THE INSTITUTE OF CHARTERED ACCOUNTANTS OF SRI LANKA

SUGGESTED SOLUTIONS

KB4 – Business Assurance Ethics & Audit

June 2018

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.
Study text reference – Page 23/26/27

(a) Fundamental principles set out in the Code of Ethics for Professional Accountants;

a. Integrity
b. Objectivity
c. Professional competence and due care
d. Confidentiality and
e. Professional behavior

Ethical and professional issues and measures to be implemented to mitigate any threats to auditor's independence and objectivity are tabulated as follows:

(b) **Issues**	(c) **Safeguards**
Self-interest threat When a firm receives a high proportion of its fee income from Hicro, there is a self-interest threat, as Anthony & Co will be concerned about losing the client. Former Senior in Charge becoming the Accountant of the Hicro	• Reducing the dependency on the client • External quality control reviews • Consulting a third party, such as a professional regulatory body or a professional accountant, on key audit judgments. **For audit staff joining client;** • Modifying the audit plan • Assigning individuals to the audit team who have sufficient experience in relation to the individual who has joined the client Having an independent professional accountant review the work of the former Member of the audit team
Familiarity threat Senior partner of Anthony & Co, Mr. Silva has been the Partner in charge of the audit of Hicro since its incorporation 7 years ago	• Periodic rotation of key members of audit team • Having a professional accountant who was not a member of the audit team to review the work of the senior personnel • Regular independent internal or external quality reviews of the Engagement • Partner rotation – (As per CA Sri Lanka Code of Ethics for Professional Accountants, key audit partner should be rotated after seven years)

Self-review threat Providing other professional services (non-audit) services to audit clients may create threats to the independence of the firm or members of the audit team.	**For non-audit services;** • Use different teams for non-audit services • Independent Partner review of audit and non-audit services

(Total: 10 marks)

Answer 02

Relevant Learning Outcome/s:
3.4.1 Discuss auditor's responsibility for preventing and detecting frauds in an audit of financial statements 3.4.2 Discuss the factors or conditions generally present in a fraud situation.
Study text reference – Page 261/265/267/268

(a) Four (04) red flags of frauds that can be identified in any business organization

- Recent or frequent changes in auditors
- Records of frequent disagreements between management and external auditors
- Evasiveness or hesitancy from management about questions relating to the financial statements
- CEO or CFO insist on attending all meetings between audit committee and the external or internal auditors
- Financial reports are significantly stronger than competitors, with little or no difference in operations
- Overly optimistic shareholder communications or new releases
- Large transactions made at the last minute that result in large revenues showing in quarterly or annual reports
- Pattern of shipping the quarterly or months sales in the last day or last week of the period
- Internal audit operates under very restrictive management conditions
- Changes in the statement of financial position which are unusual, for example delayed accounts payable or receivables growing faster than revenues
- Consistently close or exact match to planned revenues versus actual revenues
- Use of reserves to smooth out earnings
- Significant and frequent changes in estimates with no clear reason
- Management reluctance to adopt recommendations from internal and/or external auditors
- "Window dressing" of financial statements

Asset misappropriation red flags

- Internal controls breakdowns or overrides
- Any process or transaction that is unusual or out of the ordinary, such as invoices signed off by a different person, transaction amounts that are too big (or too small)
- Accounting mistakes or anomalies, such as false documents or mistakes in ledger entries
- Lifestyle changes in employees
- Employees showing behavioral changes or increased stress for no apparent reason
- Tips or complaints from other employees or stakeholders

(b) (i) Three possible fraud risk factors

Internal control breakdown –
- Olivia has the authority to purchase jewelry and sign cheques. These are two incompatible functions. Therefore, should not be performed by a single person. - Inexperienced finance assistant (CA student) working under Olivia would be intimidated by her dominating personality.
Mismatch in lifestyle and income level: - Olivia is always dressed in expensive clothes although she has a low income level. Further she has five dependent children which would further strain her low income. Therefore, the life style of this employee does not match her income level.

(ii)

- The primary responsibility for the prevention and detection of fraud and irregularities rests with management and those charged with governance.

- However, the auditor is responsible for obtaining reasonable assurance that the financial statements taken as a whole are free from material misstatement, whether caused by fraud or error.

- Auditors are required to carry out their audit with professional skepticism and perform risk assessment procedures in respect of fraud. If there is an assessed risk of fraud, the auditor must make suitable responses.

Explaining the responsibility of management
Explaining the responsibility of the auditor
What the auditor should do when there is assessed risk of fraud

(Total: 10 marks)

Answer 03

Relevant Learning Outcome/s:
2.1.1 Discuss the key aspects of corporate governance, including responsibilities of the Board and role of non-executive directors.
Study text reference – Page 83/89/107

(a) Why corporate governance is relevant to the auditor.

A company with good corporate governance is likely to be a well-managed business. It is likely to have strong controls and, in particular, a strong control environment. This in turn reduces risk and will impact on the audit approach. In contrast, risk is increased where corporate governance is weak. The auditor will need to assess this risk as part of the risk assessment process and consider the implications for the audit approach.

(b) Three (03) deficiencies in the proposed board structure of SPL

1) The board of directors of a listed entity shall include at least,
   a. Three non-executive directors; or
   b. Such number of non-executive directors equivalent to one third of the total number of directors, which-ever is higher.

In this case, the total number of directors are 9. However, non-executive directors are only 2 (there should be at least 3 non-executive directors).

2) *Three or 2/3 of non-executive directors appointed to the board whichever is higher should be independent*

In this case, both Mr. Herath and Mr. Pandula are not independent.

Mr. Herath - Close family member of Chief Executive Officer of SPL
Mr. Pandula - Has been employed by the SPL during the period of two years immediately preceding appointment as director.

3) *One non-executive director shall be appointed as Chairman of the audit committee by the board of directors.*

In this case, Ms. Wasanthi is not a non-executive director. (Non-executive directors are directors who do not have day-to-day operational responsibility for the company)

(c) Two (02) factors an entity might consider when assessing the need for an internal audit function.

- The cost of setting up an internal audit department, versus the predicted benefit
- Predicted savings in external fees, where work carried out by consultants will be carried out by the new internal audit department
- The complexity and scale of the organisation's activities, and the systems supporting those activities
- The ability of existing managers and employees to carry out assignments that internal audit may be asked to carry out
- Management's perceived need for assessing risk and internal control
- Whether it is more cost-effective or desirable to outsource the work
- The pressure from external stakeholders to establish an internal audit department

(Total: 10 marks)

Answer 04

Relevant Learning Outcome/s:2.2
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 2.2.2 Recognise the importance of IT controls in an audit, including IT general controls and IT application controls.
Study text reference – Page 163-169/137-142

(a) Assuming systems and staff are adequate, six improvement to internal controls in the existing procedure of procuring materials for construction and repair of the hotel

1. **Prepare an estimate (Budget)**
2. **Register / book for requisition:**
   - Introduce a register to enter requisition of materials and enter all requests for materials in this register;
   - Enter requests in a chronological (or date) order;
   - When a verbal request for material is communicated, the Accounts Executive needs to enter
     (a) date,
     (b) description of material
     (c) Purpose of the purchase – construction of new extension vs repair
     (d) Estimated quantity and cost of the material in the register,

     and get the Head Workman to initial the entry.

     P.S. Instead of a Register / Book for Requisition, candidates can propose the following as an alternative:

     Head workman submits a **requisition note** to Accounts Executive. The requisition note contains the date, description of material, purpose, required quantity and estimated cost and is initialed by the Head Workman. These notes are **serially numbered** and filed by the Accounts Executive.

3. **Separate Expense codes**: Assign a separate code for construction of new extension, which is capital expenditure and a separate expense code for repair.
4. **Cash cheques –** Cheques should be issued in the name of supplier and crossed as "accounts payee" only. These cheques should be entered in a register to follow up on outstanding purchases. On written request of the supplier the crossing can be cancelled.
5. **Invoices for all purchases:** Each expense needs to be supported by a **supplier's invoice. Cash receipts alone would not be sufficient**.

   Receipt of materials on site: Once materials are delivered by the Head Workman, the Accounts Executive should verify the quantity, price and the condition of the materials supplied prior to release of material to relevant locations with the following:

   (a) Details in the Register (or requisition note)
   (b) Supplier's Invoice,
   (c) Payment Voucher

6. **Settlement of Supplier's Invoice:** Once checked with corresponding documents the suppliers' invoice should be **stamped "PAID" with the date** to evidence monies have already been paid out and to ensure that the payment would not be duplicated/repeated.
7. **Funds released in excess:** Where cash has been released in excess of the actual amounts, **the** Accounts Executive needs to ensure **that** the balance money has been returned and banked intact daily.
8. **Journal Vouchers** should be compared with the Purchase Voucher and date-stamped.
9. **Review by Nora:** An independent review of all payments made at regular interval needs to be performed against original supporting documents (e.g. invoices and cost estimates/budget for construction / repair. Any exceptions need to be followed up with the Accounts Executive without delay.
10. **Advance Payments** to the suppliers should be accounted separately and reconciled regularly.

(b) Two types of IT controls that can be implemented in an IT system.

General controls: These relate to many applications and **support** the **effective functioning** of application controls by helping to ensure the **continued proper operation of information systems**. They commonly include controls over data Centre and network operations, system software acquisition, change and maintenance, access security, and application system acquisition, development and maintenance.

Application controls: The purpose of application controls is to establish **specific control procedures** over the **accounting applications** in order to provide reasonable assurance that **all transactions are authorized and recorded, and are processed completely, accurately and on a timely basis.** These operate at a business process level. They can be preventative or detective in nature and are designed to ensure the integrity of the accounting records.

(Total: 10 marks)

Question 05

Relevant Learning Outcome/s:
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. 5.6.1 Analysis non-complex audit engagements and determine whether emphasis of matter or other matter should be included.
Study text reference – Page 475-482/516-517

(a) The matters that may cast doubt about the going concern of BakeWell.

1. The production of bread is completely dependent on a single Kitchen. In January 2018, the central kitchen has suffered major damage due to floods.
2. This is an uninsured disaster – BakeWell has failed to renew insurance.
3. Kitchen has been operating only at 20% capacity from January 2018 and replacement of assets is expected to take around 3 to 4 months – This is expected to affect a loss of a major market as outdoor catering is its main income stream.

(b) Two (02) key procedures that can be performed to determine whether a material uncertainty exists due to the events / conditions assessed in Part (a) above.

1. Request the management of BakeWell to make its assessment of the entity's ability to continue as a going concern, if this has not been done.
2. Evaluate management's plans for future action;
3. Evaluate the reliability of underlying data used to prepare a cash flow forecast and considering the assumptions used to make the forecast;
4. Considering whether any additional facts or information have become available since the date the management made its assessment;
5. Requesting written representations from management and those charged with governance about plans for future action and the feasibility of these plans
6. Analyze and discuss cash flow, profit and other relevant forecasts with management;
7. Analyze and discuss the entity's latest available interim financial statements (or management accounts)
8. Read minutes of the meetings of shareholders, the board of directors and important committees for reference to financing difficulties;

9. Consider the entity's position concerning unfulfilled customer orders;
10. Review events after the period-end for any developments ;
11. Confirm the existence, terms and adequacy of borrowing facilities;
12. Determine the adequacy of support for any planned disposals of assets.

(c) The impact on the audit opinion on the financial statements of BakeWell for the year ended 31 March 2018 from matters noted in the above scenario.

- The financial and operating conditions may cast doubt about the going concern assumption due to the flood damage to the kitchen. The auditor's report will be affected by the fact that there is an uncertainty affecting the business.

- **Use of Going Concern Basis** of Accounting is **Inappropriate**:
  If, in Peter & Co's judgment, management's use of the going concern basis of accounting in the preparation of the financial statements of BakeWell is **inappropriate**, it has to express an **adverse opinion**;

- **Use of Going Concern Basis** of Accounting is **Appropriate** but a **Material Uncertainty Exists**

  (i) **Adequate Disclosure** of Material Uncertainty is **Made** in the Financial Statements

  Peter & Co will have to decide whether the inherent uncertainty is fundamental to the users' understanding. If so, the auditor's report should include an **emphasis of matter paragraph** beneath the opinion paragraph with details of this matter. It should also state that the auditor's opinion on the financial statements is **not modified** in relation to this matter.

  (ii) **Adequate Disclosure** of a Material Uncertainty is **Not Made** in the Financial Statements

  Peter & Co will have to express a **qualified opinion** or **adverse opinion**, as appropriate depending on its professional judgement.

  And

  In the **Basis for Qualified (Adverse) Opinion** section of the auditor's report, it has to state that a **material uncertainty exists** that may cast significant doubt on BakeWell's ability to continue as a going concern and that the financial statements do **not adequately disclose this matter.**

- An **'other matter'** paragraph should be included in an auditor's report to draw user's attention to the fact there is a new auditor for this year (i.e. last year's financial statements were audited by another auditor).

(Total: 10 marks)

SECTION 2

Question 06

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. 4.1.3 Discuss the audit procedures in relating to the work performed by a management's expert and an auditor's expert. 4.10.2 Explain the use of Computer Assisted Audit Techniques (CAAT) in performing audit procedures. 4.11.1 Outline substantive audit procedures to be performed in relation to account balances and classes of transactions. 4.1.2 Discuss how auditors consider the relevance and reliability of audit evidence. 4.6.2 Explain the meaning of audit sampling.
Study text reference – Page 327-328/348/318/287

(a) Three (03) factors that A&S Co. should consider when placing reliance on the work of Mr. Herath.

1. Auditor should evaluate whether the auditor's expert has the necessary competence and capabilities.
2. Auditor should evaluate the objectivity of the auditor's expert. This will include an inquiry of interest and relationships that would create a threat to objectivity.
3. Auditor should determine the nature, scope and objectives of the work of the expert by obtaining an understanding of the field of expertise of the expert.
4. Auditor should agree the nature, scope and objectives of the work, roles and responsibilities, nature, timing and extent of communications, confidentiality requirements etc. in writing with the expert.
5. Auditor should evaluate the relevance and reasonableness of the expert's work and consistency with the other evidence obtained by the auditor.
6. Auditor should evaluate relevance and reasonableness of any assumptions and methods used by the expert.
7. Auditor should evaluate the relevance, completeness and accuracy of any source data used by the expert.

(b) Acceptability of the accounting treatment adopted by NHL for kitchen equipment.

Kitchen equipment

As the equipment was not actually in the company's possession and available for use at the year-end, the advance paid should not have been accounted under plant and machinery, but rather as a pre-payment. Further, asset cannot be depreciated as it is not available for use by the company during the year.

(c) Three (03) appropriate substantive procedures **each** that you could require to perform in order to verify;

a. Land and buildings
b. New restaurant of NHL.

Land and buildings

- Physical verification of the building.

- Examine documents of title to confirm ownership.
- Enquire about any charges on the building and confirm that these have been properly recorded and disclosed.
- Review the valuer's certificate and agree to the amount used in the financial statements, with consideration also being given to his qualifications, experience and reputation.
- Assess the reasonableness of the valuation by comparison with any similar properties which may have recently changed hands on the open market.

New restaurants

- Physical verification of the asset.
- Get the title of the building confirmed by reference to Central Registry /Land Registry certificate.
- Ascertain and confirm the details of any security granted /mortgage over the asset, ensuring that this is properly recorded and disclosed.
- Review the detailed costings of the building and obtain explanations for any material variances from the original budget.
- Particular care should be taken in assessing the reasonableness of any overheads included as an element of cost.
- Review the depreciation policy for adequacy and consistency.
- Check the compliance with laws and regulations (E.G. Operating licenses)

(d) Three (03) potential advantages of using audit software.

Advantages of using audit software

1. Audit software can perform calculations and comparisons more quickly than those done manually.
2. Audit software makes it possible to test more transactions than when manually scanning.
3. Audit software may allow the actual computer files (the source files) to be tested from the originating program.
4. Using audit software is likely to be cost-effective in the long run if the client does not change its systems.

(e) Four (04) procedures that can be performed using audit software to test revenue and trade receivables of NHL.

- To perform calculations and comparisons in doing analytical procedures over revenue and receivables.
- To compare HMS system and MyAcc system to check all revenue entries in HMS are properly uploaded to MyAcc system.
- Sampling programs to extract data for testing of revenue / receivables, e.g. to select a sample of receivables for confirmation.
- Scan revenue / receivables file to ensure that all documents in a series have been accounted for, or to search for large and unusual items
- Compare data elements in different files for agreement, e.g. prices on sales invoices to authorized prices in master file
- Re-perform calculations, e.g. totaling sales ledger
- Prepare documents and reports, e.g. produce receivables' confirmation letters and monthly statements

(f) **Discuss** the relevance and reliability of the oral representation received from the debtor as a source of evidence to confirm the debtor balance.

Evidence in the form of documents (paper or electronic) or written representations is more reliable than oral representations, since oral representations can be retracted.

(Total: 25 marks)

Question 07

Relevant Learning Outcome/s:
3.6.2 Analyse financial and non-financial information of a given engagement, to identify risk of material misstatements (inherent and control risk). 4.11.1 Outline substantive audit procedures to be performed in relation to account balances and classes of transactions. 5.5.1 Analyse a non-complex audit engagement and propose appropriate modifications with sufficient justification. 1.3.2 Demonstrate an auditor's responsibility and requirements in complying with laws and regulations 4.6.2 Explain the meaning of audit sampling.
Study text reference – Page 208-220/288/506/276/277/278/312

(a) Six (06) key audit risks that should be considered when planning the audit of STC.

1) Revenue has increased by 34%, but the relative increase in cost of sales is only 18%. There could be a risk that sales are overstated or have not been recorded in the proper period. Gross profit margin has increased from 26% to 35% which could indicate a risk that costs of sales are understated, or sales are overstated.
2) There is a significant increase in property, plant and equipment. Further, a revaluation surplus has been recorded in the statement of profit or loss.
3) There is a risk that additions to property, plant and equipment are overstated due to inclusion of revenue items (repairs) that should have been expensed.
4) The increase in trade receivables of 39% could suggest overstatement of receivables due to cut off errors or irrecoverable debts not provided Trade payable has fallen despite the increase in trading activity. This would indicate payables are understated due to cut off errors.
5) Inclusion of additional production overhead to closing inventory by the finance director would suggest a risk possible overstatement of inventory.
6) Legal case in relation to gratuity payments and under/non-payment EPF balances would suggest a risk of understatement of expenses and liabilities.
7) Investment in Xiyo carrying at cost and the company's inability to provide information on its carrying value would suggest that there a risk of overstatement of investments due non- provision of impairment.
8) Fraud risk indicators – Unaccounted major repairs, sales related bonus.

(b) For the issue noted in relation to investment in Xiyo Ltd;

(I) Procedures the audit team should perform in order to resolve the issue.

(II) The impact on the audit report if the issue remains unresolved.

(I) **Audit evidence -**

- Auditors need to establish whether there is any alternative evidence that can be used to support the carrying value.
- Auditors need to obtain the last financial statements issued by Xiyo and review the net asset position of the company.

(II) **Impact on audit report –**

- If there is no alternative evidence available then there is an insufficient appropriate audit evidence regarding the carrying value of the financial investment in the balance sheet amounting to Rs. 6,450 million.
- The maximum impairment is Rs. 6,450 million which would reduce the net assets of the company and increase the loss by that amount.
- This would lead to an "Except for" limitation in scope qualification.

(c) The responsibilities of management and auditors of STC in relation to compliance with law and regulations under SLAuS 250 - *Consideration of Laws and Regulations in an Audit of Financial Statements*.

- It is the management's responsibility to ensure that the entity complies with the relevant laws and regulations.
- It is not the auditor's responsibility to prevent or detect non-compliance with laws and regulations.
- The auditor's responsibility is to obtain reasonable assurance that the financial statements are free from material misstatements and, in this respect, the auditor must take into account the legal and regulatory framework within which the entity operates.

(d) Three (03) audit procedures that should be performed by the auditor in relation to non-compliance with laws and regulations by STC.

- Obtain an understanding of the nature of the act and circumstances.
- Obtain further information to evaluate possible effect on financial statements.
- Discuss with management and those charged with governance.
- Consider the need to obtain legal advice if sufficient information is not provided and
- The issue is material.
- Evaluate the effect on the auditor's opinion if sufficient information is not obtained.
- Evaluate implications on risk assessment and reliability of written representations.

(e)

How sampling risk affects the sample size

The greater the sampling risk the greater the sample size required for a given population. The auditor must ensure that the sample size selected will provide sufficient evidence to reduce sampling risk to an acceptable level.

(Total: 25 marks)

Notice of Disclaimer

The answers given are entirely by the Institute of Chartered Accountants of Sri Lanka (CA Sri Lanka) and you accept the answers on an "as is" basis.

They are not intended as "Model answers', but rather as suggested solutions.

The answers have two fundamental purposes, namely:

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.

The Institute of Chartered Accountants of Sri Lanka (CA Sri Lanka) makes no warranties with respect to the suggested solutions and as such there should be no reason for you to bring any grievance against the Institute of Chartered Accountants of Sri Lanka (CA Sri Lanka). However, if you do bring any action, claim, suit, threat or demand against the Institute of Chartered Accountants of Sri Lanka (CA Sri Lanka), and you do not substantially prevail, you shall pay the Institute of Chartered Accountants of Sri Lanka's (CA Sri Lanka's) entire legal fees and costs attached to such action. In the same token, if the Institute of Chartered Accountants of Sri Lanka (CA Sri Lanka) is forced to take legal action to enforce this right or any of its rights described herein or under the laws of Sri Lanka, you will pay the Institute of Chartered Accountants of Sri Lanka (CA Sri Lanka) legal fees and costs.