THE INSTITUTE OF CHARTERED ACCOUNTANTS OF SRI LANKA

# SUGGESTED SOLUTIONS

## 23404 – Advanced Audit and Assurance

CA Professional (Strategic Level II) Examination
December 2014

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

**General comments**

Generally there had been an improvement in overall performance. However there is much room for improvement with regard to application of theoretical knowledge. A significant number of candidates do not read the question and the scenario in detail, resulting in answers which lack focus.

Most of the candidates demonstrated subject knowledge, application skills and ability to communicate ideas with clarity and capacity to answer what the examiner expected. However, some candidates did not keep up to the challenge. Poor marks were obtained by candidates due to;

- Failure to read and understand the question and plan the answer accordingly
- Inability answer what the examiner expected
- Demonstration of lack of technical knowledge, practical knowledge or commonsense
- Illegible handwriting

## Answer No. 01

(a)

(i) Goodwill on Freightexpo requires attention due to continuing losses, and inherent risk/judgment and/or estimations involved in auditing goodwill.

(ii) Group seems to have different reporting dates, therefore special attention in auditing consolidation adjustments is required.

(iii) Obtaining evidence on cost of investment - difficult area due to inherent risk

(iv) Fair value of investment property requires special attention due to judgment and/or estimations involved.

(v) Special attention may be required for compliance with covenants or borrowing conditions) on bank loan.

(vi) Recognition of deferred tax asset due losses increasing and judgment and/or estimations involved in auditing the same.

(vii) Staff loans and impairment due to retrenchment

(viii) Related party disclosures due to existence of ultimate controlling party and disclosures.

(ix) Revenue recognition – overstatement of profits.

(x) Variances in accounts receivable, inventory, cash and cash equivalents, accounts payable.

(18 marks)

(b) Tax services to be done by partners and staff other than the audit team, independent review by another partner.

(4 marks)

(c)

- Appropriate qualifications - Is the valuer a member of a recognised professional body, for example a nationally or internationally recognised institute of registered surveyors?
- Appropriate experience - Does the valuer possess any necessary license to carry out valuations for companies?

- How long has the valuer been a member of the recognised body, or how long has the valuer been licensed under that body?
- Relevant experience in property being valued - How much experience does the valuer have in providing valuations of the particular type of investment properties held by Consolexpo group?
- Relevant financial reporting purpose valuations. Does the valuer have specific experience of evaluating properties for the purpose of including their fair value within the financial statements?
- Independence - Does the valuer have any financial interest in Consolexpo group, e.g. shares held directly or indirectly in the company?
- Independence - Does the valuer have any personal relationship with any director or employee of the group?
- Independence - Is the fee paid for the valuation service reasonable and a fair, market based price and not contingent upon the valuation?

(5 marks)

(d) Matters to be considered:

- Whether the cost of investment is complete (inclusive legal fees etc.)
- Whether the cash has actually been paid.
- Accounting treatment in respect of consideration.
- Whether the targets have been achieved, accuracy of projectors and forecasts.
- Gathering of audit evidence in the following areas:
  - Agreement of the monetary value and payment dates of the consideration per the client schedule to legal documentation signed by vendor and acquirer.
  - Bank statement and cash book prior to year end - If payment occurs, after year end confirm that a current liability is recognised on the individual company and consolidated statement of financial position (balance sheet).
  - Board minutes approving the payment.
  - Re-computation of discounting calculations applied to deferred and contingent consideration.
  - Agreement that the discount rate used is pre-tax, and reflects current market assessment of the time value of money (e.g. by comparison to weighted average cost of capital).
  - Revenue and profit projections for the post balance sheet period, checked for arithmetic accuracy.
  - A review of assumptions used in the projections, and agreement that the assumptions are comparable with the auditor's understanding.

(5 marks)

(e)
- Audit procedures to ensure the appropriate reporting period (as there are different reporting ends) and corresponding dates are tallied.
- Audit procedures to ensure inter group transactions are eliminated in the relevant period.
- Audit procedures to disclose related party transactions.
- Audit procedures to make sure special areas are appropriately dealt within SLFRS; Deferred tax, consolidated goodwill and impairment of financial assets.
- Ensure accounting policies are consistently applied.

(3 marks)
(Total: 35 marks)

**Examiners' comments**

Part (a) - Most of the candidates have identified the risk areas straight from the scenario given, but they were not successful in reasoning out as to why they treat them as risk areas, for example;

- Goodwill - due to continuing losses, audit of goodwill requires estimation and judgment
- Determining fair value of investment property requires estimation and judgment
- Recognition of deferred tax assets requires estimation and judgment
- Compliance with covenants - special attention is required

Most of the candidates have written going concern issue as a risk area despite the note in the question that Freigtexpo Ltd will not face any going concern issue.

Part (b) - This question was well answered by almost everyone.

Part (c) - Most of the candidates have categorised the answer under the following three inquiries:

- Qualification
- Experience
- Independence

The reasons given were not satisfactory and there were irrelevant answers such as;

- The nature scope and objective of the valuer
- The significant assumptions and findings
- The understanding of the work to be performed
- The publications of the valuer

Part (d) - The correct approach should have been to identify evidence with regard to;

- the completeness of the cost of investment - cash payment, agreement ,payment dates, legal fee, and the board approval.
- accuracy in measurement, assumptions, profit projections, the arithmetic accuracy of payment consideration including deferred and contingent consideration, and discounting calculations.

Common answers were;

- Check board minutes
- Review assumptions in projections
- Check agreement
- Check bank statements

The candidates have not clearly understood the question on evidence. They wrote the audit checks instead of evidence. They should be mindful when planning the answer to present according to the specific question being asked.

Part (e) - As it carries only three marks, most candidates had written answers such as;

- ensure the appropriate reporting period
- ensure disclosure of related parties
- ensure accounting policies are consistently applied

However, there were some irrelevant answers such as;

- To determine the accuracy of calculation of minority interests despite the question mentioning that the subsidiaries are fully owned.
- To ensure that the component auditor is competent.

**Answer No. 02**

(a)

| | **Parent** | **Subsidiary A** | **Subsidiary B** | **Subsidiary C** | **Group** |
|---|---|---|---|---|---|
| Profit/(loss) before tax in Rs. million | 200 | Small % of PBT | Small % of PBT | Small % of PBT | 700 |
| *Suggested basis for materiality* | *Small % of PBT* | *Small % of PBT* | *Small % of net assets or other earnings measure* | *Small % of PBT* | *Small % of PBT* |

As the group does not have intercompany transactions, PBT as given can be used to set the materiality. For this purpose, 5% to 10% (or small percentage) of PBT may be appropriate for all components other than the loss making subsidiary. For that, an appropriate earning basis, such as gross margin, turnover or net assets can be used to base the materiality.

(5 marks)

(b) As Subsidiary B is not in Sri Lanka, the following can be concerns:

- Differences in the financial reporting framework applied in preparing the financial statements of the component and that applied in preparing the group financial statements.
- Differences in the auditing and other standards applied by the component auditor and those applied in the audit of the group financial statements.
- Independence of component teams.
- The process of translating the financial information of foreign component into the currency of the group financial statements.

(5 marks)

(c)

- Related party relationships known to the group auditor - as the group is ultimately controlled by the Perera family, this fact should be communicated to the component auditors to give due consideration.
- As there is an acquisition during the year, the methodology to be used for impairment testing of goodwill should be communicated.
- Audit of estimates of goodwill depends on the assessment of FV of assets and liabilities of the acquiree, hence the precaution for management bias in accounting estimates that affect the group should be communicated.
- Ethical requirements that are relevant to the group audit and in particular the independence requirement.

(7 marks)

(Total: 17 marks)

**Examiners' comments**

Part (a) - It is expected to discuss an appropriate basis of materiality for each of the component of the group. Majority of the candidates have identified profit before tax as an appropriate basis of materiality for the components other than the foreign subsidiary. They have identified the applicable small percentage 5% - 10%. The candidates were unable assess that the profit before tax is taken as appropriate as there is no intercompany transactions. Most of the candidates have recognised Subsidiary B as a loss making company and net assets as the most appropriate basis, but they were unable to identify earning basis, gross margin and turnover as appropriate basis of materiality.

Part (b) - This part was poorly answered. The candidates should plan their answer based on the scenario without in isolation. Most of the answers were irrelevant such as;

- Acquisition result insignificant goodwill
- Related party transactions
- Professional competence of the component auditor

Part (c) - Candidates were expected to state three considerations to be communicated to the component auditor. This is based on SLAuS 315. The most of the candidates have ignored the fact that the considerations to be informed to the component auditor are known only to the group auditor such as;

- the methodology used for impairment of goodwill
- related party transactions
- assessment of fair value of assets
- management bias

Most of the candidates had written common considerations such as;

- group management assessment of the risks that the group financial statements may be materially misstated as a result of fraud
- effectiveness of the internal control system
- non-compliance with the laws in Sri Lanka and Bangladesh

**<u>Answer No. 03</u>**

(a) <u>Support letters</u>

A support letter/comfort letter is a formal letter issued by the parent/fellow subsidiary assuring that it would financially or otherwise support a subsidiary with cash flow or other operational problems. The subsidiary with going concern issues should obtain a letter of support in order to prove its ability to continue its trading/operational existence. For those entities, the going concern basis is only applicable if they have the support from the parent/fellow subsidiaries.

The support letter should usually be approved by a board minute of the parent company or any person authorised to do so by the board of directors.

The support letter should also confirm that the parent is able to support the subsidiary (e.g. by way of the parents' cash flow forecasts).

The support letter will be issued with limited period validity. The period of support may be limited (e.g. to one year from the date of the letter or until the date of disposal of the subsidiary).

Sufficient other evidence concerning the appropriateness of the going concern assumption must therefore be obtained where a later repayment of material debt is foreseen. The fact of support and the period to which it is restricted should be noted in the financial statements of the subsidiary.

(5 marks)

(b) (i) **Going concern issue of MAC Ltd**

A qualified opinion/adverse opinion on the ground of disagreement about the appropriateness of the going concern assumption would be required if no support letter has been received.

If adequate disclosure is not made in the financial statements the auditor shall express a qualified opinion or an adverse opinion as appropriate (SLAuS 570, page 674).

However, Snow Group has issued a letter of support to MAC Ltd.

If the letter of support together with management representation is considered to be sufficient to support the appropriateness of the going concern presumption, a qualified opinion will not be necessary, provided that the support is adequately disclosed in a note to the financial statements.

However, if the evidence is sufficient, but the adequate disclosures have not been made in the financial statements, an 'except for' opinion would be required.

If the letter of support does not provide sufficient evidence (e.g. if there are doubts about the parent company's (Snow Group) ability to provide the required finance), the significant uncertainty arising should be disclosed in an emphasis of matter paragraph in the auditor's report. No qualification is required in the audit report.

If the disclosure is not there, express an adverse opinion.

(5 marks)

(ii) **Misstatement of gross profit margin in the directors' report**

The audit opinion states whether the financial statements:

– are presented fairly, in all material respects (or give a true and fair view) in accordance with the Sri Lanka Accounting Standards (SLFRS/LKAS); and
– comply with statutory requirements (where appropriate).

As per SLAuS 720, the auditor has professional responsibility to read other information in the document containing audited financial statements (such as the directors' report) to identify material inconsistencies with the audited financial statements, even though that information is not part of the financial statements prepared under SLFRS/LKAS.

GP margin presentation in the directors' report is a material inconsistency with the financial statements.

If the directors' report is corrected based on the auditors comments, an unmodified auditor's report can be issued.

However, even if the inconsistency is not resolved, the audit opinion cannot be qualified. An 'other matter paragraph' may be used to report on this matter that does not have any effect on the financial statements.

Communicate with governance and describe material uncertainty.

(5 marks)

(Total: 15 marks)

**Examiners' comments**

Part (a) - Most candidates described what was meant by a support letter. Most of the answers stated that the subsidiary with going concern issues should obtain a letter of support in order to prove its ability to continue its operational existence. However, candidates failed to write that;

- It should be approved by the board of directors
- It is issued with a limited period validity

Most candidates also failed to mention the procedure of processing the assessment of a comfort letter.

Part (b) - The candidates were asked as the audit manager whether they agree with the qualified opinion given by the audit senior. Most of the candidates have not looked into the various aspects that the audit manager should look into before qualifying the opinion. Most of the answers were based on the SLAuS 570; 'In the auditors judgment, use of the going concern assumption in financial statements is inappropriate and the auditor shall express an adverse opinion,' and failed to demonstrate their knowledge how the opinion changes if a support letter is available. Some have written that obtaining a letter of support is not adequate evidence and the auditor should assess the financial ability of the group to provide support. It reflected that they were not aware that the letter of support should include a statement confirming the ability to supporting it with cash flow forecasts of the parent company. There were good answers such as;

- Adverse opinion - if support letter is not available
  - Support letter is available but no adequate disclosure in the financial statements

- Except for opinion - Support letter provides adequate evidence but not adequately disclosed in the financial statements

- No qualification - support letter provides adequate evidence, and adequately disclosed in financial statements

- Unmodified opinion with an emphasis of matter paragraph - Material uncertainty exists on the entity's ability to continue as a going concern, adequate disclosure is made about the support letter, but support letter does not provide adequate evidence.

Part (c) - The candidates were required to explain whether they agree with the audit senior ignoring the fact that there is an inconsistency in the directors' report on the gross profit margin. Most of the candidates failed to notice that they are at the final stage of the audit and the audit report has not been issued as yet. Some have mentioned to withdraw from the engagement or withhold he auditor's report, which are not the options. Some candidates were aware that even if the inconsistency is not resolved, the audit opinion cannot be qualified and an 'other matter paragraph' may be used to describe the material uncertainty. Planning of the answer was very poor. The candidates have not read the question properly and written the impact of the inconsistency without giving attention to the impact if the directors agree to change the directors' report

## Answer No. 04

(i) Finance Leases

**Matters to consider**

***Materiality***

Leases have a significant impact to the financial statements and the amount recognised in the financial statement of Prashansa PLC are material.

Leasehold land and buildings - 36% of total assets
Finance lease liability - 32% of total assets

***Lease classification/Accounting treatment***

- Whether the leases are correctly classified as finance and operating lease as per LKAS 17 - The classification depends on whether the risk and rewards have been transferred to Prashansa PLC. The leases should only be recognised in the statement of financial position if it is classified as a finance lease.

  Indicators of risk and rewards being passed to Prashansa PLC would include:
  – Prashansa PLC is responsible for repairs and maintenance of the assets
  – A bargain purchase option exists
  – The lease period is for most of the expected useful life of the assets
  – The present value of the minimum lease payments is substantially all of the fair value of the asset.
  – Whether the amounts capitalised are solely in respect of the buildings element of the leases.

- As per LKAS 17, the land and buildings elements of leases are considered separately for the purposes of lease classification. Each part must be classified as an operating or finance lease in the same way as leases of other assets.

- The impact of the leases on the income statement must be considered. A finance charge should be calculated and expensed each accounting period, using the actuarial method of calculation (or the sum of digits method as an approximation).

- Finance lease assets should be depreciated over the shorter of the lease term and the economic useful life of the asset.

***Presentation and disclosure***

- Current and non-current split of finance lease liability in the statement of financial position.

- Disclosures required as per LKAS 17 in notes to the financial statements.

**<u>Audit evidence</u>**

- ➢ A review of the lease contract (using a copy of the lease obtained from the lessor), including consideration of the major clauses of the lease which indicate whether risk and reward has passed to Prashansa PLC.
- ➢ A calculation of the present value of minimum lease payments and comparison with the fair value of the assets at the inception of the lease (the fair value should be obtained from the lease contract).
- ➢ A recalculation of the finance charge expensed during the accounting period, and agreement of the interest rate used in the lease contract.
- ➢ Agreement to the cash book of amounts paid to the lessor i.e. deposit and instalments paid before the year end.
- ➢ A recalculation of the depreciation charged, and agreement that the period used in the calculation is the shorter of the lease term and the useful life of the assets.
- ➢ Confirmation using the lease contract that the amounts capitalised relate only to the buildings element of the lease.
- ➢ For the land elements which should be treated as operating leases, a recalculation of the lease expense recognised in the income statement (this should be calculated on a straight-line basis over the lease term).
- ➢ A recalculation and confirmation of the split of the total finance lease payable between current and non-current liabilities.
- ➢ A confirmation of the adequacy of the disclosure made in the notes to the financial statements, and agreement of the future payments disclosed to the lease contract.

(9 marks)

(ii) Financial assets

**<u>Matters to consider</u>**

***Materiality***

Financial assets have a significant impact on the financial statements and the amount recognised in the financial statement of Prashansa PLC are material i.e. 12.6 % of total assets.

The gain recognised is material to the income statement i.e. 10.9% of profit before tax.

***Accounting treatment/financial asset classification***

- As per LKAS 39, financial assets must be classified into one of four categories. Prashansa PLC classified it as Fair Value through P&L/Held for trading. To justify the classification as ‘held for trading’, the following points must be considered:

- acquired or incurred principally for the purpose of selling or repurchasing it in the near term, and
- part of a portfolio of identified financial instruments that are managed together and for which there is evidence of a recent pattern of short-term profit-taking.
- classify under current assets as the rates to financial statement describe as held for trading.

***Disclosure***

- Disclosure required under SFRS 7 *Financial Instruments: Disclosures*

- SLFRS 7 contains extensive disclosure requirements in relation to financial assets, including for example, a narrative description of how the risks in relation to the investments are managed and monitored, and quantitative disclosures including sensitivity analysis relating to the market risk associated with the valuation of investments.

**Audit evidence**

- A schedule showing all the investments held in the category, their purchase price and their yearend valuation.

- Agreement of the purchase prices of investments to supporting documentation, e.g. stockbrokers' statements.

- Agreement of the year end valuation for each investment to external sources of information, e.g. stock exchange website, financial press.

- Recalculation and confirmation of the gain recognised in the income statement.

- A review of the internal function which has been set up to manage the investments to confirm that; investments are generally short-term in nature, the investments are managed as a portfolio, and that there is evidence of frequent transactions.

- Confirmation that the other information published with the financial statements, e.g. the operating and financial review, describes Prashansa PLC's investment activities are in line with the classification of investments as held for trading, and refers to the valuation and gain made during the year.

- A review of the proposed note to the financial statements confirming adherence to the disclosure requirements of SLFRS 7, and recalculations of numerical disclosures.

(8 marks)

(Total: 17 marks)

**Examiners' comments**

The question required the candidates to explain key matters of the finance lease and financial assets and to state the audit evidence that is required by the auditor.

(i) Finance Lease

Most of the candidates were aware of LKAS 17 but they were unable to identify the matters under the three aspects, such as materiality, accounting treatment, and disclosure. Some have identified that the finance lease consists of 36% of the total assets and 32% of the total liabilities. There were good answers to describe finance lease such as;

- A lease that transfers substantially all the risks and rewards incidental to ownership of an asset
- Lessee is responsible for repairs and maintenance of the assets
- A bargain purchase option exists
- The lease period is for most of the expected useful life of the asset
- Land and buildings elements of lease are considered separately for lease classification
- Should be depreciated over the useful life of the asset and charge as an expense

Most of the candidates failed to write all the points and obtain full marks. They were unable write the specific audit evidence. Most of the answers were brief such as;

- Lease agreement
- Check cash book, and bank statements
- Board minutes

It reflected that the candidates were not trained to think 'out of the box' and plan their answers.

(ii) Financial assets

It was observed that subject knowledge with regard to financial assets was poor. Candidates knew the relevant reporting standards, such as SLFRS 7 for disclosure and LKAS 39 for recognition and measurement, but lacked the technical content of the standards. Some had written that financial assets must be classified in to four categories and described them but here it is irrelevant as the question has given that it is classified as fair value through profit or loss and categorised under held for trading. They failed to explain the considerations to justify them as held for trading. Despite the question clearly stating that the assets are all investments in listed companies, a large number of candidates had based their answers around investments in properties and some in inventory.

The answers with regard to audit evidence also were inadequate. Most had written audit procedures instead of audit evidence, but they were able obtain marks as they had written as;

- check the purchase price with a schedule of investments
- check the agreement for the purchase price
- check the fair value with CDS reports.

There were irrelevant answers such as call for confirmation from the Stock Exchange Commission, which showed that candidates were not aware of the functions of the Stock Exchange Commission.

**Answer No. 05**

| (a) **Principal Threat** | (b) **Safe guards** |
|---|---|
| **Supiri Limited**<br><br>A **self-interest threat** arises as the fees for the last year audit is still not settled. The auditor's objectivity may get affected thinking that modifying the audit opinion will reduce the possibility of recovering the amounts due from the client. | Discuss the level of outstanding fees with the audit committee or others charged with governance.<br><br>You should request your client to settle immediately the overdue amount and suspend the work of the current audit until the fees are settled.<br><br>If the audit is undertaken leaving fees unsettled, an engagement quality control review should be undertaken.<br><br>If the fees are significant and the fee is in dispute, it is unlikely that any safeguard could mitigate this threat. |
| **Brook Limited**<br><br>**Self- interest and familiarity threats** will arise. Mr. De Silva can influence the outcome of the audit of Brook Ltd. His wife is now a director of the company who owns Brook Ltd. He may apply less scrutiny during the audit and may also be reluctant to issue a modified audit opinion on the financial statements of Brook Ltd. | Mr. De Silva should not continue as the engagement partner. A review of work already undertaken by Mr. De Silva should be done by an independent reviewer. |
| **Three Star PLC**<br><br>A **familiarity threat** arises. Three Star PLC is a listed client and you as the manager had performed the engagement for more than 7 years. As such, the audit manager may trust the client too much. | The firm should consider changing the audit manager from this engagement. If it is not possible, an additional review of the audit manager's work should be performed. |
| **First PLC**<br><br>A **self-review** threat will arise when a firm performs a valuation for the financial statements that is to be audited by the same firm. Any relevant concerns with regard to the valuation will not be raised as it amounts to reviewing the work of the same firm. | If the valuation service involves material amounts to the financial statements, and the valuation involves a material amount of subjectivity, the self- review threat created cannot be reduced to an acceptable level by application of any safeguard. Accordingly such valuation services should not be accepted. |

(Total: 16 marks)

**Examiners' comments**

Most of the candidates had identified the specific threats. The question is to explain, which means means to give the reason for or cause of. However, most of the candidates had not given reasons as to why the threat arises. They have given incomplete answers such as;

- As the fees for the last year not settled
- As Mrs. De Silva is a director of the client's company
- As audit manager has performed the engagement for more than 7 years
- As the same firm has performed the valuation

***Specific comments in relation to each scenario***

Scenario (i) - The candidates had failed to explain if the audit fees are significant what action they should take

Scenarion (ii) - Some had written Mr. De Silva should not continue, and the review should be done by another partner. They have not considered how to mitigate the threat if there is only one partner

Scenario (iii) - Answered well

Scenaion (iv) - Most of the candidates had ignored the scenario where it was mentioned that the investment is significant, if so the payment for valuation service is significant. They have not mentioned that it cannot be reduced to an acceptable level by application of any safeguards.

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