

LEARNING UNIT 2 –THE AUDITING PROFESSION ACT (APA) OF THE INDEPENDENT REGULATORY BOARD FOR AUDITORS (IRBA)

DURATION: 56 MINUTES



2.1 INTRODUCTION

The APA was enacted by parliament to regulate the auditing profession in South Africa. Since you are studying the subject of auditing, it is very important for you to have a good understanding of this very important piece of legislation.



2.2 LEARNING OUTCOME AND ASSESSMENT CRITERIA

The content of this learning unit is based on the following learning outcome and assessment criteria:

Learning outcome	Assessment criteria
Exercise ethical judgments, corporate governance principles, and statutory requirements in practical situations.	<ul style="list-style-type: none">Integrate ethical principles, corporate governance principles and statutory requirements in practical situations.



2.3 LEARNING ASSUMED TO BE IN PLACE

The auditing profession act (APA) of the independent regulatory board for auditors (IRBA) was covered as part of your undergraduate studies. You must revise the content below if you are not familiar with the content.

SAICA Student Handbook 2023/2024, volume 2B:

- Auditing Profession Act (2005) (35 pages)



COMMENT

We recommend that you study the APA directly from the SAICA Student Handbook, as you may have this book with you when writing the test and/or examination according to the open book policy.

2.4 BACKGROUND

The APA, as issued by the IRBA, is applicable to Registered Auditors (RAs). You need to familiarise yourself with the examinable content thereof.

In this Learning Unit, we will only be highlighting areas with which students normally experience difficulties. **This does not imply that the areas of the APA not discussed in this Learning Unit are less important.**

Section 1 – definitions of terms used in the APA, such as "reportable irregularity" (RI)
Ensure that you use the correct terminology and refer to the correct definition when discussing issues pertaining to the APA.

Sections 37 and 38 – registration procedures for individual and firms as registered auditors.

Section 41 – conduct by and liability of registered auditors relating to public practice.

Section 44 – duties in relation to an audit

Section 45 – duty to report on irregularities
Refer to the IRBA guide – IRREG – for guidance on what constitutes an RI. (Appendix 7 of the IRREG includes examples which illustrates the application of the guide in determining the existence of a reportable irregularity).

Section 46 – limitation of the auditor's liability
This section includes the requirements an auditor must meet to be held liable by third parties who relied on an inappropriate opinion given. Section 46(8) states that the auditor cannot through agreement or in any other way limit or reduce the liability they incurred during a statutory audit.

Section 52 – reportable irregularities and false statements in connection with audits



2.5 EXAMINATION TECHNIQUE

RI's will always be hidden in a scenario, and you should always be on the lookout for them. It is very important to test whether it is a RI by comparing the given information to the definition and requirements of a RI in section 1 of the APA. Marks will be allocated for applying the theory to the scenario and not for merely stating the theory.

Do not discuss the auditor's reporting responsibility when you have identified an RI. Rather analyse the "required" part of the question carefully to ascertain whether the reporting responsibility would be applicable. Also, use the mark allocation of the question as guidance. The reporting responsibilities as per section 45 are extensive, as it would increase the mark allocation significantly.

QUESTION 2.1**10 marks**

Activity	Estimated Time			
	Reading	Writing	Marking and review	Total
SAICA ITC 2022 (Adapted)	3 minutes	15 minutes	6 minutes	24 minutes

Background information and information relevant to the audit

You are an audit manager at Bean Counters Incorporated (Bean) and you are assigned to the 30 September 2014 financial year-end audit of Afriq Bank Limited (Afriq), an investment bank specialising in unsecured lending. Afriq is listed on the Johannesburg Stock Exchange. Afriq has made headlines in recent years for all the wrong reasons, including excessive spending as well as alleged reckless lending practices.

On 7 August 2014, Afriq's share price collapsed to a 20-year low as it was unable to generate R8,5 billion needed as a result of certain categories of unsecured loans currently in default. This brought the bank to the brink of bankruptcy. Afriq shocked the market on 6 August 2014 when it released a press statement stating that it needed to raise the R8,5 billion in new capital after a warning of a massive annual loss and a bleak cash-flow outlook for the next 12 months. As a result, the chief executive officer quit. That fundraising now looks nearly impossible given that the bank needs several times more capital than it is currently worth (based on market capitalisation). All of Afriq's cash reserves have been depleted and its overdraft facilities are fully drawn.

Afriq's share price, which traded at 20c in the early morning on 7 August 2014, stood at 85c by midday. The company was valued at R1,2 billion – a precipitous fall for a company worth more than R21 billion at its height. Apart from the bank itself, one of its subsidiaries Pelerine Furnishers, announced later on the day that it had applied for business rescue (a process provided for in Chapter 6 of the Companies Act 71 of 2008) to temporarily protect its property from creditors' claims.

Costa Kiriakis, a registered chartered accountant (SA), who resigned as Afriq's chief executive officer after 21 years of service, built the bank into one of South Africa's best-known lenders by targeting low-income borrowers with expensive credit – a previously untapped market of people who had been turned away by the traditional banks when approached for loans.

Afriq's troubles stem from a business model based solely on unsecured lending (high-margin loans not backed by collateral), which it offered widely to its core market of low-income borrowers. However, these clients have been hit by rising unemployment, food and fuel cost, as well as slow growth, while Afriq has been slammed by its bad debts. Afriq's services are provided across South Africa through its branches mainly located in shopping malls.

Several other commercial banks looked to unsecured lending to boost profits in recent years but took on less risky loans and were quicker than Afriq in getting out of those loan positions when economic conditions took a turn for the worse.

Critics of Afriq's business model always maintained that such lending practices were unsustainable and reckless. The board of Afriq, at the leadership of Mr Kiriakis, however, maintained that he feels that "people should take up responsibility for their own actions" and that it is not Afriq's problem if loans are applied for by lenders knowing that they cannot afford it. For Afriq to remain sustainable in future, the question now is how much the loan

book is worth and if that is enough collateral for equity holders after the bond obligations have been fulfilled.

After the share price collapse of 7 August, Afriq said it would write off its bad loans in an attempt to create a ring-fenced “good bank”. Afriq’s bad loans comprise nearly a third of its R51 billion book, while it had R47 billion worth of bonds and long-term debt on its statement of financial position (as per its interim annual financial statements dated 31 March 2014). Furthermore, Afriq stated that it expected a headline loss of R6,4 billion for the year ended 30 September 2014 (from a loss of R365 million the previous year).

The average net loan size decreased to R13 331 for the period July to September 2014, compared with R13 868 for the first half of 2014. Pelerine Furnishers recorded merchandise sales of R2,8 billion for the nine months ended 30 June 2014; a 12% decline relative to the comparative period.

Class action lawsuit

It has come to your attention that a legal claim has been instituted by a group of current and previous lending clients against Afriq in the form of a class action lawsuit. Afriq has been subpoenaed by the lenders, represented by a leading consumer rights attorney Ms Erin Hurter, on 16 October 2014. The claim of R40 million is for hardship suffered by the lenders as a result of them experiencing financial difficulty when their loans became payable. They claim that Afriq was too lenient in granting the loans by not considering whether the lenders can afford the monthly instalments when the loan becomes due to be paid back.

You consulted the legal department of Afriq on this matter. They are of the firm opinion that the probability of the claim succeeding is extremely high. They also consider the amount of R40 million to be a fair estimate of the eventual settlement amount.

When you approached Mr Jeff Strongman, the financial director of Afriq, to discuss the effect of this matter on the 2014 financial statements, you were stunned by his response. Mr Strongman refuses to reflect this legal claim in any form in the 2014 financial statements as he is of the opinion that it “has nothing to do” with the current reporting period, as the claim was instituted after year end.

Mr Strongman has, however, agreed to include some going concern disclosures to the 2014 annual financial statements.

Restructuring of business and purchase ledger closure error

Afriq recently announced its plans to restructure its lending operations business. This will involve:

- an agreement with the South African Reserve Bank (SARB), which was signed on 26 September 2014. In terms of this agreement, the SARB will buy a part of Afriq’s bad loans, with a nominal value of R17 billion, for R7 billion;
- closing some of its branches; and
- retraining some existing staff and disposing of some surplus assets.

These plans were agreed on at a board meeting in September and announced to the shareholders on 29 September 2014. Mr Strongman agreed to make a restructuring provision to the amount of R20 million in the financial statements regarding the cost relating to the closure of some branches and staff retraining and asset disposal cost.

Mr Strongman has notified you that an error occurred in the closing of the purchase ledger at the year end. Rather than closing it on 30 September 2014, it accidentally closed one week earlier on 24 September 2014. All purchase invoices received between 24 September and the year end have been posted to the 2015-year-end purchase ledger. Afriq's purchases are solely on credit and mainly relate to the day-to day-operations from its branches.

REQUIRED

Marks

Discuss, in detail, the auditor's responsibilities with regard to the reckless lending practices under the leadership of Mr Costa Kiriakis in terms of the Auditing Profession Act. 10

SUGGESTED SOLUTION

Discuss, in detail, the auditor's responsibilities with regard to the reckless lending practices under the leadership of Mr Costa Kiriakis in terms of the Auditing Profession Act.

It has to be determined if the reckless lending practices constitute a reportable irregularity:

A reportable irregularity exists when:

- an unlawful act has been committed:
 - *Contravention of section 22 (Reckless Trading) of the Companies Act is unlawful. Furthermore, it would seem that section 76 (Standard of director's conduct) of the Companies Act has also been contravened.* (1)
- by any person responsible for the management of an entity:
 - *Mr Costa Kiriakis being the CEO at the time, was responsible for the management of Afriq.* (1)
- which has caused or is likely to cause material financial loss:
 - *As a result of the reckless lending practices, lenders may suffer financial loss when repayments cannot be made. Furthermore, Afriq may suffer financial loss as these loans may never be paid back.* (1)
- Is fraudulent or amounts to theft or which represents a material breach of any fiduciary duty owed by such person to the entity or any partner, member, shareholder, creditor or investor of the entity under any law applying to the entity or the conduct or management thereof:
 - *Reckless trading and acting contrary to section 76 of the Companies Act by Mr Costa Kiriakis is a breach of their fiduciary duties.* (1)

Therefore, a reportable irregularity exists at Afriq Bank Limited. (1)

- Bean Counters Incorporated will report the matter in a written report immediately (without delay) to the IRBA. (1)

Within three days of sending the report to the IRBA, Bean Counters Incorporated will notify the board of directors of Afriq in writing about the reportable irregularity. (1)

- A copy of the report to the IRBA will accompany the notice to the board of directors. (1)
- Within 30 days of the report being sent to the IRBA, Bean Counters Incorporated will do the following:
 - Discuss the report with the board of directors of Afriq. (1)
 - Afford the board of directors the opportunity to make representations. (1)
 - Send another report to the IRBA, informing it that no reportable irregularity is taking place or has taken place; or the suspected reportable irregularity is no longer taking place; or the reportable irregularity is continuing. (1)

As a reportable irregularity is taking place, Bean Counters Incorporated may not issue an unqualified audit report.

(1)

Available 12
Maximum 10
13 marks

QUESTION 2.2 – SELF ASSESSMENT QUESTION

Activity	Estimated Time			Total
	Reading	Writing	Marking and review	
Med Manage (Pty) Ltd	4 minutes	20 minutes	8 minutes	32 minutes

Background information

You are an audit senior at Bakeng & Kgomotso Auditors Incorporated (B&K), currently involved in the finalisation stage of the statutory annual audit of Med Group Limited (Med) and its two subsidiaries, Medschem Medical Scheme (Medschem) and Medmanage (Pty) Ltd (Medmanage), for the financial year ended 30 June 2021. Med is a Johannesburg Stock Exchange (JSE) listed company in the health care industry of South Africa. The final materiality for the 2021 statutory annual audit is set at R3 million for Medschem, R1,2 million for Medmanage and R 4 million for the consolidated financial statements of Med.

Medschem is an independent non-profit medical scheme governed by the Medical Schemes Act and regulated by the Council for Medical Schemes. Medschem has a good record of diligently paying their clients' qualifying medical costs and providing excellent service to its members. Medschem is administered separately by Medmanage, an authorised financial services provider and for-profit private company. By separating medical scheme and administration functions between Medschem and Medmanage, the Med group of companies has been able to gain a significant competitive advantage by expanding its offerings to the health care market without contravening the Medical Schemes Act.

In addition to providing administration services to Medschem, Medmanage offers medical industry related services and products to medical scheme members. These services and products include for example the purchase and repackaging of vitamins as well as endorsed weight management products. The group of companies has proven to be highly profitable since it was founded in 1993. However, the global Covid-19 pandemic that hit South Africa and the rest of the world in 2020, changed the healthcare landscape significantly.

The Med group of companies saw a significant decline in profits in the 2021 financial year. Although Medschem initially experienced large surpluses and reserves after fewer operations and doctors' visits at the beginning of the outbreak, the scheme had to pay higher claims as hospitalisations due to Covid-19 increased later during the outbreak. The Council for Medical

Schemes further stressed that uncertainty exists around how Covid-19 will affect medical schemes in the long term.

Raw material procurement from Bestpack

A decision was taken at a Medmanage board meeting before year end, to procure the necessary repackaging and labelling raw materials for the Swiss vitamin supplements from Bestpack (Pty) Ltd. Bestpack is a family business that is renowned for providing high quality packaging materials at affordable prices.

Medmanage's marketing director, Mr Adrian Viljoen, owns 15% of the equity interest of Bestpack and the remaining interest is held by his son. His son is also the managing director of Bestpack. Due to this relationship, Medmanage was able to negotiate a lucrative discount on the contract. As such, the entire board of directors, including Mr Adrian Viljoen, unanimously voted in favour of the contract at the board meeting.

REQUIRED

Marks

Determine whether a reportable irregularity exists in terms of the Auditing Profession Act with regards to MEd manage (Pty) Ltd's board decision to award the procurement of packaging materials contract to Bestpack.

12

Communication skills – clarity of expression

1

SUGGESTED SOLUTION

Determine whether a reportable irregularity exists in terms of the Auditing Profession Act with regards to Medmanage (Pty) Ltd's board decision to award the procurement of packaging materials contract to Bestpack

1. Whether an unlawful act or omission has occurred **(How?)**: (1)
2. Adrian Viljoen contravened section 75 of the Companies Act by not declaring his interest in and voting on the contract with Bestpack. (1)
3. Whether the unlawful act has been committed by someone responsible for management of the entity **(Who?)**: (1)
4. The unlawful act was committed by Adrian Viljoen, the marketing director of Medmanage. (1)
5. Whether the unlawful act could result in a material financial loss to any partner, member, shareholder, creditor or investor **(Who?)**: (1)
6. The contract is void as Adrian Viljoen did not comply with the requirements of section 75 (section 75(7) and unless ratified by the shareholders or the court, (1)
7. could result in penalties to **(Who?)** Medmanage levied by Bestpack if the contract is declared void; or (1)
8. financial loss to **(Who?)** Bestpack if the contract is cancelled. (1)
9. However, the shareholders of Medmanage would probably ratify the contract as it appears very beneficial for Medmanage (good quality at affordable prices, including

lucrative discounts) and would most probably not result in financial loss to any party.
(1)

10. Whether it relates to fraud or theft **(Why?)**: (1)
11. The unlawful act does not seem to relate to fraud or theft as it may not be intentional, and the contract terms are fair and beneficial to Medmanage. (1)
OR
12. Adrian Viljoen might have intentionally, fraudulently not declared his interest in order to win a contract for his son. (1)
13. Whether the unlawful act constitutes a material breach of fiduciary duty **(Why?)**: (1)
14. Non-compliance with section 75 is a significant breach of the companies act, which would be considered a material breach of a director's duty of care, skill and diligence(1)
15. If the agreement was indeed the best available option for Medmanage (e.g. good quality at affordable prices, including lucrative discounts), it could be argued that this does not amount to a material breach of his fiduciary duty as Adrian Viljoen acted in the best interest of the company. (1)

OR

16. based on the above, a reportable irregularity exists.

Conclusion: Based on the above, if a RI exists, the auditor will need to report a reportable irregularity to the IRBA. (1)

Communication skills – clarity of expression (1)

Available 17

Maximum 13



EXAM TECHNIQUES IN ANSWERING THIS QUESTION

This is a straightforward question. During an assessment it is important to identify the what the examiner expects from you. It is important to not only list the theory, but also to **apply** the theory to the scenario.

Student often struggle with the application of the scenario to the theory. In order to assist you, ask yourself **“Who, What, When, Where, Why and How”** the theory is applicable. Think of the words **“5 Whiskeys and a Hotel”** 5 W's and H.

Please remember to provide a conclusion on the question as many students tend to forget this.