

CA



THE INSTITUTE OF  
**CHARTERED** ACCOUNTANTS  
OF SRI LANKA

# SUGGESTED SOLUTIONS

## **23404 – Advanced Audit and Assurance**

CA Professional (Strategic Level II) Examination  
DECEMBER 2013

**THE INSTITUTE OF CHARTERED ACCOUNTANTS OF SRI LANKA**

## Answer No.01

a)

The finance company has 56 branches, and they provide standard products. Accordingly, it can be assumed that the internal controls are designed centrally.

Branch visits can be done either

- based on random basis to test controls or
- select based on the significance of the branch in terms of the overall finance co. to carry out substantive procedures . The selection criteria can be branch profits , total loans and advance, non performing loans and advances or deposits or any other criteria that denotes the significance of each branch in comparison to the overall finance company.

b)

Considerations re reducing substantive audit procedures

- Reasons for deviations (e.g person responsible on holiday) should be looked into determine if it indicates
  - isolated error
  - lack of operation of control i.e. control failure
  - or lack of evidence of control e.g. no signature or initials evidencing the checking
- Whether extended testing prove satisfactory
- Whether compensating controls exist

c ) key areas of audit risk and explanation	d) audit procedures in response
I. <u>Related party transactions</u> : KMPs <u>hold a significant proportion of ownership</u> .	<ul style="list-style-type: none"><li>▪ Understand if there is a <u>process</u> in the Finance co <u>to capture and disclose all related party transactions</u></li><li>▪ Call for <u>confirmations</u> from related parties</li><li>▪ obtain <u>written representation from management regarding the completeness</u> of related party disclosures</li></ul>
II. Gross <u>loans has increased</u> with <u>significant increase in Gold loans</u> and <u>real estate loans</u> . Given the <u>current trend in Gold and real estate prices</u> , this is a significant matter for audit concern.	<ul style="list-style-type: none"><li>▪ <u>assess whether the provisions made in respect of each category are adequate</u> in the light of the information available.</li><li>▪ <u>evaluate the collectability of loans</u></li><li>▪ consider whether any <u>additional provisions need to be established against gold and real estate loans given the current conditions</u></li></ul>

c ) key areas of audit risk and explanation	d) audit procedures in response
<p>III. <u>Other financial liabilities include securitization, subject to financial covenants.</u></p>	<ul style="list-style-type: none"> <li>▪ <u>Understand the financial covenants for the securitization agreements</u></li> <li>▪ <u>Determine if covenants are met and if not communicate with those who are charged with governance</u></li> <li>▪ <u>Whether disclosures required by SLFRS7 is met.</u></li> </ul>
<p>IV. PPE have been <u>revalued</u> during the year. Revaluation requires <u>appropriate estimates of fair value</u>. The <u>revaluation reserve shows a reduction</u> ).</p>	<ul style="list-style-type: none"> <li>▪ <u>Obtain the valuation report and understand the basis, independence), qualifications and experience, of the valuer</u></li> <li>▪ <u>Compare the value to other similar properties in the locality</u></li> <li>▪ <u>re-perform calculations, involved in the revaluation surplus and deficit</u></li> <li>▪ <u>determine appropriate note disclosure of FV</u></li> </ul>
<p>V. <u>Risk management note has many qualitative narrations, that require documentary evidence</u>. It is noted that <u>cost of debentures is high</u> and hence <u>appropriate risk management measures are relevant</u> information for users.</p>	<ul style="list-style-type: none"> <li>▪ <u>Understand the process and data gathering of risk management disclosures</u></li> <li>▪ <u>test a sample of data in the risk disclosures</u></li> <li>▪ <u>obtain written evidence of risk management activity of the company such as approved policies generated and tabled reports , risk management committee meeting minutes.</u></li> </ul>
<p>VI. <u>Available for sale financial assets have a significant deficit /decrease in valuation held in OCI</u> It is important to understanding the instrument that are classified as available for sale as such instruments are measured at fair value, this instrument is not actively trade stabilizing the fair value may require arise of observable or unobservable data.</p>	<ul style="list-style-type: none"> <li>▪ <u>Determine if there has been a significant and prolonged fair value decrease</u></li> <li>▪ <u>Understand the instruments (AFS) and inquire basis used to assess the fair value.</u></li> <li>▪ <u>Ensure disclosure requirement of SLFRS 7 is met.</u></li> </ul>
<p>VII. Debenture issue -this is material to financial statements, important to understand terms and conditions of debentures as it may affect recognition as debt, measurement &amp; disclosure requirement in terms of LKAS 32, 39 and SLFRS 7</p>	<ul style="list-style-type: none"> <li>▪ <u>Read the debenture agreement to understand the key terms and it meets the definition of debt.</u></li> <li>▪ <u>Ensure that debentures are initially recognized at fair value with applicable transactions cost that are directly attributable.</u></li> <li>▪ <u>Ensure disclosure requirements.</u></li> </ul>

c ) key areas of audit risk and explanation	d) audit procedures in response
<p>VIII. Other areas of audit concern based on the provided information</p> <ol style="list-style-type: none"> <li>a. PPE increased by 35%, but not in line with depreciation charge in PL</li> <li>b. Post employment benefits appears very low despite significant personal costs</li> <li>c. Impairment charges require significant judgments</li> <li>d. Cash and Cash Equivalents increased by 97%</li> <li>e. Lease rentals receivable increased by 50%.</li> <li>f. Loans and Receivables increased by 15%</li> <li>g. Other financial assets by 50%</li> <li>h. Deferred tax assets by 58%</li> <li>i. Due to Banks by (27%)</li> <li>j. Due to Customers by 42%</li> <li>k. Debt Issued and Other Borrowed Funds by 68%</li> <li>l. Other Financial Liabilities by 500%</li> <li>m. Net interest income fluctuation significant</li> <li>n. Fees and comm. income by 40%</li> <li>o. Other opex increased 19%</li> </ol>	<ul style="list-style-type: none"> <li>▪ Any appropriate audit procedure relevant for the issue and the reason.</li> </ul>

e) Points for inclusion in the engagement letter-

- i. To whom the report is addressed to- to avoid any third party reliance
- ii. period covered by the forecast
- iii. scope of the forecast and review
- iv. statement of directors responsibility on the forecasts
- v. limitation clause that forecasts could be significantly different from actual results
- vi. limitation of liability clause or suitable risk mitigation measures
- vii. intended use and limitations of the report

## Answers No. 02

(A)

- (a) Prepare a questionnaire that can be used to assess the valuer's professional competence and objectivity
- a. Professional qualifications? Is he a member of a recognized professional body in the field of valuation
  - b. Years of experience in relation to valuing properties?
  - c. Are there any legal, reputational issues in relation to previous valuation?
  - d. Are there any significant financial interests with the entity? (shares, loans, performance based payment, etc.)
  - e. Is he an employee of the entity?
  - f. Any personal relationship with any director or employee of the company?
  - g. Fees paid and the basis?
- (b)
- The extent to which the accounting estimate depends on judgment.
  - The sensitivity of the accounting estimate to changes in assumptions.
  - The existence of recognized measurement techniques that may mitigate the estimation uncertainty (though the subjectivity of the assumptions used as inputs may nevertheless give rise to estimation uncertainty).
  - The length of the forecast period, and the relevance of data drawn from past events to forecast future events.
  - The availability of reliable data from external sources.
  - The extent to which the accounting estimate is based on observable or unobservable inputs.
- (c) Fair Value PLC will use this value only for 10 years. Even though LKAS 40 permits them to recognize the same as Investment property, they do not hold freehold rights. Fair Value PLC only has ability to earn rent income for the period of 10 years; therefore Income approach is more appropriate as a fair value estimation model.
- (d)
- a. Current market rent income for similar property / Rent income
  - b. Possible increase in rent income / Inflation
  - c. Maintenance expenses, taxes, etc.
  - d. Economic life of the building / Useful life of the building
  - e. Discount rate appropriate to the time period used

(B)

- (a) A qualification is required in audit report on financial statement for the year ended 31 Dec 2013. Even though the statement of financial position is not materially misstated, the income statement is misstated as the opening balances were not adjusted. Further, the comparative information (statement of financial position as 31 Dec 2012 and Income statement for the year ended 31 Dec 2012) are also misstated.

**Basis of qualification**

We were appointed as auditors of the company on December 31, 2013. NP & Co was the auditor for the company for the year ended December 31, 2012 and issued a unmodified audit opinion on the financial statements for the year ended December 31, 2012. However we were unable to satisfy ourselves with the assumptions and basis used in the measurement of inventory in the statement of financial position as of December 31, 2012. The company did not have proper policy on assessment of net realizable value. Since opening value of the inventory enters into the determination of the financial performance and cash flows, we were unable to determine whether adjustments might have been necessary in respect of the profit for the year reported in the income statement and the net cash flows from operating activities reported in the cash flow statement.

- (b) The auditor's report still will have a qualification on the comparative figures.

When the auditor's opinion on the prior period, as previously expressed, was modified, the unresolved matter that gave rise to the modification may not be relevant to the current period figures. Nevertheless, a qualified opinion, a disclaimer of opinion, or an adverse opinion (as applicable) may be required on the current period's financial statements because of the effects or possible effects of the unresolved matter on the comparability of the current and corresponding figures.

In this case, the matter has an impact on profit and loss for the year ending 31 December 2013. Therefore comparative information of income statement is misstated.

### Answer No. 03

(a) **Characteristics of a company limited by guarantee such as The Centre for poverty Eradication**

A company limited by guarantee is a company that does not issue shares, the members of the company undertakes to contribute to the assets of the company in the event of its being put into liquidation, in an amount specified in the company's articles.

The Registrar may direct that the association be registered as a company limited by guarantee, without the addition of the word "Limited" to its name when the Registrar is satisfied that the association is to be formed for promoting commerce, art, science, religion, charity, sport, or any other useful object, and intends to apply its profits or other income in promoting its objects, and to prohibit the payment of any dividend to its members. These clauses are generally incorporated into the Articles of the company.

(b) **Areas to be audited and audit procedures that need to be carried out.**

- **Foreign Grant- *Purpose of the grant and if it is correctly classified in the financial statements***

The agreement entered in to with the foreign fund need to be obtained. If an agreement is not available all correspondence with the fund need to be obtained. The agreement/correspondence need to be read to ascertain if there are any conditions attached to the grant and whether the centre has complied with the specified conditions.

Whether the centre placement of grant in an long term FD can utilize the interest to meet administration expense needs to be ascertained. As the centre does not seem to have done activity with the funds received, there could be a breach of grant conditions.

Non compliance with the grant conditions could require the return of the grant. This too needs to be determined.

Based on a detailed understanding of the nature and purpose of the grant and whether the centre has complied with its requirements the auditor need to determine whether the grant has been classified and presented fairly in the financial statements

- **Charity Dinner dance -*Income from sale of tickets***

An own calculation of the income earned from the sale of tickets need to be made by determining the number of tickets sold and the price thereof. For this the following need to be obtained,

- a certificate from the company that printed the tickets, confirming the number of tickets printed
- The unsold tickets need to be obtained to ensure that they have not been sold.

- **The disbursement of the profits of the event to the selected housewives**  
The centre's minutes need to be perused to identify the persons selected to receive the profits for the dinner dance.

Further, acknowledgements/ documentary evidence to validate the receipt of funds by the selected housewives is required.

(c) **Steps you will take,**

- Ensure what the senior has identified is correct by reading the correspondence /agreement entered in to with the foreign party.
- Assess its impact to the financial statements and the audit report.
- If you conclude that there is a significant impact, you may want to obtain views from your firm's technical partner/ partner on this identification and whether your impact assessment and conclusions are correct.
- Discuss this issue with the management/ directors of the centre to obtain their position regarding this non compliance and the current position with regard to the grant. You may request the management to make these representations in writing.
- If the non compliance has not been resolved, according to your assessment if it impacts on the financial statements modify the audit report.

**Answer No. 04**

- (a) Criteria you would use to assess the ability to use the work of the Internal audit department and the assessment of Tiles (Pvt) Limited.

i) **The objectivity of the internal audit department**

You need to consider,

- To whom the internal auditor reports to (it should be the Board of Directors or the audit committee if one exists).  
In Tiles (Pvt) Limited, the chief Internal auditor reports to the finance director. This would indicate that independence could be limited as the internal audit is reporting to the person responsible for the systems and procedures which are being investigated.
- Whether the Internal Audit has any operating responsibilities or any constraints or restrictions  
In Tiles (Pvt) Limited one of the staff members is working part time as a credit controller, so he should not be involved in any work relating to the credit control side of the business.
- Whether the department and its members are independent  
In Tiles (Pvt) Limited two of the staff have been transferred internally and while the advantage of this is their background knowledge, they may be in a position where they are reviewing systems they put in themselves and work which they have performed themselves.

ii) **The technical competence of the internal auditors**

Consider whether the internal audit staff have adequate technical training and proficiency.

At Tiles (Pvt) Limited the department seems to include a good balance of accounting and computer expertise. The Chief Internal Auditor is a member of a relevant professional body and the staff have some training in audit.. However, the staff members are relatively new to the roles which they are now performing.

iii) **Whether work has been carried out with due professional care**

Consider if the work is properly planned, supervised, reviewed and documented.

At Tiles (Pvt) limited it appears that the work has been planned although this work schedule should be approved and monitored by the Board of Directors to enhance independence.

The external auditor needs to assess the documentation to determine whether sufficient evidence is collected to support conclusions and whether the conclusions are logical.

They need to reassess the adequacy of the audit manuals and the work programs. And also whether the work is supervised and reviewed.

iv) **Whether there is likely to be effective communication between the internal auditors and the external auditor**

It seems that communication between the internal and external auditor will be effective as the management has not placed any restriction on their communication and has asked the chief internal auditor to share all of his reports and manuals.

(b)

- **Systems Documentation**

As the internal audit have documented the company's systems rather than repeat the work we would confirm the system as recorded via walk through tests. We would be very thorough with our walk through tests as the systems were documented by staff who may have been responsible for some of the systems and who certainly worked with them. So their descriptions could reflect their perceptions rather than reality.

The extent of our reliance would depend on the details included in the documentation, particularly whether it includes controls.

We would then need to evaluate the system.

- **Tests of Sales and Receipts**

We would assess the nature, scope and extent of testing, the quality of the work done and documentation thereof. We would then assess the results of the work done, the subjectivity involved in the evaluation of the audit evidence gathered.

The assessed risk of material misstatement at assertion level.

- If the controls have been satisfactorily tested, we may be able to reduce the level of our independent testing.

- **Tests of purchases and payments**

As the work has not yet been started, we can discuss the methodology (the timing, the extent of audit coverage, sampling methods etc.) and documentation requirements with the Internal audit team and ensure that it meets our requirements. This would enable us to rely more heavily on the work. However, we will still need to perform our independent testing.

**Answers No. 05**

(A)

(a) WP PLC

A **self-interest threat** to professional competence and due care is created if the fee quoted is so low that it may be difficult to perform the engagement in accordance with applicable technical and professional standards for that price.

Possible safeguards are;

- Making the client aware of the terms of the engagement and , in particular, the basis on which fees are charged and which services are covered by the quoted fees
- Assigning appropriate time and qualified staff to the task.
- All applicable assurance standards , guidelines and quality control procedures are being complied with.

(b) PHAC PLC

Using the same senior personnel ( Partner in this example) on an assurance engagement over a long period of time may create a familiarity threat.

The significance of the threat will depend upon factors such as

- The length of time that the individual has been a member of the assurance team
- The role of the individual on the assurance team

- The nature of the assurance engagement
- Structure of the firm.

Safeguards

- Rotate the engagement partner who served the client for significant period.
- (B).
- Disclosure is permitted by law and is authorized by the client or the employer
  - Disclosure is required by law
  - There is a professional duty or right to disclose when not prohibited by law.

NOT FOR SALE



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