Part (d) Discuss whether the incorrect calculation and reporting of the loan covenants and lack of approval and disclosure of directors remuneration constitute RI’s

Note to markers: Award the mark only once for the requirements of section 1 (RI) and the rest of the marks for application of the scenario thereto

1. E&I in their capacity as auditors of Magic, have reason to believe that – ½
2. An unlawful act or omission has been committed ½

2.1 The board are guilty of breaching several sections of the Companies Act because:
- Loan covenants: Acted recklessly (sec 22) with intention to defraud Capitol Bank
- Directors remuneration: Fraudulent financial reporting or intention to defraud (sec 29) as non-compliance with IFRS and Companies Act
- Both items: Directors not acting in good faith, care, skill & diligence/ in best interest of the company (sec 76)
- Both items: Fraudulent reporting/intention to defraud breach common law principles to act honestly, etc. (why)

3. By any person responsible for the management of the entity ½
3.1 The directors of Magic approved all the decisions including their own remuneration, debt ratios disclosed to the bank, etc. (conducted at management level).

4. Has or is likely to cause financial loss to the entity, shareholders, creditors, etc. ½
4.1 The remuneration paid to individuals is likely to cause a financial loss to the entity/holding company as the profits of the company will decrease.

4.1.1 It is further likely that the entity will suffer losses if the debt covenants are not met.
4.1.2 The remuneration is likely not disclosed to SARS who will therefore not receive the total amount of tax due from Magic.
4.1.3 There may also be financial loss to the creditor, being Capitol Bank, if Magic is unable to make the required interest and capital repayments.

5. Is the act or omission fraudulent or does it amount to theft ½
5.1 The incorrect reporting of Capital Bank loan covenants could be considered fraudulent.
5.2 The payment by the directors to themselves without authorisation amounts to fraud.

6. Material breach of fiduciary duty owned by the directors ½
6.1 All above constitutes a breach of the fiduciary duties of the directors of Magic (why).

7. Conclusion: Based on the information provided, all the conditions appear to have been satisfied and E&I have a duty to report an irregularity in terms of section 45 to IRBA.

Communication skills – logical argument 1

Available for part (d) 17 marks: Max 13

TOTAL FOR PART (d)

Part e) Tests of controls to test the operating effectiveness of the key controls over Magic’s capital expenditure

1. Inspect the minutes of the capital expenditure committee to confirm that (process):
- such a committee exists;
- past capital expenditure decisions are reviewed on a regular basis to ensure returns on investments are in line with the expectations of Magic’s shareholders / or project cancelled because the return is not in line with expectations.

2. Inspect minutes of directors meetings for proof of approval of capital expenditure (process).

3. Enquire from directors/company secretary to confirm that no director may enter/ have entered into capital expenditure contracts without board approval (process).

4. Project management (process):
- ensure sound project management principles applied through enquiry from management/project managers or inspect project management policy if available;
- obtain a list of names of staff involved in capital expenditure projects and assess if they have the skills and experience required for the job (qualified and experienced);
- enquire from project managers how they determine staff requirements and skills for Projects.
5. Test the controls over capital expenditure spend by selecting a sample of capital expenditures during the year from the ledger accounts and (test working of controls):
   - trace the recommendation for the project through to the capital expenditure committee documents/minutes;
   - trace the approval of the project expenditure through to the directors minutes;
   - inspect the contracts with suppliers and ensure contracts are signed by both supplier & Magic authorized representative;
   - follow the contracts through to the budgets and cash flows (falls within budget).
   Note: No marks awarded if direction of testing is wrong (must be from expenditure to approval).

6. General (controls):
   - Inspect a sample of progress reports/contracts and confirm that it at least includes expected finalisation dates and a comparison between the actual cost and the approved budget;
   - Inspect budgets and cash flows to confirm it is reliable (overall budgetary control).

7. Other valid points …………………………………………………………………………………..Max 1

**PART F) SUBSTANTIVE PROCEDURES**

i) To test the completeness of the spreadsheet provided for directors’ remuneration (WP A110)

1. Spreadsheet:
   - recalculate the total of the spreadsheet to confirm that all amounts on the spreadsheet have been included in the total;
   - compare the totals per the spreadsheet to the accounting records to confirm that they have been accurately captured.

2. Make the audit team members allocated to the audit of expenses aware of the possible incorrect allocation of directors’ related costs as operating expenses e.g. fuel, vehicle repairs and maintenance and travel cost.

3. Confirm, in writing, the amounts of directors’ emoluments with each of the directors.

4. Inspect minutes of board meetings to identify amounts approved to be paid to executives not reflected on the schedule.

5. Extract a list of electronic payments from the bank statements made with the name (account number) of the directors as payee and for these items;
   - if these represent directors remuneration cost - ensure recorded on the spreadsheet.

6. Extract a list of travel expenses paid during the time that the directors took annual leave and ensure that all the expenses during this time are allocated to the spreadsheet.

7. Compare the basic salary as per the employment contracts to the basic salary on the spreadsheet to confirm not understated and included.

8. Select a sample of expense items from the relevant expense accounts (travel costs, entertainment, etc.), and inspect the supporting documents (e.g. invoices) to verify that it is valid company operating expenses and not related to directors remuneration.
   8.1 If directors personal expenditures are found in these accounts, request the client’s accounting function to analyse and correct all such expense accounts between personal and company expenditures, and audit the adjusting journal entries.

9. Perform analytical procedures on expenses (compare to budgets, prior years and month by month), such as fuel, vehicle repairs and travel costs, and follow up on any unexpected fluctuations and possible overstatement, as expenses may include amounts that should be classified as director’s remuneration (understated).

10. Inspect directors registers/statutory returns/CIPC confirmations to ensure all directors during the year included on the schedule (even if they resigned before year end)

11. Inquire from the payroll clerk whether there are any other costs awarded to the directors which have not been included on the spread sheet.

12. Recalculate the share of profit and agree to amounts included in spreadsheet (10%).

13. Inspect payments to the defined contribution plan and request management to include in the schedule.

14. Other valid points …………………………………………………………………………………..Max 1

**Available for part (f) (i) 20 marks: Max 11**

**TOTAL FOR PART (f)(i)**

2
### (ii) To test the completeness of long term debt (Wp D100)

1. Compare the list of long-term debt for the current year with the list of the previous year and follow up on any omissions in current year:
   - for instalment agreements of prior year not on the current year’s list, follow up that it is been paid in full during the year.  

2. Inspect minutes of meetings for authorisation of any new long-term debt during the current year and ensure that it has been accounted for on the list (not omitted).  

3. Obtain a management representation letter on the completeness of long-term debt.  

4. When reviewing minutes of directors’ and capital expenditure committee meetings, be attentive for any unrecorded long-term debt (or ‘off-balance sheet finance structures’).  

5. Obtain a schedule of all leased assets at year-end and confirm that there is no operating leases that should be classified as long term finance leases per IAS 17.  

6. Inspect bank statements and cash books for:
   - instalments paid to financial institutions and trace this to the lease agreement and ensure accounted for on list of long term debt;
   - large deposits received from financial institutions and confirm that if these relate to financing obtained, they are reflected as long term debt.  

7. Third party correspondence & confirmations: with clients permission obtain & agree:
   7.1 Confirmation from Capitol bank on the amount of the long term debt outstanding;
   7.2 Confirmation from Bankers (bank confirmation letter) on outstanding long term debt or contingencies;
   7.3 Confirmation from Attorneys regarding securities registered/mortgages for long term debt of the company.
   7.4 Confirmation from Instalment finance house regarding the existence of unrecorded long term debt  

8. Inquire from management and directors of any source of funding for major capital expenditure during the current year, such as the new 4D theatre, which has not been accounted for.  

9. Inspect the trial balance/general ledger accounts of Magic for any interest payments made during the year and match it to long-term debt to ensure completeness of long-term debt.  

10. Agree general ledger amounts for loan / lease obligation to trial balance and financials  

11. Other valid points…………………………………………………………………………………………………………………………Max 1  

| Available for part (f) (ii) 16 marks : Max | 10 |
|TOTAL FOR PART (f)(ii) |

### (iii) To test compliance with the covenant requirements of the long-term loan (WP D105)

1. Obtain the loan agreement and verify the covenant requirements per the loan agreement, and that all have been communicated to us by management.  

2. Contact Capitol Bank with clients permission to clear uncertainties on the interpretation of the covenant requirements (e.g. EBITDA/R).  

3. If uncertain on any of the legal requirements, obtain legal advice:
   - consider reliance on legal advisors work: ISA 501/620 (independence, competence, objectivity, etc.).  

4. COVENANT: FINANCIAL STATEMENTS WITHIN 6 MONTHS  
   Enquire whether the financial information has been supplied to the bank in compliance with the covenants / or point out 6 months have been exceeded:
   - If compliant, obtain a copy of the financial information sent to Capitol and confirm that:
     - it was send within 6 months of year end, and
     - that it corresponds to the financial statements presented for audit purposes  

5. COVENANT: BOARD & MANAGEMENT REMUNERATION; capped R2million  
   Obtain a schedule of all assets distributed/withdrawals during the financial year to directors and management (total remuneration) and deduct from these bona fide operational costs required to perform the day to day task as director, and ensure it does not exceed R2mil.  

6. COVENANT: EBITA interest cover  
   Recalculate the EBITDA ratio and the days working capital ratio once financial statements have been audited.
| 7. | **COVENANT: DAYS WORKING CAPITAL** | Recalculate the days working capital taking into account all cost as required for inventory as per IAS 2 (and IFRS) - and advise management of the error in their calculation | 1 |
| 8. | **Inspect the reports that management of Magic have submitted to Capitol Bank regarding compliance with the debt covenants and consider whether it agrees with our workings** | | 1 |
| 9. | **Inspect communications from Capitol Bank** to Magic re its views / thoughts on the company’s compliance with the covenant requirements / other arrangements made. | | 1 |
| 10. | Consider whether **Capitol Bank has revoked the loan after year end.** | | 1 |
| 11. | **Other valid points** | | Max 1 |

Available for part (f) (iii) 16 marks : Max 10

| (iv) | To test the **presentation and disclosure** of the long term debt in the annual financial statements |
| 1. | **Inspect the annual financial statements** for Magic and consider if the **PRESENTATION and disclosure of the long term debt** is complete and accurate in terms of :
- the applicable accounting framework, in this case **IFRS** as required by the Companies Act; | 1 |
- the **accepted accounting policies of Magic**. | 1 |
| 2. | Check disclosure against the **requirements of IFRS7**. Ensure the following is disclosed:
- **Interest expense**; | ½ |
- Exposure to **interest rate risk** ; | ½ |
- Exposure to **liquidity risk**; | ½ |
- How the **liabilities were classified** (amortised cost). | |
| 3. | Inspect the financials and determine that the following **DISCLOSURE ARE CORRECT**:
- **details of securities** that have been provided for the **instalment sales agreements** and the Sandton plot; | 1 |
- **covenants**, terms and encumbrances; | 1 |
- **amounts, facts and dates** are accurate and complete through inspection of the **loan** and instalment agreements; | 1 |
- classification of amounts (short and long term) is done correctly by recalculation; | 1 |
- specifically consider whether **disclosure as long term** is still appropriate given that the debt covenants appear to have been **breached** at year end, rendering the loan repayable within 15 days. | 1 |
- Ensure correct disclosure in terms of **IAS 17** | 1 |
| 4. | Inspect the financial statement disclosures and ensure **wording is clear and understandable.** | 1 |
| 5. | Deal specifically in the **management representation letter** with the correctness of disclosure in the financial statements | 1 |
| 6. | Agree all amounts (Included in the Statement of financial position and the **notes/disclosures**) to the Lead Schedule (which agrees to the trial balance). | 1 |
| 7. | **Other valid points** | | Max 1 |

Available for part (f) (iv) 14 marks : Max 6

TOTAL FOR PART (f)(iv) 6

| Communication skills – clarity of expression for part f(i) to f(iv) | 1 |

TOTAL FOR PART (F) (MAX38)

TOTAL FOR PART II: MAX60