THE INSTITUTE OF CHARTERED ACCOUNTANTS OF SRI LANKA

SUGGESTED SOLUTIONS

KB4 – Business Assurance Ethics & Audit

December 2015

SECTION 1

Answer 01

Relevant Learning Outcome/s:	
1.2.1	Analyse threats in complying with fundamental and ethical principles, including independence of auditors in an audit of financial statements.
1.2.2	Outline safeguards to mitigate threats in complying with fundamental and ethical principles.

Suggested detailed answer

(a) - the fact that Saman has been in the audit team for the last 5 years indicates that he is quite familiar with the staff of the client. Further, the manager who was in charge of last year's audit has just joined the bank as the finance manager. This means that Saman's relationship with the client staff becomes much greater leading to a **familiarity threat**.

- the engagement partner knows that Saman also has an ambition of joining a bank once he becomes qualified. This is indicative of a **self-interest threat** as Saman may be motivated by a desire to impress the bank's senior staff so that he can influence them in a future employment opportunity at the bank.

(6 marks)

(b) The firm can take one of the following measures to address the threats mentioned above.

- Replace or rotate Saman with another manager for the bank audit. This will ensure that the close relationship between the audit manager and the finance manager is removed.
- Retain Saman as the audit manager and appoint a separate senior audit manager for a detailed review of the work of Saman and his team in relation to the bank audit.
- Keep the audit committee of the bank informed of the fact that the finance manager was the ex-audit manager, but that the audit firm has taken steps to mitigate the possible threats to independence.
- Arrange with the bank to get another finance professional (if available) to coordinate with the auditors for this year.

(4 marks)

(Total: 10 marks)

Answer 02

Relevant Learning Outcome/s:
2.2.1 Analyse non-complex business processes and identify the internal controls in place in the context of the main business, such as - Order to receipt - Procurement to pay - Payroll - Cash management and investment - PPE and inventory management

Suggested detailed answer

(a) **Fixed asset management**

- Implement a capital expenditure budget and approve all capital expenditure in advance
- Maintain a complete and up-to-date fixed asset register and reconcile the fixed asset register balances with the fixed asset general ledger balances at regular intervals
- Tag all fixed assets with unique identification codes and check them to the fixed asset register
- Perform physical verification of fixed assets at regular intervals
- Set limits of authority for purchase and disposal of fixed assets and approve all fixed asset purchases and disposals
- Approve transfer of fixed assets between various construction sites
- Implement approval for commissioning of assets constructed
- Implement physical safeguards for fixed assets

(5 marks)

(b) **Petty cash management**

- Maintain a petty cash imprest system
- Authorise all petty cash advances through sequentially controlled IOUs
- Set maximum advance limits for petty cash expenses
- Set limits on the type of expenses that can be met by petty cash
- Set a maximum period to settle petty cash advances
- Count petty cash on a surprise basis
- Sequentially control all petty cash settlement vouchers
- Check petty cash expenses in the petty cash settlement vouchers to supporting documents
- Set an approval level for petty cash vouchers

(5 marks)

(Total: 10 marks)

Answer 03

Relevant Learning Outcome/s:
5.3.1 Explain the differences between an emphasis of matters and other matters.
5.6.1 Analysis non-complex audit engagements and determine whether emphasis of matter or other matter should be included.

Suggested detailed answer

(a) The emphasis of matter paragraph should be incorporated immediately after the opinion paragraph.

- Use the heading "Emphasis of Matter" or another appropriate heading
- Matter referred in the emphasis of matter paragraph should be clearly described in the financial statements and clear reference should be given in the paragraph
- Paragraph must state that the opinion is not modified because of the emphasis of matter

(3 marks)

(b)

Emphasis of matter	Other matter
Refers to a matter clearly described in the financial statements	Refers to a matter other than described in the financial statements
Referred matter is fundamental to users' understanding of the financial statements	Referred matter is relevant to users' understanding of the audit, auditor's responsibilities and audit report

(2 marks)

(c) Since this is a major catastrophe that has happened and the financial statement users should know this matter in order to understand the financial statements, it should be disclosed in the financial statements under "events after the reporting date" by the management. The auditor should also incorporate an emphasis of matter paragraph in the audit report referring to the matter disclosed in the financial statements**.** If management does not agree to disclose this event in the financial statements, the auditor should consider a modification in the audit report.

(5 marks)

(Total: 10 marks)

Answer 04

Relevant Learning Outcome/s:
4.1.1. Discuss different audit procedures which can be used as audit evidence 4.1.2. Discuss how auditors consider the relevance and reliability of audit evidence

Suggested detailed answer

(a)

- Enquiry: seeking information from client staff on the unusual movement noted in the monthly revenue balances and the fact that certain GDNs are not signed. Strength of evidence depends on the knowledge and integrity of the source of information. Enquiry alone does not provide sufficient audit evidence to detect a material misstatement at assertion level nor is it sufficient to test the operating effectiveness of controls.
- Confirmation: calling for confirmations directly from the debtors. This is the process of obtaining a representation of information or an existing condition directly from a third party.
- Analytical procedures: review of the monthly revenue to identify any unusual fluctuations and relationships.
- Inspection of tangible assets
- Observation
- Re-calculation
- Re-performance
- Inspection of records

(2 marks)

(b) The following concerns can be noted with regard to the procedures carried out by Ramani and Kapila and their findings:

(i) There appears to be unusual fluctuations with regard to sales, and the documentation of the answers given by the sales manager does not appear to be adequate. We may need to verify a sample of sales in the first half and the second half of the month to ensure that goods have been properly delivered and accepted by the client. We may need to verify a sample of GDNs in months we see significant variances and eliminate the risk of manipulation of the sales balances in the second half of the month.

(ii) When a control weakness is noted in the GDN process, just getting explanations is not adequate. If this is a consistent occurrence we may have to do additional procedures with regard to the completeness of sales.

(iii) There is also a concern raised with regard to the completeness of sales in the TOC, where we identified that GDNs were not always signed by the security guard and the customer. This could also be related to the unusual variance found in (a) above. The audit team may need to do a quantity reconciliation to verify the sales transactions for a few months to rule out the possibility of manipulations.

(iv) With regard to the confirmation process, to protect the integrity of the process we need to ensure that we post the confirmations. Handing the confirmations to the office assistant for posting could have compromised the integrity of the process. This, together with the unusual variances we are seeing, also raises concerns of the existence of accounts receivables. Therefore, we may need to speak to the client and send the confirmations out exercising proper controls over the process.

(v) The confirmation process would be a critical process to this audit with the unusual variances and control lapses noted by us. We may also decide to do some additional procedures to review the debtors and follow through by checking the business address of the large sales accounts provided by the client for purposes of AR confirmation, and doing a more thorough review of the confirmations received back from the customers.

(8 marks)

(Total: 10 marks)

Answer 05

Relevant Learning Outcome/s:
2.2.1. Discuss the key aspects of corporate governance, including responsibilities of the Board and role of non-executive directors. 2.2.3. Analyse design, implementation and operating effectiveness of identified controls.

Suggested detailed answer

(a)

Internal control	Internal control objective
Merchandiser checks the customer details and credit limit prior to processing sales orders	Ensure sales are valid and recoverable and customers are with good credit ratings
Head of Finance approves the new customers in the sales system	Ensure sales are valid and recoverable
Head of Sales approves the sales order	Ensure sales are valid and accurate
Stores manager authorises dispatch notes	Ensure all goods leaving the company are authorised
Finance clerk checks the details in the sales order and dispatch note before preparing the invoice	Ensure sales are correctly invoiced
Head of Sales approves the sales invoices	Ensure recorded sales are accurate and valid
Segregation of duties between sales, issuance of goods, invoicing and cash receipt.	Ensure internal checks and restricted access to assets, so that one person is not responsible for taking orders, recording sales and receiving payments

(6 marks)

(b)

- Observe and evaluate the segregation of duties operating.
- Select a sample of new customers and check the approval of the finance manager.
- Select a sample of sales orders to ensure that the merchandiser has checked the credit limits and customer details.
- Select a sample of sales orders and check the approval of the Head of Sales.
- Select a sample of dispatch notes and check the approval of the stores manager.
- Select a sample of invoices and check for the three-way match between sales order, dispatch note and invoice.
- Select a sample of invoices and check the approval of the Head of Sales.

(4 marks)

(Total: 10 marks)

SECTION 2

Answer 06

Relevant Learning Outcome/s:	
3.6.1	Analyse financial statements using analytical procedures, to identify any unusual relationships which require further investigation.
3.6.3	Outline the overall response of the auditor to identified risk of material misstatements

(a) **Variance Analysis of PaintWell (Pvt) Limited**

PaintWell (Pvt) Limited Income Statement			**Variance Increase/ (Decrease)**	**% Variance**
For the year ended	**31 March 2015**	**31 March 2014**		
	Rs.	**Rs.**	**Rs.**	**Rs.**
Revenue	8,479	11,777	(3,297)	(28%)
Cost of sales	(7,553)	(8,202)	(648)	8%
Gross profit	926	3,575	(2,649)	(74%)
Administrative expenses	(2,249)	(2,205)	43	(2%)
Distribution expenses	(284)	(423)	(139)	33%
Other operating expenses	(122)	(180)	(58)	33%
Profit from operating activities	(1,729)	767	(2,494)	(326 times)
Finance expenses	(154)	(324)	(170)	(53%)
Profit from ordinary activities before taxation	(1,883)	443	(2,324)	(525 times)
Income tax expense	(185)	(290)	(105)	36%
Profit after taxation	(2,068)	153	(2,221)	(1,458 times)

	31 March 2015	**31 March 2014**
Gross profit margin	11%	30%
Administrative expenses/Sales	27%	19%

PaintWell (Pvt) Limited **Statement of Financial Position**			**Variance Increase/ (Decrease)**	**% Variance**
As at	**31 March 2015**	**31 March 2014**		
	Rs.	**Rs.**	**Rs.**	**Rs.**
ASSETS				
Non-current assets				
Property, plant & equipment	9,562	8,928	633	7%
Long term receivables	2,245	2,245	-	0%
Total non-current assets	**11,807**	**11,173**	634	6%
Current assets				
Inventories	3,724	1,203	2,521	209%
Trade & other receivables	4,512	3,688	823	22%
Short term investments	789	3,437	(2,648)	(77%)
Cash in hand and at bank	1,005	912	93	10%
Total current assets	10,032	9,242	790	9%
Total assets	**21,838**	**20,415**	1,423	7%
Equity & Liabilities				
Equity				
Stated capital	3,000	3,000	-	0%
Capital reserve	2,598	2,598	-	0%
Revenue reserve	1,893	3,961	2,068	52%
Total equity	**7,491**	**9,559**	**2,068**	**22%**
Non-current liabilities				
Interest bearing borrowings	3,143	1,166	1,977	170%
Deferred tax liabilities	355	345	10	3%
Retirement benefit obligations	532	491	41	8%
Total non-current liabilities	**4,030**	**2,002**	2,028	101%
Current liabilities				
Trade & other payables	5,288	5,667	(379)	(7%)
Income tax liabilities	39	32	7	24%
Short term borrowings	2,465	1,739	726	42%
Interest bearing borrowings	1,268	398	870	218%
Bank overdrafts	1,255	1,017	238	23%
Total current liabilities	**10,316**	**8,854**	1,462	17%

(5 marks)

(b)

1. PaintWell (Pvt) Limited has made a loss of Rs. 2 million against a marginal profit last year. This indicates a decline in the margins of the company. The Finance Director (FD) has also indicated that the Marketing Director (MD) left the company and started his own company, importing and selling paint from China. This could have had a direct impact on the company as the MD can now tap into the same clients and offer to sell paint at much cheaper rates. This along with the competition from other imported paint, and the fact that two of the main customers are going out of business, raises concerns with regard to the going concern of the company.

2. The drop in sales is 28%, against a budgeted drop of 50%, due to two long-term customers going out of business. It is possible that these two customers contributed to the bulk of the sales. The sales team is remunerated based on sales. If the drop was 50%, the sales team's remuneration would have also dropped by 50%. This raises the risk of possible overstatement of sales to decrease the drop in remuneration by the sales team. What did the sales team do to reduce the expected drop of 50% to 28%?

3. Sales have dropped by 28%, but the trade and other receivables have increased by 22%, which is unusual. This could indicate problems with the recoverability of debts and the need for a provision for impairments especially with the two main contractors going out of business.

4. The drop in gross profit margin was 19%. While sales dropped by 28%, the drop in cost of sales (COS) is only 8%. Is it possible that COS is overstated?

5. COS has decreased by 8% and inventory has increased by 209%, which is also unusual. The FD spoke about reducing the quality of paint. Could there be a buildup of low quality stocks returned by customers? There is also the possibility of overstating inventory or the possibility of impairment of inventory due to the drop in sales.

6. The borrowings and overdraft balances have increased significantly. However, the interest expense has dropped by 53%. Could there be an understatement of finance charges?

7. Is the tax charge reasonable as the company has made losses during the year?

8. There is also a long-term receivables balance without any movements. Could there be any impairment indicators relating to this balance? Is this a related party transaction balance, which could be an interest free loan?

9. Interest bearing borrowings have increased significantly. What is the risk of non-compliance with the loan covenants?

(10 marks)

(c)

Assessed risk	Possible audit response
1. Reduced unit sales and eroding margins due to competition and loss of long-term customers raise concerns with regard to the going concern of the company.	• Discuss future plans with regard to the company with its management, with emphasis on how they propose to increase the margins. • Review the company budgets and future plans to assess the going concern of the company. • Obtain representations from the management on how they plan to fund future operations, including servicing of the significant borrowings. • Review correspondence with the banks for any evidence of withdrawal or extension of facilities. If there are bank covenants linked to performance on which facilities depend, review compliance with these, and increase testing on areas where management could manipulate performance indicators (such as provisions). • Review post year-end results and cash flow forecasts for evidence of the company's ability to continue as a going concern. • Consider requesting a disclosure in the financial statements with regard to the going concern ability of the company.
2. Possibility of manipulation of revenue.	• Perform analytical procedures where monthly revenue is compared to expectations and budgeted revenue. Unexpected deviations should be investigated. • Perform a year-end cut off test by agreeing pre year-end sales by inspecting supporting documentation. Trace post year-end transactions back to a supporting documentation to test that revenue was recorded in the proper period. • For a sample of contracts/GDNs, verify the revenue was recognised according to the provision of services/goods.
3. There is an increased risk of irrecoverable debts and the need for a provision for impairments.	• Obtain a break-up and an age analysis for year-end debtors • Test the accuracy of ageing by tracing a random sample of invoices to verify that the ageing is accurate. • Call for confirmations for a sample of long outstanding debtor balances to identify whether any of the balances are disputed. • Identify the year-end receivable balances still outstanding at the date of the audit by reviewing post year-end receipts from customers. • For amounts still outstanding, establish whether these are provided for. • Ensure a provision has been made for any uncollectible balances of the contractors that went out of business. • Review the aged debtor analysis and customer correspondence files for evidence of disputes with

	receivables and consider the adequacy of any related receivables allowance.
4. Possible overstatement of cost of sales (COS) balances.	• Perform a monthly analytical review procedure to compare sales vs. COS and identify and investigate any unusual variances noted. • For a sample of COS entries recorded prior to the year-end, verify that the transactions relate to pre year-end sales by inspecting the contract/other supporting documentation. • Review the COS ledger account and significant journal entries passed to COS to identify and investigate any unusual entries. • Review the year-end stock observation results and identify any significant stock differences. Determine how such differences have been accounted by the management. • Review the cut-off test done for sales and purchases and ensure that goods received and sold have been properly accounted for during the period of purchase/sale.
5. The possibility of overstating inventory and the possible impairment of inventory.	• Attend the year-end inventory observation and verify the physical existence of the inventory. • Examine the instructions to identify slow moving inventory when attending the inventory count. • Increase the emphasis on reviewing the year-end aged inventory analysis for evidence of slow-moving inventory or obsolete inventory. • Review the inventory valuation as at the year-end. • Review the cut-off test done for sales and purchases and ensure that goods received and sold have been properly accounted for during the period of purchase/sale. • Ascertain sales values for items sold post year-end that were in inventory at the year-end to ensure their net realisable value (NRV) was higher than the cost recorded as part of the inventory value in the financial statements.
6. Risk of understatement of finance charges.	• Review the loan agreements and obtain details of the interest charges as per the loan agreements. • Perform an independent calculation of the interest for the year and compare it with the recorded interest expense. • Review the independent confirmations received from the lenders and agree the interest for the year as per the confirmation.
7. Reasonability of the tax charge in line with the fact the company has made losses during the year.	• Obtain the provisional tax computation done by the client and check for reasonability. • Review the tax filing in the prior year and ensure that any over/under provisions have been properly accounted for. • Inquire from the client and confirm that no assessments have been received in respect of any prior year tax filings.

8. Reasonability of accounting for the long-term receivable balance.	• Obtain details of the long-term receivables and discuss the nature of the balance with the client. • Call for an independent confirmation. • Establish whether it is a related party receivable balance. If so, ensure that the required related party disclosure is made in the financial statements. (i) inquire whether there is an agreement between the two parties and review the terms as per the agreement. (ii) check whether this is an interest free loan and if so request the client to make the required disclosures in the financial statements and account for the notional interest and fair value of the loan. • Assess whether there is any indicator of impairment and if so request the client to test for impairment and make provisions for any impairment noted.
9. Significant increase in interest bearing borrowings.	• Obtain a break-up of the borrowings and call for independent confirmations and agree the balances outstanding and other details. • Obtain loan agreements and review the terms of the lending and loan covenants. • If there are bank covenants linked to performance, on which facilities depend, review compliance with these, and increase testing on areas where management could manipulate performance indicators (such as provisions). • Check settlement of the loan repayments. • Review disclosures with regard to borrowings in the financial statements.

(10 marks)

(Total: 25 marks)

Answer 07

Relevant Learning Outcome/s:
4.10.2 Explain the use of Computer Assisted Audit Techniques (CAAT) in performing audit procedures.
4.8.2 Explain procedures that should be performed to reduce the risk arising from related party transactions.
4.12.1 Outline procedures required to identify events occurring between the date of financial statements and the date of the audit report.
4.13.1 Assess events and conditions that may cast significant doubt about the going concern assumption.
4.13.2 Outline procedures required to evaluate the validity of the going concern assumption.
4.1.2 Discuss how auditors consider the relevance and reliability of audit evidence.

Suggested detailed answer

(a)

- Auditors can test programme controls as well as general internal controls associated with computers such as input/output controls, authority, segregation of duties and certain application controls.
- Auditors can test a greater number of items more quickly and accurately than would be the case otherwise (e.g. sample size can be increased to obtain more assurance about the population within a limited time period).
- Auditors can test transactions rather than paper records of transactions that could be incorrect (e.g. the auditor can check the flow of the transactions and identify errors and omissions).
- CAATs are cost-effective in the long-term if the client does not change its systems (e.g. with the same system, the auditor can use the same CAATs and this would reduce the time taken to perform audit procedures).
- Results from CAATs can be compared with results from traditional testing. If the results correlate, overall confidence is increased.

(3 marks)

(b)

- Inspect the joint venture agreement and evaluate whether the business rationale (or lack thereof) suggests a fraudulent purpose (e.g. is it overly complex? does it have unusual terms of trade? does it lack a logical business purpose?).
- Check whether the terms of the transactions are consistent with the management's explanations.
- Check whether the transactions have been accounted for and disclosed properly as per SLAuS 550.

(3 marks)

(c) (i) **Auditor's responsibility regarding the lawsuit**

This matter directly affects the operations of the company. If the company is found guilty their permit may be cancelled and operations could be ceased. In this scenario, the auditor:

- Should inquire from the management and obtain sufficient understanding of the matter.
- Obtain further information such as referring correspondence with the Environmental Authority to identify the material impact to the financial statements.
- Discuss the issue with management and those charge with governance
- If the auditor determines that sufficient disclosures are not done in the financial statements and evidence is not provided by the management, the matter should be reported in the audit report and the auditor should inform the respective legal authorities.

(3 marks)

(ii) **Audit procedures to identify subsequent events**

- Review management procedures for identifying subsequent events to ensure that such events are identified.
- Read minutes of general board/committee meetings and enquire about unusual items.
- Review the latest available interim financial statements and budgets, cash flow forecasts and other management reports.
- Obtain evidence concerning any litigation or claims from the company's solicitors (only with client permission).
- Obtain written representation that all events occurring subsequent to the period-end, which need adjustment or disclosure, have been adjusted or disclosed.

(4 marks)

(d) **Financial**

- Huge accumulated losses and continuously incurring losses
- Negative operating cash flows
- Net liability position and net current liability

Non-financial

- Existence of major customers with stable customer base
- Non-compliance with terms in the permit granted by the Environmental Authority

(5 marks)

(e)

- Obtain and analyse cash flow, profit and other forecasts done by the management
- Analyse and discuss the entity's latest available interim financial statements (or management accounts)
- Enquire from the entity's lawyer about litigation and claims
- Confirm the existence, legality and enforceability of arrangements to provide or maintain financial support with related and third parties
- Obtain and review reports of regulatory action relating to the lawsuit
- Check the rescheduling of loans

(3 marks)

(f)

- Audit evidence from **external sources** is more reliable than that obtained from the entity's records, because it is from an independent source.
- Evidence obtained **directly by auditors** is more reliable than that obtained indirectly or by inference.
- Evidence obtained from the entity's records is more reliable when the related **control system operates effectively.**
- Evidence in the form of **documents (paper or electronic) and written representations** is more reliable than oral representations, since oral representations can be retracted.
- **Original documents** are more reliable than photocopies or facsimiles, which can easily be altered by the client.

(4 marks)

(Total: 25 marks)

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1. to provide a detailed example of a suggested solution to an examination question; and

2. to assist students with their research into the subject and to further their understanding and appreciation of the subject.

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