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

# **SUGGESTED SOLUTIONS**

**KB4 – Business Assurance Ethics & Audit**

**June 2017**

## 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.
1.5.2 Assess the adequacy of audit documentation in a given scenario.
Study text reference: Pages 29,67

(a)

(i) **Self-interest threat**

Sarath, who is the husband of the new partner Sujatha, purchases mobile phones from M-Viz (Pvt) Ltd. This could lead to a self-interest threat for Sujatha. Since Sarath purchases goods at the same prices as other customers, it may not constitute a significant threat to independence. However, the magnitude of the purchasing transactions should be assessed. If that results in a threat to independence, then safeguards may be necessary.

(ii) **Familiarity or intimidation threat**

The former audit partner Fernando has joined M-Viz (Pvt) Ltd as the finance director. This may create a familiarity or intimidation threat. If a significant connection still remains between the audit firm and the former partner, no safeguards could reduce the threat to an acceptable level. If there is no significant connection, safeguards can be applied.

(4 marks)

(b) **Safeguards for a self-interest threat**

- Terminating Sarath's business relationship with M-Viz (Pvt) Ltd or reducing the magnitude of the relationship.
- Changing the audit partner of M-Viz (Pvt) Ltd from Sujatha to another partner.

**Safeguards for a familiarity and intimidation threat**

- Modifying the audit plan.
- Assigning individuals to the audit team who have sufficient experience in relation to the individual who has joined the client (i.e. Fernando).
- Having an independent professional accountant review any work performed by Fernando on the current audit of M-Viz (Pvt) Ltd.

(2 marks)

(c) Form and content of audit working papers

- The size and complexity of the entity
- The nature of the audit procedures to be performed
- The identified risks of material misstatements
- The significance of the audit evidence obtained
- The nature and extent of exceptions identified
- The audit methodology and tools used
- The need to document a conclusion or the basis for a conclusion not readily determinable from the documentation of the work performed or audit evidence obtained.

(4 marks)

**(Total: 10 marks)**

## Answer 02

<b>Relevant Learning Outcome/s:</b>
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.
2.2.3 Analyse design, implementation and operating effectiveness of identified controls.
Study text reference: Pages 164 – 167

<b>(a) Control</b>	<b>(b) Test of control</b>
The invoices are matched to the relevant goods received note (GRN) and purchase order (PO).	Select a sample of invoices and check whether there is evidence that they are matched with the relevant GRN and PO.
Batch controls are utilised in the data entry process. This enables data entry errors to be identified and corrected on a timely basis.	Observe the invoice entry process to ensure batch control sheets are being completed and agreed to the batch system report.  With the client's permission, attempt to process a sample of invoices without confirming batch totals. The system should not process the invoices without confirmation of the data.
Invoices are stamped as "recorded" once the invoices are entered into the system. This ensures completeness of data processing and prevents invoices being processed twice, reducing the risk of under or overstatement of trade payables.	Select a sample of invoices recorded in the system and inspect them to ensure they are stamped as "recorded".
The accountant checks and authorises individual payments. Payments should be authorised by a senior member of the finance department to minimise the risk of error or fraud.	For a sample of payments made, inspect the evidence of the accountant's review and authorisation.
Segregation of duties prevents fraud and errors. Payments are made by the cashier and recorded by the purchase ledger executive.	Observe the purchasing system to ensure there is adequate segregation of duties between payment of invoices and recording of payments in the ledger.

Invoices are stamped as “paid” and filed separately from the invoices not yet paid. This prevents invoices being paid twice.  (4 marks)	Inspect a sample of invoices for evidence of the “paid” stamp and ensure they are kept separate from the invoices not yet paid.  (4 marks)
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(c) Control objectives relating to the purchases system of PQR

- To ensure that recorded purchases represent goods and services received.
- To ensure that all purchase transactions that have occurred have been recorded.
- To ensure that recorded purchases represent the liabilities of the entity.
- To ensure that purchase transactions are correctly recorded in the accounting system.
- To ensure that purchase transactions are recorded in the correct accounting period.

(2 marks)

**(Total: 10 marks)**

**Answer 03****Relevant Learning Outcome/s:**

3.6.1 Analyse financial statements using analytical procedures, to identify any unusual relationships which require further investigation.

Study text reference: Page 230

(a)

For the year ended	2016	2015	Variance	
	(Rs. '000)	(Rs. '000)	(Rs. '000)	%
Revenue	11,430	10,205	1,225	12%
Cost of sales	(8,860)	(8,980)	(120)	- 1.3%
Gross profit	2,570	1,225	1,345	
Administrative expenses	(350)	(352)	(2)	-1%
Selling and distribution expenses	(511)	(465)	46	10%
Finance expenses	(426)	(560)	(134)	- 24%
Profit/(loss) before tax	1,283	(152)	1,435	
Gross profit margin	23%	12%		
Net profit margin	12%	-2%		

(4 marks)

(b) **Risk areas that require further audit work**

- Revenue has increased by 12%, but cost of sales has decreased by 1.3%. We would expect an increase in revenue to be matched by a corresponding increase in cost of sales. This could indicate a risk in revenue recognition, incorrect revenue cut off or recording of sales that may not have occurred. Further, it could also indicate an error in the valuation of closing inventory. Given that the company lost orders from its main customer, it is doubtful whether revenue could have increased by 12%.
- Gross profit ratio has increased from 12% to 23%. The auditor will need to focus on this change, which would involve significant focusing on the revenue and cost of sales figures, to establish the reasons for the increase.
- Administrative expenses have decreased by 1% when there is an increase in salaries by 10%, which is unusual. Therefore the auditor is required to pay attention to the administrative expenses.
- Finance expenses have decreased by 24% though the company obtained a loan from a bank and interest was payable immediately after the disbursement. Therefore, the auditor is required to check the accuracy of the calculation and accounting of the interest expense.

(6 marks)

**(Total: 10 marks)**

## Answer 04

Relevant Learning Outcome/s:
4.8.2 Explain procedures that should be performed to reduce the risk arising from related party transactions.
4.10.2 Explain the use of Computer Assisted Audit Techniques (CAAT) in performing audit procedures.
Study text references: Pages 461, 318

(a)

Person/entity	Related party	Why	Transaction
Silva	Yes	Chairman/Director	No transactions mentioned
Ramani	Yes	Director	No transactions mentioned
Porcelain Works (Pvt) Ltd	Yes	Director has controlling interest	Purchase of raw materials

(4 marks)

(b) **Information relevant to identifying the risks associated with related parties**

- Enquire from management and directors whether transactions have taken place with related parties, which are required to be disclosed by the disclosure requirements applicable to the entity.
- Review prior-year working papers for names of known related parties.
- Review minutes of meetings with shareholders and directors and other relevant statutory records such as the register of directors' interests.
- Review accounting records for large or unusual transactions or balances, in particular transactions recognised at or near the end of the financial period.
- Review confirmations of loans receivable and payable, and confirmations from banks. Such a review may indicate the relationship, if any, of guarantors to the entity.
- Review investment transactions, for example purchase or sale of an interest in a joint venture or other entity.
- Enquire the names of all pension and other trusts established for the benefit of employees and the names of their management and trustees.
- Enquire the affiliation of directors and officers with other entities.
- Review the register of interests in shares to determine the names of principal shareholders.
- Enquire from other auditors currently involved in the audit, or predecessor auditors of their knowledge of additional related parties.
- Review the entity's tax returns, returns made under statute and other information supplied to regulatory agencies for evidence of the existence of related parties.
- Review invoices and correspondence from lawyers for indications of the existence of related parties or related party transactions.

(4 marks)

(c) **Benefits of using audit software to perform tests on computer files and databases**

- Audit software can perform calculations and comparisons more quickly than those done manually.
- Audit software makes it possible to test more transactions than when simply manually scanning printouts. For example, audit software may facilitate searches for exceptions, such as negative or very high quantities, when auditing inventory listings. This additional information will give the auditor increased comfort that the figure being audited is reasonably stated.
- Audit software may allow the actual computer files (the source files) to be tested from the originating program, rather than the printouts from spool or previewed files that are dependent on other software (and therefore could contain errors or have been tampered with following export).
- Using audit software is likely to be cost-effective in the long term if the client does not change its systems.

(2 marks)

**(Total: 10 marks)**



## Answer 05

Relevant Learning Outcome/s:
4.13.1 Assess events and conditions that may cast significant doubt about the going concern assumptions.
5.6.1 Analyse non-complex audit engagements and determine whether emphasis of matter or other matter should be included.
Study text reference: Pages 477, 480, 504

(a) **Reasons for uncertainty over going concern**

- QS has lost its market leadership because a successful competitor has emerged with an ERP solution at a competitive price. Therefore there is a decline in turnover, which casts doubt about the going concern of the business.
- Existing shareholders have declined to invest further in QS. If the new investor also refuses, QS may not be able to purchase the new ERP solution.

(4 marks)

- (b) There is a material uncertainty regarding going concern, which has been disclosed in the financial statements. In this situation, the opinion on the financial statements will be unmodified but the auditor's report will include an emphasis of matter paragraph, which is an explanatory paragraph detailing the uncertainty.

(4 marks)

- (c) The company prepares financial statements in accordance with two accounting frameworks. The auditor is required to report on both sets of financial statements.

- The auditor shall include an "other matter paragraph" as it is relevant to the users' understanding of the audit and auditor's responsibilities. The other matter paragraph should state that the auditor has issued an audit report on the financial statements for the year ended 31 March 2017 prepared based on another GAAP.
- The auditor shall include an "emphasis of matter paragraph", which will refer to the paragraph that describes the basis of accounting (Swiss GAAP)

(2 marks)

**(Total: 10 marks)**

## SECTION 2

### Answer 06

Relevant Learning Outcome/s:
1.4.1 Explain the type of matters that should be communicated through an engagement letter.
3.4.2 Discuss the factors or conditions generally present in a fraud situation.
2.1.1 Discuss the key aspects of corporate governance, including responsibilities of the Board and role of non-executive directors.
Study text references: Pages 55, 105 – 108, 266 – 267

(a) **Items that should be included in the audit engagement letter**

- Objective and scope of the audit of the financial statements.
- Responsibilities of the auditor.
- Responsibilities of the management.
- Identification of the applicable financial reporting framework for the preparation of financial statements.
- Reference to the expected form and content of any reports to be issued by the auditor.
- Statement that there may be circumstances in which a report may differ from its expected form and content.
- Other points may also be included e.g. basis for fees, use of experts etc.

(5 marks)

(b) **Fraud red flags**

- The CEO and CFO insist on attending all the meetings between the audit committee and the external or internal auditors.
- Internal audit operates under very restrictive management conditions as the CEO determines the scope of internal audit.
- There are large and unusual journal entries during the last quarter, increasing the value of closing stock and reducing the cost of sales. The CFO and accountant are unable to explain the transactions and the entries approved by the CEO.
- Internal audit department is under-staffed.

(4 marks)

(c)

<b>Fraud risk factor</b>	<b>Conditions/factors in the fraud triangle</b>
A very small internal audit department without sufficient experience.	Opportunity
Internal audit department lacks independence and direct access to the board of directors.	Opportunity
Ability to make exceptions to the accounting and control procedures.	Opportunity
Internal audit department mainly tests internal controls from an operating perspective rather than testing controls related to financial reporting.	Opportunity
The CEO is a dominant and controlling person having close relationships with senior managers.	Opportunity
The bonus incentive in the compensation package for the CEO and CFO are tied to profit targets.	Incentive/Pressure/Motivation
Management performance is measured in terms of year-over-year revenue growth.	Incentive/Pressure/ Motivation
Need to meet loan covenants of the bank loan.	Incentive/Pressure/ Motivation
The attitude that actions can be justified for the greater good of the company.	Attitude/Rationalisation
Excessive interest by the CEO in increasing TM's share price.	Attitude/Rationalisation

(6 marks)

(d)

Internal audit can play a key role in assessing and monitoring internal control policies and procedures by:

- In effect, acting as the auditors for the board by reviewing reports not audited by the external auditors.
- Being the experts in fields such as auditing and accounting standards of the company and assisting in the implementation of new standards.
- Liaising with external auditors, particularly where external auditors can use internal audit work and reduce the time and, therefore, cost of the external audit.

(6 marks)

(e) **Limitations of the internal audit function**

- Internal auditors are employed by the organisation and this can **impair their independence and objectivity** and the ability to report fraud/error to senior management because of perceived threats to their continued employment within the company.
- To ensure transparency, best practice indicates that the internal audit function should have a **dual reporting relationship**, i.e. report to both management and those charged with governance (the audit committee). If this reporting structure is not in place, management may be able to unduly influence the internal audit plan, scope, and appropriate reporting of issues.
- Internal auditors are **not required to be professionally qualified** (as accountants are) therefore there may be limitations in their knowledge and technical expertise.
- Even if they are professionally qualified, due to the perceived lack of independence compared to external professionals, internal audit work would not be accepted on many assignments where the interested party is an external stakeholder.

(4 marks)

**(Total: 25 marks)**

## Answer 07

Relevant Learning Outcome/s:
4.11.1 Outline substantive audit procedures to be performed in relation to account balance and classes of transactions.
4.12.1 Outline procedures required to identify events occurring between the date of financial statements and the date of the audit report.
4.6.3 Explain different methods used for selecting samples in audit sampling.
Study text reference: Pages 298, 313, 449, 450 – 451, 472 – 474, 486 – 487

- (a)
- At the planning stage (preliminary analytical review)
  - During the audit testing stage (substantive procedures)
  - At the final review stage (final analytical procedures)
- (3 marks)
- (b) In this scenario the engagement team has used Monetary Unit Sampling (MUS). MUS is a type of value-weighted selection in which sample size, selections and evaluation result in a conclusion in monetary amounts.
- MUS is a more appropriate sample selection method in this case, compared to other sample selection methods (random, haphazard, systematic, block). One benefit of this approach in defining the sampling unit is that audit effort is directed to the larger value items because they have a greater chance of selection, and therefore it can result in smaller sample sizes.
- However, this sampling method does not cover the credit balance of trade debtors and debtors less than Rs. 750,000. There can be errors in unchecked balances.
- (5 marks)
- (c) The customer has filed the legal case on 30 October 2016, which is prior to the year-end date. The court has issued the order to pay on 30 April 2017. Therefore there is evidence of conditions that existed at the financial year-end and before the issuance of the financial statements. As a result, this is an adjusting event and requires a provision in the financial statements. The treatment by the management is correct.
- (4 marks)
- (d)
- Understand the management procedures to identify subsequent events.
  - Inquire from management and those charged with governance (where appropriate) as to whether any subsequent events have occurred, which might have affected the financial statements. Obtain written representations from management.
  - Read the minutes of meetings held with the entity's shareholders, management and those charged with governance after the date of the financial

statements, and inquire about matters discussed at the meetings for which minutes are not yet available.

- Read the entity's latest subsequent interim financial statements.
- Obtain the current status of any litigation and claims to the date of the auditor's report from the entity's lawyers.
- Review bank statements after the balance sheet date to identify major cash payments and receipts.
- Review journal entries after the balance sheet date for evidence of significant adjustments/write-offs that relate to the audit period or those which could affect the financial statements.
- Review government regulations, laws and policies newly introduced, which will impact the entity.

(5 marks)

(e)

- Obtain a copy of the court order or other documents that confirm that the company is liable to pay for damages (*Existence*).
- Ensure the provision is accurate and complete in relation to the amount specified by the court order (*Completeness and accuracy*)
- Review management and board minutes discussing the legal case.
- Check the subsequent payments to the other party.
- Obtain written representation from the management regarding the provision.

(4 marks)

(f)

- Check whether the method used to calculate the provision is in accordance with the measurement basis specified in the relevant financial reporting framework.
- Check the accuracy of data used for the calculation.
- Check the reasonableness of assumptions used for the calculation.
- Check if the process and methods used for making inventory provisions are consistent with the prior period audit.
- Test the reliability and completeness of the reports (e.g. inventory sub-ledger or other detailed listing, age of the slow-moving items) used to assess the provision for slow-moving, excess, obsolete, scrapped or damaged items (E.g. ensuring IT general controls' comfort over IT systems used for inventory management).
- Check if slow-moving, excess, obsolete, scrapped or damaged inventory items are omitted from the detailed analysis by checking the information gathered during the physical verification of inventory.

(4 mark)

**(Total: 25 marks)**



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