QUESTION 1

Background

IQ Inc. (‘IQ’) was appointed as the new external auditor of Furnco (Pty) Ltd (‘Furnco’) on 1 April 2012. One of IQ’s managers in the Technical Department, Ms Bella Cohen, referred this work to the firm. The Technical Department is responsible for assisting audit teams with queries about financial reporting issues. Ms Cohen’s father started Furnco in 1980. The company’s year end is 31 December 2012. You are a trainee on the audit of Furnco.

Furnco’s head office and manufacturing plant are located in Cape Town, with showrooms throughout the country. Distribution of goods takes place from Cape Town and depots in Durban, Port Elizabeth and Johannesburg. Furnco employs more than 250 permanent staff to handle every aspect of its business, from manufacturing or importing the latest trendy furniture to after sales service. Approximately 40% of goods are imported from China. Furnco prides itself on its free and fast delivery to customers using its own delivery fleet. With over 30 years’ experience in the South African furniture industry, Furnco is considered a specialist in its field. The company currently processes approximately 12 000 orders per annum.

Mr Cohen is the chief executive officer and acting chief financial officer. All Furnco’s shares are owned by Mr Cohen and his wife. Furnco’s success lies in selling large volumes of high quality furniture at reduced prices directly to the public. Until the current downturn had a negative impact on revenue, this ethos had led to tremendous growth year after year and has gained the company many loyal customers.

During the financial year ended 31 December 2011 Furnco embarked on a project to renovate its showrooms and improve its logistics. Prior to this project, Furnco had a single storage facility at which goods were received and dispatched. Furnco has now set up distribution centres throughout the country which act as depots for receiving products from overseas or the manufacturing plants and for dispatching goods to customers. Costs of R10 million relating to the implementation of this project were incurred in the 2011 financial year. The project has resulted in significantly reduced lead times and much faster delivery. The new showrooms have more space for in-store promotions. Management expects a 20% increase in sales as a result of the showroom renovations and a 10% decrease in costs due to the new distribution process.

The company had material inventory, accounts receivable, and property, plant and equipment balances at 31 December 2011. Customers purchasing on credit have 24 months to repay amounts owing and, as with other similar companies, credit losses are significant. Management uses a provision matrix that specifies fixed provision rates (based on past experience and industry trends) for the number of days a debt is overdue.

Furnco makes use of a perpetual inventory system. Inventory records are maintained on a spreadsheet. Management performs regular cycle counts to adjust the book value of inventory to the actual value and also performs a full inventory count once a year.

Imports are denominated in US dollar. The company uses forward exchange contracts to hedge the risks associated with foreign currency fluctuations. The company’s policy is to hedge 50% of anticipated cash flows.

The following accounting policy relating to cash flow hedges is disclosed: ‘The effective portion of changes in the fair value of derivatives that are designated and qualify as cash flow hedges is recognised in other comprehensive income. When the forecast transaction which is hedged results in the recognition of a non-financial asset (inventory), the gains and losses
previously deferred in equity are transferred from equity and included in the initial measurement of the cost of the asset. The deferred amounts are ultimately recognised in cost of goods sold in the case of inventory.’

During the current year, an impairment charge of R5 million was recognised in the statement of comprehensive income against the value of property, plant and equipment as a result of impairment reviews performed during June 2012.

The company expects an operating loss in the current year due to the impact of exchange rates on foreign currency transactions not hedged and the impairment of property, plant and equipment. Management is under significant pressure from investors to minimise the impact of foreign currency on the financial results of the entity.

**Predecessor auditor**

The predecessor auditor qualified her audit opinion in 2011 as follows:

‘We did not observe the counting of the physical inventories at the Johannesburg depot at the end of the year and we were unable to satisfy ourselves by alternative means of the inventory quantities held at 31 December 2011. As a result we were unable to determine whether any adjustments might have been necessary in respect of recorded or unrecorded inventories.’

Inventory held at the Johannesburg depot has always been deemed to be material.

IQ has already received a letter from the predecessor auditor in which she stated that she had resigned from this audit and there is no reason why IQ should not accept the appointment as auditor of Furnco.

During the planning phase of the 2012 audit, the IQ audit team experienced great difficulty in reconciling opening balances to the financial statements audited by the predecessor auditor. For example, the carrying amount of property, plant and equipment in the fixed asset register differs from the amount disclosed in the previous financial statements by R1 810 500. The financial manager explained that the predecessor auditor never gave Furnco the final adjusting journal entries arising from the 2011 audit to process to the fixed asset register. When the financial manager queried this with the predecessor auditor, she replied: ‘Sorry, the audit file of Furnco seems to be missing, so I unfortunately cannot assist you.’
Planning materiality

The following working paper was prepared by Tick Evans, one of the members of the audit team. This is the only working paper in the audit file that addresses materiality in planning and performing the audit.

**Client:** Furnco  
**Prepared by:** TE  
**Date:** 15/7/2012  
**Reviewed by:** ID  
**Date:** 25/7/2012  
**Year end:** 31 December 2012

**Subject:** Materiality in planning and performing the audit

**Source of data:** The latest forecast results for the 2012 financial year were used because IQ is performing the audit for the first time. These were approved by management and are for the full 12 months of the 2012 financial year.

<table>
<thead>
<tr>
<th></th>
<th>2012</th>
<th>2011</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Forecast</td>
<td>Audited</td>
</tr>
<tr>
<td>(Loss) / Profit after tax for the year</td>
<td>(8 589)</td>
<td>4 454</td>
</tr>
<tr>
<td>Revenue</td>
<td>58 322</td>
<td>51 983</td>
</tr>
<tr>
<td>Gross profit</td>
<td>16 950</td>
<td>12 950</td>
</tr>
<tr>
<td>Total assets</td>
<td>40 748</td>
<td>45 748</td>
</tr>
</tbody>
</table>

It was decided to use profit or loss for the year as a basis for calculating materiality as it is one of the most important figures to users of financial statements. The company’s main focus is profit and for this reason profit or loss was considered to be the appropriate basis for calculating materiality.

**Calculation of materiality:** 10% of loss for the year = R858 900, rounded to R860 000.

**Conclusion:** R860 000 seems to be an appropriate materiality figure. This is also in line with paragraph A4 of ISA 320, *Materiality in Planning and Performing an Audit*, which states that profit before tax from continuing operations is often used for profit-oriented entities.