SUGGESTED SOLUTIONS

KB4 – Business Assurance Ethics & Audit

June 2016

SECTION 1

Answer 01

Relevant Learning Outcome: 1.4

Suggested Detail Answer:

(a) ***Explain the purpose of a letter of engagement and why a letter of engagement is sent before any new audit appointment is accepted.***

The purpose of a letter of engagement is to clearly define the extent of the auditor's/management responsibilities and to minimize the possibility of any misunderstanding between the auditor and the client.

If a letter of engagement is not sent to clients both new and existing, there is scope for argument and misunderstandings about the precise extent of the respective obligations of the clients and its auditors and directors.

(b) ***State four (04) main contents of a letter of engagement.***

1) The objective and scope of the audit
2) The auditor's responsibilities
3) Management's responsibilities
4) Identification of the applicable financial reporting framework for the preparation of the financial statements
5) Reference to the expected form and content of any reports to be issued by the auditor and a statement that there may be circumstances in which a report may differ from its expected form and content

(c) ***Discuss actions you would take in response to the non-reply by the management to your draft engagement letter.***

(1) The Auditor should make an appointment to meet the MD and clearly explain the pre-conditions of the audit to him and ensure that the letter is signed before the commencement of the audit.
(2) The auditor shall not accept the audit engagement or not commence any audit work until the engagement letter is signed.

(Total 10 marks)

Answer 02

Relevant Learning Outcome: 2.1

Suggested Detail Answer:

(a) ***Outline 2 benefits of having an audit committee.***

I. Improve the quality of financial reporting, by reviewing the financial statements on behalf of the Board
II. Create a climate of discipline and control which will reduce the opportunity for fraud
III. Enable the non-executive directors to contribute an independent judgment and play a positive role
IV. Help the finance director, by providing a forum in which he can raise issues of concern, and to get things done which might otherwise be difficult
V. Strengthen the position of the external auditor by providing a channel of communication and forum for issues of concern
VI. Provide a framework within which the external auditor can assert his independence in the event of a dispute with management
VII. Strengthen the position of the internal audit function, by providing a greater degree of independence from management
VIII. Increase public confidence in the credibility and objectivity of financial statements

(b) ***Analyse the composition of the audit committee at Spark Plc highlighting any concerns with regard to the composition***.

(1) The AC chair is the Finance Director, who is also responsible for the preparation and presentation of the Financial Statements. There appear to be a conflict of interest with regard to the selection of the FD as the AC chair. The chairman of the AC should be a non-executive director, appointed by the board.

(2) The two non-executive directors (NED) do not have any experience in financial reporting. At least one NED should have experience in financial reporting to ensure the independence and effectiveness of the AC. In this situation it is likely that they will rely on the AC Chair who is also the FD to guide them on such matters.

(c) **Explain** how the auditor should respond to the statement given by the audit committee chairman in connection with the impairment in forming the audit opinion.

The auditor is required to obtain independent evidence and arrive at a conclusion with regard to the matters noted by him/her during the audit. The auditor cannot accept the position taken by the audit committee alone and conclude on the matter with regard to the impairment. In this instance, there is more reason not to accept the AC position due to the AC chair being the FD who is responsible for the preparation of the Financial Statements.

In this instance, the Auditor should politely explain to the AC that the company needs to prove via the required assessments as per SLAS 36- Impairment of Assets, that the investment is not impaired and pass the necessary accounting entries if there is an impairment. If this is not done, the auditor may need to qualify his audit opinion.

(Total 10 marks)

Answer 03

Relevant Learning Outcome: 3.1

Suggested Detail Answer:

(a) Explain why professional skepticism needs to be maintained throughout the audit

Professional skepticism is necessary for the critical assessment of audit evidence. This includes questioning contradictory audit evidence and the reliability of documents and responses to inquiries and other information obtained from management and those charged with governance. It also includes consideration of the sufficiency and appropriateness of audit evidence obtained in the light of the circumstances, for example, in the case where fraud risk factors exist and a single document of a nature that is susceptible to fraud, is the sole supporting evidence for a material financial statement amount.

Maintaining professional skepticism throughout the engagement is necessary if the practitioner is, for example, trying to reduce the risks of:

1. Overlooking unusual circumstances.
2. Over-generalizing when drawing conclusions from observations.
3. Using inappropriate assumptions in determining the nature, timing, and extent of the procedures and evaluating the results thereof.

(b) Outline procedures to identify risk of material misstatements.

Observation

1. Consider information obtained from the client acceptance process is relevant for identifying risks of material misstatement
2. Obtain an understanding of the industry through publications or websites related to the industry.

Inquiry

3. Obtain an understanding of the entity through inquiries of management and internal audit.
4. Inquire from those charged with governance such as audit committee and board of directors.
5. Discussion with audit partners, managers and staff who have handled audits of other primary dealers within the firm

Inspection

6. Review of reports prepared by management (such as quarterly management reports and interim financial statements) and those charged with governance (such as minutes of meetings of the board of directors).
7. Review of documents (such as business plans and strategies), records, and internal control manuals.

Analytical procedures

8. Analytical procedures using anticipated results of the entity from budgets or forecasts or industry information

(Total 10 marks)

Answer 04

Relevant Learning Outcome: 4.3.

Suggested Detail Answer:

(a) ***Identify two (02) assertions covered by obtaining direct confirmations.***

Assertion	**Confirmation Procedure**
Existence	*Verification of trade receivables by direct confirmation is providing audit evidence to satisfy the objective of testing whether customers exist and owe bona fide amounts to the company. Thereby the auditor ensures that the "existence" and "rights and obligations" assertions are satisfied.*
Rights and obligations	

(b) ***Discuss three (03) important points that you would consider from the details given in the above table*** **in selecting the** ***sample to send out confirmations.***

I. **Large or material items.** 32% of the balances are from 15 debtors with balances over Rs. 500,000. Selecting these balances ensure that no material error has occurred and partly to increase the overall value of items tested

II. **Debtors with balances more than six months old.** 13% of the Debtors are included in this balance. The aging is also not adequate to determine if a provision is required for these balances. There is also a high risk of non-payment as the exact age of the debtors in this category may be unknown to XYZ PLC.

III. **Receivables in the range Rs 100K –Rs 499K.** 51% of the Debtors are from this category.

IV. **Receivables in the range Rs 0-100K -**This group is unusual because 30% of the debts are over 6 months and 35% in the 2-6 month category. Additional testing may be necessary to ensure that the receivables exist and to confirm that XYZ PLC is not overstating sales by including many low value receivable balances in the ledger.

V. **Negative balances.** There are 12 negative balances. A sample of these should be selected to ensure the credit balance is correct and to ensure that payments have not been posted to the wrong ledger account.

VI. **A random sample of remaining balances to provide an overall view of the accuracy of the receivables balance.**

(c) **Outline the audit work to be performed on the following replies given by the customers.**

- ***balance not agreed by the customers***
- ***balance agreed by the customers***

The audit work required on the various replies to a receivables' circularisation would be as follows.

(i) ***Balances agreed by customer***

All that is required would be to ensure that the debt does appear to be collectable, by reviewing cash received after-date or considering the adequacy of any allowance made for a long-outstanding amount.

(ii) ***Balances not agreed by customer***

All balance disagreements must be followed up and their effect on total receivables evaluated. Differences arising that merely represent invoices or cash-in-transit generally do not require adjustment, but disputed amounts, and errors by the client, may indicate that further substantive work is necessary to determine whether material adjustments are required.

(Total 10 marks)

Answer 05

Relevant Learning Outcomes: 5.5 and 5.6

Suggested Detail Answer:

(a) Potential impact on financial statements

I. All these invoices have been invoiced but not dispatched. It shows that risks and rewards have not yet been transferred to the customer. As per *LKAS 18 Revenue*, such orders cannot be recognized as sales. They should remain as inventory of the company.

<u>Orders placed towards the year end</u>-

Revenue overstated by Rs. 20 Mn.
Trade receivable overstated by Rs. 20 Mn.
Inventories understated by Rs. 15 Mn.
Cost of sales overstated by Rs. 15 Mn.

II. Although the matter relating to a lawsuit has been appropriately disclosed in the financial statements, it is of great importance as it is fundamental to the users' understanding of the financial statements. It has a major impact on the financial statements.

(b) On the basis that management proposes no further action, **recommend** your views on the audit opinion as a result of the issues discussed in (a) above.

I. The reversal of the sales due to the cut off error will reduce the profits by 21% and net assets by 17%. Inventory would increase by Rs. 15Mn which is 27% of the inventory. The impact of the disagreement with the client is material but not pervasive on the financial statements. Therefore the audit report should be modified by way of a qualified opinion.

II. As there is an uncertainty relating to the future outcome of the legal case, an emphasis of matter paragraph should be included in the auditor's report without further qualifying the opinion.

(Total 10 marks)

SECTION 2

Answer 06

Relevant Learning Outcomes: 1.2 and 2.2

Suggested Detail Answer:

a) **Assess the threat to independence and objectivity faced by Perera & Co. if it accepts to perform a detailed system study on the internal control of SRL.**

Name the potential threat. Required to "assess" the threat to independence. Need to elaborate it further.

Self-Review Threat

Self-review threat – the threat that a professional accountant will not appropriately evaluate the results of a previous judgment made or service performed by the professional accountant, or by another individual within the professional accountant's firm or employing organisation on which the accountant will rely when forming a judgment as part of providing a current service;

b) Two (02) safeguards available for the above identified threat:

1. Using staff members other than audit team members to carry out the work
2. If non—audit services are performed by a member of the audit team, using an independent partner or senior staff member (not part of the audit team) to review the work performed
3. Obtaining the Board's approval for work undertaken
4. Modify the scope of work to ensure that the auditor takes no responsibility to implement the control.

c) Two (02) weaknesses in the purchasing system

1. Purchase Orders should be based on the production budget. When orders are based on the production budget, the company may not face stock outs and costs can also be saved. In the given scenario purchase orders are based on stock levels.
2. Purchase Orders are not authorized.
3. When goods are received at the stores, goods are not physically checked for quality and quantity. The Goods Received Note (GRN) is raised based on the supplier's delivery note.
4. Stock records are updated in the GRN based on the supplier's delivery note and not on the actual quantity received.
5. No reconciliation is performed between the stores and the accounts department stock balances.
6. There is no indication that the Purchase Order, Supplier Invoice, GRN are matched prior to payment of invoices.

d) Assess four (04) possible risk areas requiring further audit work

1. Since the government is going to ban the use of raw material "Sabbic", the company may be unable to produce its most profitable product, "Supermet". It may affect the profitability of the company. Therefore the appropriateness of the going concern assumption may be doubtful.

2. Revenue has increased 31% year on year. This may indicate a risk in revenue recognition where the revenue cut off may be incorrect or sales may have not occurred. The risk in revenue recognition should be considered.

3. Revenue has increased by 31% during the year. The gross profit and net profit of the company have reduced. The main reasons for the decrease in profitability is the increase in cost of sales and administration expenses. Research & Development expenditure which may qualify to be capitalized may have been charged to profit or loss resulting in an overstatement of expenditure.

4. Total borrowings, including both current and non-current interest bearing liabilities have increased by 65%. The corresponding increase cannot be seen in finance charges, which has increased only by 11%. The company has obtained a related party loan to finance research & development expenses. This loan may have been granted at a concessionary interest rate. As per LKAS 39 – Financial Instruments, Interest should be charged at effective interest rate. Therefore finance charges may have been understated.

5. The company has made significant investments in capital work in progress. These assets may be available for use and need to be depreciated. This may have resulted in an overstatement of profits.

6. The company's property, plant and equipment together with capital work in progress may have an impairment indicator due to the banning of the raw material "Sabbic". The need for accelerated depreciation should be assessed.

7. Although revenue has increased only by 31%, the debtors have increased by 64%. There may be long outstanding debtors for which adequate provisions have not been made resulting in overstatement of profits.

e) **Outline 2 possible audit responses to identified risks**

1. Going concern
   a. Request management to make its assessment of the going concern assumption.
   b. Evaluate management's plans for future action.
   c. Evaluate the reliability of underlying data used to prepare the cash flow forecast considering the assumptions used.
   d. Request written representations from management about plans for future action and the feasibility of these plans.

2. Revenue recognition
   a. Understand and evaluate control activities over revenue.
   b. Identify and test controls over revenue specifically targeting cut off and occurrence of sales.

c. Perform substantive testing to address sales cut off and occurrence.
d. Perform detail analytical review to substantiate sales.

3. Overstatement of Research and Development Expenditure
   a. A schedule should be obtained for R & D expenses
   b. Confirm that development costs conform to LKAS 38 criteria by inspecting details of projects and discussions with technical managers and engineers.
   c. Inspect invoices and other supporting evidence to validate expenditure incurred on R& D projects.

4. Understatement of Interest expense and Related party loan
   a. Inquiries should be made from the management regarding the related party loan.
   b. Loan agreement should be obtained and terms and conditions of the loan should be checked.
   c. Loan amortization schedule should be obtained and the interest rate should be based on the effective interest rate.

5. Overstatement of profit on Capital Work In Progress
   a. Inquiries should be made from management regarding the nature of capital WIP
   b. Physical verifications should be carried out.
   c. Inspect invoices and other supporting evidence for a sample of capitalized expenses and available for use status.
   d. Check whether capitalized expenses satisfy the recognition criteria specified in LKAS 16.

6. Impairment indictors
   a. Inquire from management if they have made any assessments on the impairment of property, plant and equipment.
   b. Review the property, plant and equipment used in the production of Supermet sheets and check whether the remaining useful lives are in line with the phasing out of the raw material Sabbic.
   c. Check whether the carrying value of property, plant and equipment used for production of Supermet is less than its recoverable amount.

7. Overstatement of profit due to increase in trade debtors
   a. Obtain an ageing for the receivables and review the adequacy of the allowance for impairment through discussions with management and reviewing correspondence with debtors.
   b. Check subsequent settlement of debtors.
   c. Direct confirmations should be obtained for a sample of debtors including long outstanding debtors to ensure the existence.

8. Cash flow issues due to the increase of interest bearing liabilities.
   a. Review loan agreement
   b. Check classification
   c. Discuss with management
   d. Obtain direct confirmation

(Total 25 marks)

Answer 07

Relevant Learning Outcomes: 4.7/4.8/4.11

Suggested Detail Answer:

(a) Demonstrate why it is important to identify related parties and transactions with related parties in the preparation and presentation of financial statements.

I. **Transactions between two or more related parties may not be 'at arm's length' basis**. -Where transactions are not on an arm's-length basis the directors can artificially change the amounts involved in order to manipulate the revenues, profits and financial position of companies; this may impact on the truth and fairness of the financial statements.

II. **To ensure proper disclosure of the related party relationships to users of financial statements** - knowledge of the relationship between parties to a transaction may affect the way in which the transaction is viewed by the users of financial statements, even if it is conducted on normal commercial terms.

(b) Analyse 4 possible related parties or related party transactions that the auditor should consider for gathering audit evidence.

I. Mr. Madaptha is the significant shareholder of the company. He is also the Chairman of the Company. Therefore, the auditor should identify the names of his close family members. The auditor should review to ensure that the company has also identified these relationships and is ensuring that any transactions with the close family members are captured and reviewed for required disclosures in the financial statements.

II. Mr. Madapatha is a well-known businessman and has several other companies which are owned by him. Therefore, the auditor should identify the names of the companies in which Mr, Madapatha or his family has a significant ownership interests. The auditor should review to ensure that the company has also identified these relationships and is ensuring that transactions with such related parties are captured and reviewed for the required disclosures in the financial statements.

III. Mrs. Madapatha is a director of this company. She is a close family member of Mr. Madapatha and hence considered a related party of Global Plc. She is a director of Miracle (Pvt) Ltd in which the company has a long term investment amounting 18 % of the stated capital of the investee company as at 31st December 2015. The auditor should also scrutinise this relationship further to evaluate whether Miracle (Pvt) Ltd could also be considered a related party. If so, transactions with Miracle should also be considered for disclosure under related party transactions.

IV. At present three of the company vehicles are used by Mr. Madapatha and his family. It is stated that the company does not plan to disclose this as a related party transaction as it is only a temporary arrangement. Transactions with related parties should be considered for disclosure irrespective of the length of the term or the financial consideration charged.

(c) *List procedures an auditor should carry out when auditing accounting estimates in order to assess whether the estimates are reasonable.*

I. Test the management process
II. Use an independent estimate
III. Review subsequent events

(d) (i) Calculate the decline in value of investment, if any, as at 31December 2015.

	Rs. Mn
Total Net Asset Value of Miracle (Pvt) Ltd	435
18% of the Net Assets of the Miracle (Pvt) Ltd (435 * 18%)	78.3
Cost of the Investment by Global Plc	125
Decline based on Net Asset Value(a-b)	**(47)**

(ii) Analyse the accounting and auditing issues arising from the above calculations.

The net asset value is lower by Rs 47 Mn compared to the cost of investment. This can be considered an impairment indicator which requires the management of Global Plc to test the investment for any potential impairment.

(e) Recommend:

(i) to the management the method available to substantiate the value of the investment in ML , and

(ii) to your audit senior the procedure that he should follow in auditing the investment in ML.

The management will be required to assess the present value of future cash flows to determine the **Value in Use** of the investment or to determine the **Fair Value less cost to Sell** value using valuation techniques. The auditor should discuss with the management the process to determine whether there is a provision required for an impairment to be booked in the financial statements of Global Plc and test the provision for impairment independently. In this scenario, the management and/or auditor may need to use an expert to test the assumptions used in the valuations.

(Total 25 marks)

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