruments such as foreign exchange contracts will be freely available. Where necessary, an effective tax rate of 25,75% should be used.
- 2 Any proposed amendments to tax legislation from the National Budget announced in November 2014 ARE NOT EXAMINABLE in this ITC.

QUESTION 1

100 marks

You are an audit trainee at CTZ Auditors ('CTZ') and part of the external audit team of Sports Electronics (Pvt) Ltd ('SET'). CTZ has two partners and 15 professional staff members, and its offices are located in Mount Pleasant, Harare. CTZ was appointed as auditor of SET in September 2014. Management has requested that the audit for the financial year ended 30 September 2014 ('FY2014') be completed as soon as possible after the year end, as the company's bankers urgently require the financial statements in order to assess an application for finance received from SET.

SET is a rapidly growing company in the information technology (IT) sector and a manufacturer of wearable connected devices for sport, fitness and wellness. The company was formed three years ago by five friends who met at university. Being sport fanatics, they identified a gap in the market for affordable, reliable and fashionable devices for sportsmen and sportswomen that track motion and activity such as distance travelled, calories burned and active time of exercise. The company operates from leased premises in Msasa, which house the manufacturing operations, the warehouse and the administrative offices.

SET has since incorporation been funded by the shareholders from savings and personal borrowings, but as a result of the rapid growth of its operations, the shareholders urgently need capital to fund its operations and to stimulate future growth. SET has exhausted all its overdraft facilities, and the bank has indicated that additional facilities will only be considered if the company receives a clean audit report. The directors also intend growing the business as fast as possible and to list the company in two years' time in order to unlock value for its shareholders. The directors see themselves as 'go-getters' and very dynamic, and persons to whom failure of the business is not an option. They are determined to maximise the value of the business at all costs.

As all the shareholders are directors, they have in the past elected to apply section 150(7) of the *Companies Act*, Chapter 24:03, and accordingly SET's annual financial statements were neither audited nor independently reviewed. However, in view of their need for additional finance they now require audited financial statements, and have resolved to be audited from FY2014 onwards. This was why CTZ was appointed as the company's external auditors.

Except for the financial director, all the directors have an engineering background, and have limited financial and regulatory knowledge. They have in the past relied heavily on CTZ to provide them with accounting services, as CTZ assisted with setting up the small accounting function, and with the preparation of the financial statements in accordance with International Financial Reporting Standards for the last two years. The directors have stated that they also want CTZ to assist them with the listing of SET in two years' time.

The audit is currently in progress, and the following workpapers are available:

- A101 – Understanding the entity and its environment
- A301 – Risk management and strategy
- K100 – Inventory
- X101 – Audit findings: Sundry accounts receivable

Materiality for the audit has been set at \$85 000. CTZ's audit methodology requires as far as possible maximum use of the relevant firm's general audit software on all audits.

Client: SET	Year end: 30/09/2014	A101/1
Prepared: A Clerk	Date: 15/10/2014	
Reviewed:	Date:	
Subject: Understanding the entity and its environment		

1 Nature of the business

SET's activities comprise the manufacture and sale of wearable connected devices for sport, fitness and wellness. The company has a small research and development department that focuses on developing new products for the market, together with software updates for its existing products.

SET's only tracking device, called SEMS, was developed by the five entrepreneurs in the garage of one of their parents, and once the prototype was stable and tested, manufacturing was outsourced to a company in China. In order to gain more control over the production process, manufacturing operations were moved to the present Msasa premises in October 2013. The product proved to be very popular as it is durable, fashionable and very affordable in comparison to similar overseas products.

SEMS uses a three-axis accelerometer to sense the user's movement, which measures steps taken, distance cycled or swum, etc., and then combines it with user data to calculate calories burned and the distance of the activity, as well as its duration and intensity. It also measures sleep quality by tracking periods of restlessness, how long it takes for the wearer of the device to fall asleep and the duration of actual sleep. SEMS has wireless capabilities, which allow the user to upload the data tracked to a smartphone application ('app').

SET offers a free website service, called MyFitness, that is available with or without the SEMS tracker and that can be used for recording and viewing data. Users can log their food intake, activities, weight, blood pressure, heart rate and glucose levels and then monitor them over time. Users can also set daily and weekly goals for themselves. This data can also be synchronised between MyFitness and the app. MyFitness is hosted on SET's IT platform.

For a subscription fee of \$25 per annum, the user can access additional functionality on MyFitness and the app, such as altitude analysis, lap times and the ability to post data directly to their Facebook or Twitter profile. This is very popular amongst sportsmen and sportswomen, serving to stimulate friendly rivalry and competition amongst them.

2 Directors and corporate governance

The directors are all equal shareholders (20% each) in the company. The directors subscribe to the principles of sound corporate governance and corporate citizenship.

3 Overview of operations

The manufacture of the tracking devices is a relatively simple process and involves –

- sourcing the internal components from a supplier in China (computing boards, GPS tracking units, batteries, etc.);
- sourcing external components from a local supplier (plastic and rubber casings); and
- assembling the tracker units, installing the software and packaging the devices at the factory in Msasa.

Once the tracker devices are packaged they are stored in the warehouse.

Client: SET	Year end: 30/09/2014	A101/2
Prepared: A Clerk	Date: 15/10/2014	
Reviewed:	Date:	
Subject: Understanding the entity and its environment		

Sales are made mainly to Zimbabwean retailers or directly to Zimbabwean customers via the website and agents at major sporting events.

An identification number is assigned to each SEMS tracking device upon installation, and the device is then activated by sales staff on a sales website provided by SET.

4 Business processing and IT

The company makes use of standard enterprise resource planning (ERP) software. The software is used for accounting and to manage the production process.

CTZ's IT specialist reviewed the general control environment at SET and highlighted various issues with regard to the server that hosts the websites, including the following:

- The server can be accessed by most employees as it also houses other applications used by SET (such as the ERP software);
- There is a lack of backups, which was recently highlighted when unauthorised access by a disgruntled customer caused the server to crash. Valuable customer information and device activation information were consequently lost; and
- The database of the device activation details loaded by sales staff is not password protected.

The IT systems, database and website hosting are all located at the Msasa premises. The maintenance and operation of the database and software systems are outsourced to a local IT service provider.

5 Financial performance

The company incurred a pre-tax loss of \$1 050 000 in FY2014 that was mainly attributable to start-up costs and sales that had not yet reached optimum levels. The directors are, however, confident that the company will be profitable in FY2015.

6 Developments during FY2014

The following important developments that had a significant impact on the business occurred late in FY2014:

6.1 Contract for consignment sales

SET entered into an agreement with Warehouse for Sportsmen ('WFS'), a leading sport department store in Zimbabwe, for the retail distribution of the SEMS tracking devices. The agreement stipulates that WFS stores may sell the devices. Inventory would be supplied to the WFS stores on a consignment basis.

Client: SET	Year end: 30/09/2014	A101/3
Prepared: A Clerk	Date: 15/10/2014	
Reviewed:	Date:	
Subject: Understanding the entity and its environment		

6.2 Privacy and security concerns regarding the MyFitness website

In June 2014 the MyFitness website was criticised for its default user activity-sharing setting. All users have the option of keeping their physical activity information private, but some users were unaware that the information was public by default. SET responded to the criticism by changing the default setting to private and requesting that search engines remove indexed user profile pages from their databases.

Client: SET	Year end: 30/09/2014	A301
Prepared: A Server	Date: 15/10/2014	
Reviewed:	Date:	
Subject: Risk management and strategy		
<p>The directors and certain key employees held a strategic breakaway session in 2014 to identify areas of risk and opportunities and to formulate a strategy for future growth.</p> <p>During the strategy session the following aspects were identified as factors that could negatively impact the business:</p> <ul style="list-style-type: none"> • SET is starting to face external competition, with major smartphone manufacturers bundling their own fitness devices with phones. • SET's competitive edge has mainly been due to the low retail price of its devices, but it has had to increase its prices as a result of various strikes in the manufacturing industry, which have affected SET's suppliers. • The financial director has also expressed concerns about the movement in exchange rates where supply is denominated in currencies other than USD, as these have had a negative effect on her forecasts. This increases the risk of incorrectly priced devices. <p>The directors resolved to find mitigating strategies for the following risks, identified as the main risks facing SET:</p> <ul style="list-style-type: none"> • New entrants to the market; • Pricing pressure; and • Currency risk. 		

Client: SET	Year end: 30/09/2014	K100
Prepared: AB Clerk	Date: 11/11/2014	
Reviewed:	Date:	
Subject: Inventory		

At 30 September 2014 the following inventory balances were reflected in the financial statements:

	Note	\$'000
Raw material	1	150
Work in progress	2	–
Finished goods		
Warehouse		140
On consignment at WFS	3	180
		470

Inventories are measured at the lower of cost, determined using the weighted average cost formula, and net realisable value.

Notes

- 1 Raw material includes imported internal components of \$60 000. SET placed an order for internal components a few weeks before the year end. The financial director received confirmation from the Chinese supplier that the components were shipped free on board shortly before year end, and has accordingly accounted for it in the year-end inventory figures.
- 2 As the assembly of a unit only takes 40 minutes, no work in progress exists.
- 3 On the tenth of every month the sales manager of SET meets with the WFS distribution manager and determines the number of devices required for sale during the next month. The consignment inventory is then delivered to WFS's warehouse from where it is distributed to the various stores.

WFS uses a standard inventory management system that produces detailed inventory reports. The agreement with WFS also stipulates that it will provide SET with a certificate of consignment inventory on hand at its various locations on a monthly basis.

Client: SET	Year end: 30/09/2014	X101
Prepared: AC Clerk	Date: 5/12/2014	
Reviewed:	Date:	
Subject: Audit findings: Sundry accounts receivable		

Sundry accounts receivable

During the audit of accounts receivable the audit clerk noticed an amount of \$95 000 that had been included in sundry accounts receivable.

Upon further investigation the financial director revealed that she approved a personal loan to herself as she is struggling financially as a result of ploughing all her savings into the company. She stated that she has correctly recorded the details of the loan in the accounting records, but she did not alert the other directors because 'she doesn't question their engineering decisions, so they should not question her accounting decisions'.

INITIAL TEST OF COMPETENCE, JANUARY 2015
PROFESSIONAL PAPER 2

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

QUESTION 1, PART I – REQUIRED		Marks	
		Sub-total	Total
(a)	Discuss the factors that CTZ should have considered before accepting the engagement as the external auditor of SET.	14	
	<i>Communication skills – clarity of expression</i>	1	15
(b)	Identify and describe the risk of material misstatement that exists at the overall financial statement level for the audit of the FY2014 annual financial statements of SET.	14	
	<i>Communication skills – clarity of expression</i>	1	15
(c)	Describe the general controls that SET should implement to restrict access to the server and to ensure the integrity and validity of the client data on the database.	10	
	<i>Communication skills – clarity of expression</i>	1	11
(d)	Describe the risks of material misstatement relating to the valuation of SET's inventory.	8	8
(e)	List the substantive procedures you would perform to verify the existence and completeness of SET's inventory on hand at year end.	15	15
(f)	Identify and briefly describe the following with regard to the loan to the financial director: <ul style="list-style-type: none"> • Regulatory implications; • The impact on the audit report; and • The impact on the rest of the audit. Ignore taxation.	8	
	<i>Communication skills – clarity of expression</i>	1	9
Total for part I			73