THE INSTITUTE OF CHARTERED ACCOUNTANTS OF SRI LANKA

SUGGESTED SOLUTIONS

KB4 – Business Assurance Ethics & Audit

December 2017

SECTION 1

Answer 01

Relevant Learning Outcome/s: 1.1.1 and 1.3.1
1.1.1 Demonstrate the need to comply with the fundamental and ethical principles applicable to all members of the Institute of Chartered Accountants of Sri Lanka. 1.3.1 Demonstrate the legal and regulatory factors affecting an audit of financial statements.
Study text reference: Pages 24 and 48

(a)

- Whether the interests of all parties (including affected third parties) could be harmed if the client or employer consents to the disclosure of information by the professional accountant.
- Whether all the relevant information is known and substantiated, to the extent that it is practicable. When the situation involves unsubstantiated facts, incomplete information or unsubstantiated conclusions, professional judgment shall be used in determining the type of disclosure to be made, if any.
- The type of communication that is expected and to whom it is addressed.
- Whether the parties to whom the communication is addressed are appropriate recipients.

(b) According to the Code of Ethics for Professional Accountants issued by CA Sri Lanka, a professional accountant has an obligation to respect the confidentiality of the information about the employer's affairs. However, he can disclose such information if he is given specific authority to disclose such facts or if there is a legal or professional duty or right to disclose such facts. In this scenario, the finance manager is required by law to submit such information. Therefore, he has to submit the required information to SLAASMB.

(c)

- Member of CA Sri Lanka
- Registered auditor

(Total: 10 marks)

Answer 02

Relevant Learning Outcome/s: 2.1.1 and 2.1.2
2.1.1 Discuss the key aspects of corporate governance, including responsibilities of the Board and role of non-executive directors. 2.1.2 Explain the need for an audit committee, including the benefits of an audit committee to the shareholders of a listed entity.
Study text reference: Pages 86 and 96-99

(a)

- Every public company should be headed by an effective Board, which should direct, lead and control the company.
- There are two key tasks at the top of every public company – conducting the business of the Board, and facilitating executive responsibility for the management of the company's business. There should be a clear division of responsibilities at the head of the company, which will ensure a balance of power and authority, such that no one individual has unfettered powers of decision.
- The chairman's role in preserving good corporate governance is crucial. As the person responsible for running the board, the chairman should preserve order and facilitate the effective discharge of Board functions.
- The Board should ensure the availability within it those with sufficient financial acumen and knowledge to offer guidance on matters of finance.
- It is preferable for the Board to have a balance of executive and non-executive directors, such that no individual or small group of individuals can dominate the Board's decision taking.
- The following also can be considered:
  - ➢ The Board should be provided with timely information in a form and quality appropriate to enable it to discharge its duties.
  - ➢ There should be a formal and transparent procedure for the appointment of new directors to the Board.
  - ➢ All directors should be required to submit themselves for re-election at regular intervals, and at least once in every three years.
  - ➢ Boards should periodically appraise its own performance in order to ensure that its responsibilities are satisfactorily discharged.
  - ➢ Shareholders should be kept advised of relevant details in respect of directors.
  - ➢ The Board should be required, at least annually, to assess the performance of the CEO.

(b)

- Assist Board oversight of the preparation, presentation and adequacy of disclosures in the financial statements, in accordance with Sri Lanka Accounting Standards.
- Assist Board oversight of the company's compliance with financial reporting requirements, information requirements of the Companies Act and other relevant financial reporting related regulations and requirements.

- Assist Board oversight of the processes to ensure that the company's internal controls and risk management procedures are adequate to meet the requirements of the Sri Lanka Auditing Standards.
- Assist Board oversight of assessing the company's ability to continue as a going concern in the foreseeable future.
- Assist Board oversight of the independence and performance of the company's external auditors.
- Making recommendations to the Board, pertaining to appointment, re-appointment and removal of external auditors and to approve the remuneration and terms of engagement of the external auditors.
- Discussion of the audit plan, key audit issues and their resolution, management responses and the proposed remuneration of the auditor.
- Discussion of the company's annual audited financial statements and quarterly financial statements with management and the auditor.
- Discussion of the company's earnings press releases and financial information and earnings guidance provided to analysts and rating agencies.
- Discussion of policies and practices with respect to risk assessment and risk management.
- Ensuring that a process of sound system of internal control is in place.
- Ensuring that an effective internal audit function is in place.
- Meeting separately, periodically, with the management, auditors and internal auditors.
- Establishing mechanisms for the confidential receipt, retention and treatment of complaints alleging fraud received from internal/external sources and pertaining to accounting, internal controls or other such matters.
- Assuring confidentiality to whistle-blowing employees.
- Setting clear hiring policies for employees or former employees of the auditors, and reporting regularly to the board of directors.

(c)

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

(Total: 10 marks)

Answer 03

Relevant Learning Outcome/s: 2.2
Control activities in different business process - Design effectiveness - Implementation - Operating effectiveness
Study text reference: Pages 145, 164 and 165

(a)

(i) **Control weaknesses**	(ii) **Potential implications**
There is no three-way matching of the supplier invoices with the goods received note and the approved purchase orders.	In the absence of the three-way match, it is not possible to ensure that the invoices (goods) paid for are the same goods ordered and received. As such, the purchases, stocks and trade payables may be misstated.
At stores, there is no indication that staff receiving the goods check them with the PO approved.	There is no comfort that what they have received is what was ordered. Transactions may be invalid. There is opportunity for fraud.
Mathematical accuracy of the supplier's invoice is not verified by the accounts department.	Accuracy of the liability/recorded liabilities is affected.
PO is sent to a supplier of the purchasing manager's discretion (i.e. there no approved supplier list).	Opportunity for fraud to take place, chance of selecting unsuitable suppliers.
At the stores level, quality of the goods are not checked prior to raising the GRN.	Goods of poor quality, with incorrect quantities may be accepted to inventory. This would have implications on inventory valuation.
Lack of segregation of duties – store clerk raises the GRN and updates inventory records.	Provides an opportunity to perpetrate fraud as the store clerk is responsible for incompatible functions.

6

(b)

- It should not include language that conflicts with the opinion expressed in the auditor's report.
- It should state that the accounting and internal control systems were considered only to the extent necessary to determine the auditing procedures to report on the financial statements, and **not** to determine the adequacy of internal control for management purposes or to provide assurances on the accounting and internal control systems.

- It should state that it discusses only deficiencies in internal control, which have come to the auditor's attention as a result of the audit, and that other deficiencies in internal control may exist.
- It should also include a statement that the communication is provided for use only by management (or another specific named party).

(Total: 10 marks)

Answer 04

Relevant Learning Outcome/s: 3.1.4, 3.2.1 and 3.5.1
3.1.4 Identify the procedures used in risk assessment. 3.2.1 Demonstrate the difference between risks of material misstatements at financial statement level. 3.5.1 Assess the appropriateness of different benchmarks when calculating the level of materiality.
Study text reference: Pages 205, 223 and 233

(a)

- Helps the auditor to ensure key areas more susceptible to material misstatement are adequately investigated and tested during the audit.
- Helps identify low risk areas where reduced testing may be appropriate, thereby ensuring time is not wasted by over-testing these areas.

(b) Audit risks	(c) Audit procedures
Misstatement of revenue	Test the recorded sales to invoices/payments made by the customer while checking the accuracy of the pricing used, and check that the sale recorded on the system matches the invoice amount that was paid by the customer.
Misstatement of costs of goods sold and indirect expenses	Substantively trace costs to invoices. Analytical procedures comparing movements to the prior year and validate explanations for reductions (e.g. trace reduced prices/volumes to invoices)
Misstatement of accounts receivable	Assess post year-end payments received from customers and assess the recoverability of unsettled debts through discussion with management and review of aged listing.
Misstatement of accounts payable/ accruals	Post year-end cash payment/invoice testing to identify potential year-end liabilities settled in the post year-end period to ensure they are recorded/identified at the year-end.

(d)

- ISA 320 includes a number of factors to consider when choosing a benchmark.
- These include the nature of the entity and the industry in which it operates, and whether users focus on particular items in the financial statements.
- Also important is the relative volatility of the benchmark, so some reference to previous periods is common.

Arguments for profit before tax if a candidate mentioned normalised profits

- It is understandable that profit is deemed an important benchmark in a profit-making business.
- However, this can raise a number of questions:
  - What if the profits are very volatile from one year to the next?
  - What if the entity has made a loss in the year?
  - What if the entity has broken-even in the year?
- Some of the problems above are solved by looking at the 'normalised' profits.
- It is also possible to use an average of the benchmark (e.g. the average profit before tax over 3–5 years), which can smooth out the volatility.

Arguments for revenue

- Where materiality would differ widely, even though the scale of the business is largely the same, sometimes auditors simply have to accept that normalised profit may not be appropriate and a different benchmark, such as total revenue, should be used.

The following points cannot be accepted as correct answers.

Arguments against total assets

- *Total assets might be appropriate for an entity with significantly higher values in the balance sheet compared to its income statement (such as an investment property entity). In this case this is not evident.*

Arguments against profit before tax

- *If the candidate has not mentioned normalisation of profits, profit before tax cannot be considered as an appropriate benchmark for calculating materiality due to the significant volatility.*

(Total: 10 marks)

Question 05

Relevant Learning Outcome/s: 3.2.1
Demonstrate the difference between risks of material misstatements at assertion level and risk of material misstatement at financial statement level.
Study text reference: Pages 231-236

(a)

- Risk of material misstatement at the financial statement level refers to risks that relate pervasively to the financial statements as a whole and potentially affect many assertions. Risks of this nature are not necessarily risks identifiable with specific assertions at the class of transactions, account balance, or disclosure level. Rather they represent circumstances that may increase the risks of material misstatement at the assertion level, for example, through management override of internal controls.

- Risks of material misstatement at the assertion level may particularly affect assertions about classes of transactions, account balances, and disclosures.

(b)

- Operations exposed to high competition in the market – in light of the increased competition and the subsequent reduction in selling price, there is an increased risk that UBL is facing going concern difficulties.
- Inability to service debts on time – UBL has not been able to service its loans per repayment schedules. This indicates constraints on the cash flows of the company.
- Changes in key personnel, including departure of key executives – the financial controller has been dismissed and his duties have been allocated between the finance division team, which has increased their workload. This increases the inherent and control risk within UBL as the overworked finance team members may have made errors within the accounting records, and there is no one working in a supervisory capacity.
- Management override of controls – the directors need to reach a profit level of Rs. 50 million in order to receive their annual bonus. There is a risk that they might feel under pressure to manipulate the results through the judgments taken or through the use of provisions.

(c)

- Valuation of inventories – UBL has decreased the selling price of products significantly and there are increased levels of inventory expected at the year-end. It is possible that the selling price may have fallen so that the net realisable value (NRV) of inventory is below cost. LKAS 2 *Inventory* requires inventory to be stated at the lower of cost and NRV. Hence it is possible that inventory is overvalued.

- Warranty provision – due to a change in the material supplier, the quality of products used has deteriorated and this has led to customers claiming their building warranty. If the overall number of people claiming the warranty is likely to increase, then the warranty provision should possibly be higher. If the directors have not increased the level of the provision, then there is a risk that the provision is understated.

- Trade receivables – in order to increase sales, the management has offered extended credit terms to the customers. Hence, it is possible that there may be debtors, which will result in an understatement of the bad debt provision.

(Total: 10 marks)

Answer 06

Relevant Learning Outcome/s: 4.5.1, 4.12.1, 4.9.1 and 4.3.1
4.5.1 Discuss the responsibility of an auditor in the verification of physical inventory. 4.12.1 Outline procedures required to identify events occurring between the date of financial statements and the date of the audit report. 4.9.1 Discuss the use of written representation as audit evidence, including its limitations 4.3.1 Explain the use of external confirmation in gathering audit evidence.
Study text reference: Pages 369, 380, 394, 471-473, 485, 486

(a)

- Review previous year's arrangements.
- Discuss with the management the inventory count arrangements and significant changes.
- Assess the nature and volume of the inventory.
- Assess risks relating to inventory.
- Assess identification of high-value items.
- Assess method of accounting for inventory.
- Assess unit of measurement of inventory.
- Assess location of inventory and how it affects inventory control and recording.
- Assess internal controls and accounting systems to identify potential areas of difficulty.
- Ensure a representative selection of locations, inventory and procedures is covered.
- Ensure sufficient attention is given to high-value items.
- Arrange to obtain from any third parties confirmation of inventory they hold.
- Consider the need for expert help.

(b) To identify inventories that may be worth less than cost, the following work could be carried out.

- Examine the computerised inventory control system and the list of items showing an unacceptably low turnover rate.
- Review the inventory report for items already described as seconds or recorded as damaged.
- Discuss with the management the current position regarding slow-moving inventories, and their plans and expectations in respect of products that may be discontinued.
- At the physical inventory count, look for inventory that is dusty, inaccessible, not moving in general and mark these on the inventory sheets.
- Find out whether any production lines are unreliable and therefore products are frequently returned for repairs, as these may be unpopular.
- Review the trade press or other sources to see whether there are any outdated equipment.

(c)

(i)

- In accordance to LKAS 10 *Events after the Reporting Period*, any events after the period-end and which give additional information of the conditions that existed at the period-end, should result in the adjustment of the related figures
- Per LKAS 2 *Inventory*, inventory held at the period-end and included in the financial statements should be valued at the lower of cost and net realisable value
  Selling of the equipment at Rs. 120,000 in October 2017 is an event after the reporting period, which gives evidence that the realisable value is lower than the cost

(ii) Since the audit has not yet been finalised and the audit report has not yet been issued yet, the value of inventory at the period-end should be reduced by Rs. 600,000 .

(d)

- Written representations are provided by management internal to the organization, and on their own they do not provide sufficient appropriate audit evidence about the issues they relate to. Therefore, they will often need to be corroborated to sources of evidence from third parties.
- However, since in this scenario the management has refused to allow the auditor to confirm the balance and there have been no payments from the debtor for the past nine months, then there is insufficient evidence obtained by the auditor.
- In addition, the fact that management has provided reliable written representations does not affect the nature or extent of other audit evidence to be obtained by the auditor about specific assertions in the financial statements.
- If the representation is written as opposed to oral, then this will increase the reliability as an evidence source.

(e) SLAuS outline what the auditor's response should be when management refuses permission for them to contact third parties for evidence.

- If the management asks the auditor not to seek the confirmation, the auditor shall enquire about the management's reasons for the refusal, and seek audit evidence regarding the validity and reasonableness of the reasons.
- The auditor shall also evaluate the implications of the refusal on the assessment of the risk of material misstatement and on the nature, timing and extent of other audit procedures.
- The auditor shall perform alternative audit procedures to obtain relevant and reliable audit evidence.
- If the auditor concludes that the refusal is unreasonable, or the auditor cannot obtain relevant and reliable audit evidence elsewhere,
  - ➢ the auditor shall communicate with those charged with governance
  - ➢ or consider the implications for the auditor's report

(f) If management does not provide one or more of the requested written representations, the auditor shall:

- Discuss the matter with management.
- Re-evaluate the integrity of management and evaluate the effect this may have on the reliability of representations and audit evidence in general.
- Take appropriate actions, including determining the impact on the auditor's report.

(Total: 25 marks)

Question 07

Relevant Learning Outcome/s: 4.4, 5.5, 3.6 and 1.5
4.4 Discuss the requirements to be considered by an auditor in an initial engagement. 5.5 Analyse a non-complex audit engagement and propose appropriate modifications with sufficient justification. 3.6 Risk of material misstatements 1.5 Audit documentation
Study text reference: Pages 65-66, 203, 320-321 and 506-517

(a)

(i)

- The auditor shall obtain sufficient appropriate audit evidence about whether opening balances contain misstatements that materially affect the current period's financial statements.
- The auditor shall determine whether the prior period's closing balances have been correctly brought forwarded or restated.
- The auditor shall determine whether appropriate accounting policies are consistently applied or changes have been properly accounted for and adequately presented and disclosed.

(ii)

- If the auditor is not able to confirm the opening balance, the auditor shall express a qualified opinion or a disclaimer of opinion
- If the opening balances contain misstatements that materially affects the current year's financial statements, the auditor shall express a qualified opinion or an adverse opinion.
- If the auditor concludes that the accounting policies are not consistently applied in relation to opening balances, or changes have not been properly accounted for and adequately presented and disclosed, the auditor shall express a qualified opinion or an adverse opinion.
- If a prior-period modification remains relevant and material to the current period's financial statements, the auditor shall modify the auditor's opinion on the current period's financial statements accordingly.

(b)

- Examine supporting documents to verify dates of commencement and cessation of activities necessary to construct the building (e.g. planning permission or building plan approval, certificate of completion etc. issued by the local authority), and determine whether the proportion of borrowing costs capitalised is appropriate for capitalisation per accounting policy.
- Compare the balance per the general ledger to the balance per the asset register and call for explanation of any difference.
- Physically inspect the building to confirm that it exists, is in use and in good condition. Confirm all the items in the asset register are physically inspected.
- Re-perform calculation of borrowing costs.

- Examine documents of title for land and building, including the title deeds, land registry certificates, title reports, architects certificate etc.
- Trace costs incurred to supporting documents (e.g. contractor's invoices, other supplier invoices, bill of quantities etc.) to ensure only costs eligible for capitalisation have been included, and capitalisation has commenced and ended appropriately.

(c)

- Depreciation charge/profit before tax
- Deferred tax arising from temporary difference arising on the building
- Retained earnings or accumulated losses brought forward

(d)

The mere fact that the auditor was not able to attend the inventory count is not grounds for qualification. The auditor has to consider if alternative/additional procedures could be performed to ascertain the inventory balance as at the year-end. An example of such a procedure is observing a current physical stock take and test-checking the rollback reconciliation to the year-end inventory quantities. The inventory roll-back reconciliation should be prepared by the management. If the auditor is able to obtain sufficient appropriate audit evidence (as mentioned earlier) regarding the year-end inventory balance, the audit opinion need not be modified.

However, if the management is unable to reconcile the current physical inventory count with the year-end inventory quantities, or significant time has lapsed since the financial year-end, the auditor may have to modify the auditor's report on the basis of the scope limitation. Expressing a qualified opinion or a disclaimer opinion is dependent on the financial impact of the scope limitation, whether it is material and pervasive to the overall financial statements. It is fair to say that the auditor should have explored/exhausted all possible solutions with the management, before deciding to issue a modified audit report.

(e)

- Enables the reporting partner to ensure all planned work has been adequately completed.
- Provides details of the work done for future reference.
- Assists in planning and control of future audits.
- Encourages a methodical approach.
- Provides evidence of the auditor's basis for a conclusion about the achievement of the overall objectives.
- Provides evidence that the audit was planned and performed in accordance with SLAuSs and other legal and regulatory requirements.
- Assists the engagement team to plan and perform the audit.
- Assists team members responsible for supervision to direct, supervise and review audit work.
- Enables the team to be accountable for its work.
- Allows a record of matters of continuing significance to be retained.

- Enables the conduct of quality control reviews and inspections (both internal and external).

(f)

- Matters that give rise to significant risks (as defined in ISA 315).
- Results of audit procedures indicating (i) that the financial statements could be materially misstated, or (ii) a need to revise the auditor's previous assessment of the risks of material misstatement and the auditor's responses to those risks.
- Circumstances that cause the auditor significant difficulty in applying necessary audit procedures.
- Findings that could result in a modification to the audit opinion or the inclusion of an emphasis of matter paragraph in the auditor's report.

(Total: 25 marks)

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