You are a first-year trainee accountant at Dynamico Auditors, and part of the team currently engaged on the external audit of Hofstein Ltd (‘Hofstein’), a company listed on the Johannesburg Securities Exchange. Hofstein holds a 51% interest in Retailers Online Ltd (‘Reton’), an online catalogue retailer selling household appliances and furniture. Reton has a 30 September year end. Dynamico Auditors also holds the appointment as external auditor of Reton.

Dynamico makes extensive use of general audit software.

The following are extracts from the 2012 audit file of Reton:

<table>
<thead>
<tr>
<th>Work paper</th>
<th>Reference</th>
</tr>
</thead>
<tbody>
<tr>
<td>Overview of the group activities</td>
<td>B–100</td>
</tr>
<tr>
<td>Extracts from separate financial statements</td>
<td>C–100</td>
</tr>
<tr>
<td>System description: Revenue and receivables</td>
<td>K–100</td>
</tr>
<tr>
<td>Internal control weaknesses: Revenue and receivables</td>
<td>K–101</td>
</tr>
<tr>
<td>Inventory</td>
<td>Q–101</td>
</tr>
</tbody>
</table>
1 Introduction

Reton sells household appliances and furniture for cash (± 30%) and on credit (± 70%) via its online portal to ± 300 000 customers. The company performs internal credit-worthiness checks on all new customers. The company procures its stock from within the Hofstein group as well as from external suppliers. Approximately 60% of its suppliers are local and 40% foreign. The company hedges against currency movements, but does not apply hedge accounting.

2 Business overview

Trading conditions were challenging in 2012 as consumers faced high transport and utility costs, which resulted in less disposable income. However, continued merchandise innovation and focused market strategies have enabled the company to maintain its gross profit margins. Management expects trading conditions to remain unchanged.

3 Corporate governance

Mr John Mtembu, the chief executive officer, leads a robust Board of Directors with strong independent directors. It maintains a culture of effective corporate governance and ensures that the company complies with the Code of and Report on Governance Principles for South Africa (King III) in all material respects.

4 Outsourcing of website maintenance and catalogue design

Outsourcing of website maintenance and catalogue design to CTO (Pty) Ltd ('CTO') was approved during February 2011. CTO is a company formed by the previous chief information officer of Reton, Mr Martin Benade. Mr Benade is now the chief executive officer of CTO. On 1 July 2012 Reton obtained a 51% interest in CTO in return for intellectual property rights transferred to CTO. The key management of CTO, who are all former staff members of Reton’s Information Technology Department, hold the remaining interest via the CTO Management Trust. Mr Benade remains on Reton’s Board of Directors as a non-executive director. The Board of Reton approved a three-year loan of R8 million which was advanced to CTO on 30 September 2012 as start-up capital.

5 Strategy and risk

Areas that impact on sustainable growth are identified annually and are aligned to the stakeholder engagement process. The following are stakeholders with an interest in the business:

- Customers,
- Suppliers of merchandise and services,
- Shareholders and the broader investment community,
- Communities in which the group operates,
- Employees at head office and stores throughout the group, and
- Industry regulators who monitor compliance.
The following are material matters and key risks which have been identified by the Board of Directors:

<table>
<thead>
<tr>
<th>Strategic objective</th>
<th>Key risks</th>
<th>Management plans</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Credit management</strong></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
| Optimise the quality of the debtors’ book by improving collections, reducing debtor costs and exploring further sales opportunities | Inability to maintain optimal quality of debtors’ book owing to –  
- high levels of unemployment  
- deteriorating economic conditions |  
- Focus on increasing the number of satisfactorily paying customers  
- Implement customer segmentation and credit limit strategies |
| **Merchandising** | | |
| Maintain competitive advantage by sourcing exclusive, quality, value for money merchandise |  
- Suppliers and distribution partners perform below standard  
- Lack of depth in supplier base  
- Exchange rate fluctuations |  
- Establish reliable back-up supplier channel  
- Further improve supply chain management through system enhancements  
- Manage foreign currency risk |
| Maintain customer focus |  
- Poor execution of the customer-focused business model  
- Selling goods at low or no profitability  
- Insufficient experienced operational staff |  
- Grow the customer base through new customer acquisition and retention initiatives  
- Expand the store footprint  
- Focus on stable store management through training, recruitment and selection strategies |
| **Capital management** | | |
| Manage financial risks and the liquidity requirements of the business effectively | Ineffective capital management could impact on profitability and returns to shareholders |  
- Ensure access to capital at all times  
- Manage currency exposure  
- Manage the investment portfolio |
| **Human capital** | | |
| • Institute ongoing development of staff for management positions  
• Ensure retention of current management  
• Attract competent individuals as required | Inability to attract, develop and retain suitable staff for executive and operational management positions |  
- Run training and development programmes  
- Establish employee incentive schemes  
- Use focused recruitment and selection practices  
- Transform the company through broad-based black economic empowerment |
Client: Reton  
Year end: 30/09/2012  
Prepared by: PH  
Date: 17/11/2012  
Reviewed by: HJ  
Date: 19/11/2012  
Subject: Extracts from separate financial statements

### EXTRACTS FROM THE STATEMENT OF COMPREHENSIVE INCOME

<table>
<thead>
<tr>
<th>Notes</th>
<th>2012 Unaudited</th>
<th>2011 Audited</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>R'000</td>
<td>R'000</td>
</tr>
<tr>
<td>Revenue</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Merchandise sales</td>
<td>456 800</td>
<td>409 600</td>
</tr>
<tr>
<td>Finance income</td>
<td>229 200</td>
<td>204 000</td>
</tr>
<tr>
<td>Insurance premiums</td>
<td>91 300</td>
<td>90 300</td>
</tr>
<tr>
<td>Other</td>
<td>75 100</td>
<td>61 200</td>
</tr>
<tr>
<td>Cost of sales</td>
<td>61 200</td>
<td>54 100</td>
</tr>
<tr>
<td>Net profit after tax</td>
<td>145 000</td>
<td>133 000</td>
</tr>
</tbody>
</table>

### EXTRACTS FROM THE STATEMENT OF FINANCIAL POSITION

<table>
<thead>
<tr>
<th>Notes</th>
<th>2012 Unaudited</th>
<th>2011 Audited</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>R'000</td>
<td>R'000</td>
</tr>
<tr>
<td>Non-current assets</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Property, plant and equipment</td>
<td>27 800</td>
<td>25 100</td>
</tr>
<tr>
<td>Intangible assets</td>
<td>9 100</td>
<td>7 000</td>
</tr>
<tr>
<td>Loan to CTO</td>
<td>1</td>
<td>8 000</td>
</tr>
<tr>
<td>Current assets</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Inventory</td>
<td>2</td>
<td>97 700</td>
</tr>
<tr>
<td>Trade and other receivables</td>
<td>353 500</td>
<td>342 700</td>
</tr>
</tbody>
</table>
### Notes to the financial statements

#### 1  Loan to CTO

The company made a loan to CTO on 30 September 2012. The loan is unsecured, bears no interest and is repayable on 30 September 2015. The company has not designated the loan to be measured at fair value through profit and loss.

**Further explanatory audit work paper note**

1.1 A unrelated commercial bank recently offered CTO a three-year loan with a single capital repayment at the end of the period. The loan would bear interest at a fixed rate of 11.5% per annum.

1.2 The prime overdraft rate is 12.5% per annum.

#### 2  Inventory

Inventory, comprising merchandise held for resale, is valued at the lower of cost and net realisable value. Cost is determined using the weighted average basis, net of trade and settlement discounts. Net realisable value is the estimated selling price in the ordinary course of business, less estimated costs necessary to make the sale. Provision is made for slow-moving, redundant and obsolete inventory, as well as sales returns.

**Further explanatory audit work paper note**

2.1 The company operates a periodic inventory system.
1 General system overview

Sales are either for cash or on credit and orders are placed via telephone, fax or online.

2 Ordering

New online customers need to open an account by registering on the system. Once registered, customers log on to the system using a unique account number and password. The credit vetting division assigns a credit limit to each new customer.

Once an order has been captured on the system, customers are notified by means of a cell phone text message (sms). Orders can be cancelled telephonically or online. Cash orders can be paid by electronic funds transfer or credit card. All credit card purchases are protected by the 3D Secure Process, a credit card verification process.

3 Deliveries

Distribution to customers is done from four outlets by means of the company’s delivery vehicles or through delivery agents. Each customer receives a sms upon despatch of goods. Delivery notes are automatically generated from orders once the goods have been packed and are ready for delivery. Customers sign for deliveries to acknowledge receipt of goods. Invoices are generated once the goods have been delivered and signed delivery notes returned to the administration department.

4 Returned items

Customers may return goods within 21 days free of charge via post or delivery to any of the four distribution outlets. The goods need to be accompanied by an original invoice. Returned items are inspected prior to a refund being given.
The following system weaknesses were identified during the performance of tests of controls:

**Weakness 1**

A review of the access rights assigned to staff in the credit vetting division showed that the debtors’ clerks have limited viewing rights, but are able to capture credit limits and make adjustments to the limits. The access rights of the two credit managers allow them to create new customer accounts, override system functions and process journal entries. They also have full viewing rights.

**Weakness 2**

Not all delivery notes were signed by customers upon receipt of goods. Also, some invoices had no corresponding delivery notes whatsoever. Upon further investigation, it was found that in some instances no invoices were generated for actual shipments to customers.
The company's merchandising strategy is based on the philosophy that customers are attracted to its website by its products rather than by the credit which is offered. The focus is therefore on providing customers with differentiated household ranges. This is achieved by the following means:

- Innovative product sourcing globally, so that customers are offered distinctive and affordable furniture and appliances;
- Value-added features on products to ensure differentiation and increase the perceived value; and
- Six-monthly launches of new furniture and appliance ranges, ensuring that customers are constantly offered fresh and original products.

Products are sourced locally and internationally, to ensure that Reton offers exclusive products. Imports ensure that furniture ranges use the latest designs and are produced with the most modern manufacturing techniques. International factories also provide a broader range of developmental designs and offer a wider variety of raw materials, which allow for more product differentiation than local factories. Furthermore, imports offer price and design advantages and mitigate the risk of local supply disruption.

According to the stock controller, significant unexplained inventory losses were identified at inventory counts during the year, but the operations director has been too busy to investigate them.