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

# SUGGESTED SOLUTIONS

## **06204 - Audit and Assurance**

Certificate in Accounting and Business II Examination  
September 2014

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

### General Comment

The paper was within the syllabus and based on the content within the study text. There were a few questions on practical issues in order to test the basic knowledge in the application of principles. Students who have not scored at least 30 marks were not prepared for the exam. Their answers were of poor quality. If they had read at least the study text (part I) they could have easily obtained the pass mark.

### Answer No. 01

- (a)
- (i) A three party relationship involving practitioner, responsible party and intended users
  - (ii) An appropriate subject matter
  - (iii) Suitable criteria
  - (iv) Sufficient appropriate evidence
  - (v) A written assurance report in the form appropriate to a reasonable assurance engagement or a limited assurance engagement
- (b)
- (i) Inherent risk
  - (ii) Control risk
  - (iii) Detection risk
- (c)
- (i) Risk of overlooking suspicious circumstances
  - (ii) Risk of over-generalising when drawing conclusions from observations
  - (iii) Risk of using faulty assumptions in determining the nature, timing and extent of audit procedures and evaluating the results thereof
- (d) In a reasonable assurance engagement, sufficient appropriate evidence is obtained as part of a systematic engagement process that includes obtaining an understanding of the engagement circumstances, assessing risks, responding to assessed risks by performing further procedures. However, in a limited assurance engagement, procedures performed are deliberately limited relative to a reasonable assurance engagement.
- (e) **SLAuS 600**
- (i) Whether the component auditor understands and complies with ethical requirements, especially independence
  - (ii) The component auditor's professional competence
  - (iii) Whether the group engagement team will be able to be involved in the work of the component auditor to the extent necessary to obtain sufficient and appropriate audit evidence.
  - (iv) Whether the component auditor operates in a regulatory environment that actively oversees auditors.

- (f) (i) (1) Authority to extend credit terms being given to the marketing manager only
- (2) Sales returns and overdue debtors not considered for incentives
- (ii) (1) Authority to extend credit terms being given to the marketing manager only can lead to sales dumping to achieve targets and issues in settlements by debtors.
- (2) Sales returns and overdue debtors not considered for incentives can lead to regional managers only being interested in selling and not collecting dues, and over-invoicing of goods to earn higher incentives and returning goods in the following month.
- (iii) (1) Credit terms must be pre-agreed and should be altered only if a formal request is received from a client by a credit committee consisting of top management
- (2) Settlement of invoices by clients and sales returns by clients are required to be adjusted to the incentive calculation of sales staff.
- (3) Recovery procedure

## **Examiners' comments**

Part (a) – Candidates were expected to identify the key elements of an assurance engagement. It was pleasant to see almost all the candidates have understood the question and answered well. As the question was to identify the key elements, the candidates did not have to explain their answers; they had to write in point form. Some candidates had wasted their time on explaining the elements of an assurance engagement.

Part (b) - Candidates were expected to list three components of assurance engagement risks. Most of the candidates had understood the question and their answers were of good quality. It reflected that the candidates had the subject knowledge. However, some candidates had explained the components in detail which was not required. Some had written irrelevant answers such as:

- Fundamental risk
- Risk of substantive procedure
- Materiality risk
- Sample test

Part (c) - Candidates were expected to state the risks that can be reduced with an attitude of professional scepticism. Professional scepticism is described as an attitude that includes a questioning mind, being alert to conditions which may indicate possible misstatements due to error or fraud, and a critical assessment of evidence. Only a small number of candidates had answered correctly; their answers were relevant and of good quality. However, about 80% of the candidates had not understood the question, and written irrelevant answers such as the risks of an assurance engagement.

- Inherent risk.
- Control risk
- Detection risk

Part (d) - This question was based on the evidence gathering process of a reasonable assurance engagement and a limited assurance engagement. Almost all the candidates had answered this question. Candidates who had read the study text and the SLAuS have answered well. It reflected that they had planned their question and answered. However, some candidates had written the objective of a reasonable assurance engagement and limited assurance engagement, ignoring the fact that the question was on the evidence gathering process.

Part (e) - This part related to the group audit, and candidates were expected to write matters that are to be considered in getting an understanding of the component auditor. About 50% of the candidates had understood the question and answered well. However, some candidates had written irrelevant answers such as; who appoints the auditor, whether a separate audit report is issued for the component.

Part (f) - This was a practical question on internal control weaknesses, testing knowledge in a real situation. Almost all the candidates had identified the internal control weakness. Although candidates had identified the internal control weakness, they were unable to identify the implication of such weaknesses; they have written that there will be frauds collusion, losses to the company, liquidity problems, and working capital problems. Most of them were unable to identify that as the returns were not considered for incentives, sales can be increased in one month and in the following month the same can be returned.

## Answer No. 02

- (a)
  - (i) To determine the resources to be deployed for specific audit areas (e.g. experience of team members, involvement of experts)
  - (ii) To determine the number or resources to be allocated to each specific audit area
  - (iii) To determine when these resources to be deployed
  - (iv) To determine how such resources are managed directed and supervised
  
- (b)
  - (i) Pressure on sales staff to achieve revenue target. This may lead to incorrect recognition of revenue.
  - (ii) Lack of segregation of duties due to the accountant performing work of the finance manager.
  - (i) Ability, competence of the accountant to perform the tasks of the finance manager with the same due care.
  - (ii) Revenue entries that are passed manually towards the year end.
  
- (c)
  - (i) User's expectations regarding disclosure of certain items.
  - (ii) Industry specific disclosures
  - (iii) Attention focused on a particular aspect of the entity's business that is separately disclosed in the financial statements.
  
- (d)
  - (i) Circumstances beyond the control of the entity
  - (ii) Circumstances relating to the nature or timing of the auditor's work
  - (iii) Limitations imposed by the management
  
- (e)
  - (i) It is more efficient and effective to check 100% than sampling
  - (ii) Some items are always material and therefore no sampling is acceptable
  - (iii) Internal controls are so weak that there is no proper background to use sampling techniques
  - (iv) Auditor may decide sometimes that it should check some items fully
  - (v) High audit risk items and areas
  - (vi) Areas and items where the auditor has past experience of misstatement in the books of account
  - (vii) Population has a small number of large value items
  
- (f)
  - (i) Who appoints the auditor of the component
  - (ii) Whether a separate auditor's report is to be issued on the component
  - (iii) Legal requirements
  - (iv) The extent of any work performed by other auditors
  - (v) Degree of ownership by parent
  - (vi) Degree of independence of the component's management

### Examiners' comments

Part (a) - The question expected to test the benefits to the audit of establishing the audit strategy. About 30% of the candidates had answered how the audit strategy helps the auditor to carry out the audit. They had the subject knowledge and the answers were of good quality.

However, some candidates were unable to understand the question which was on benefits. Some have written that audit strategy sets the scope, timing and direction of the audit that guides the development of audit plan. Some have written about the nature and the extent of resources such as selection of engagement team and assignment of the team members. It reflects that they had the subject knowledge but were unable to organise the answer to the question.

Part (b) - The objective was to test the practical knowledge of the candidates on application of principles. In the given scenario candidates were expected to identify the circumstances that indicate frauds and errors. Majority of the candidates had written good answers. Candidates were able to pick the answers directly from the question such as pressure on the staff to achieve revenue target, and revenue entries are passed manually towards the end of the year. However, there were some irrelevant answers such as;

- Sales staff try to complete contracts with low quality
- Misuse of materials

Part (c) - This part required candidates to state two factors to be considered in determining materiality level of disclosure. It part was poorly answered although it was in the study text. Candidates had ignored the fact that the question is on disclosure, and were unable to identify even examples such as related party, management remuneration, and application of financial reporting framework, laws and regulation, industry disclosure such as research and development and pharmaceutical. Majority wrote irrelevant and incomplete answers such as;

- Nature of business
- Economic environment
- Profit revenue and net assets

Part (d) - This part attempted to test the knowledge of the candidates on modification of the audit opinion. Majority of the candidates had answered well they had written examples such as records of accounts have been destroyed, timing of the appointment was such that the auditor is unable to observe physical count of stocks, management imposes certain limitations such as not allowing requesting for confirmation certificates from external parties.

Part (e) - This part expected the candidates to write instances where sampling is not considered as an appropriate technique in the audit. This is based on study text 1.4.5. Candidates have written answers of good quality.

Part (f) - This part was regarding a group audit where there are many subsidiaries. The question is whether each of these subsidiaries requires a separate engagement letter. Instead of giving factors to be considered whether to send separate letters of appointments to subsidiaries, some have written the content of a letter of appointment. The following irrelevant answers were also noted;

- Check the relationship with the management
- Discuss with the management
- If separate auditors are appointed, separate letters should be sent

**Answer No. 03**

- (a) (i) Integrity  
(ii) Objectivity  
(iii) Professional competence and due care  
(iv) Confidentiality  
(v) Professional behavior
- (b) (i) Scenario 1 – there is a threat of familiarity due to Anuja Perera’s long association with the client.  
Scenario 2 – there is a threat of self-interest due to Anuja Perera’s investments at PIL.
- (ii) Scenario 1 – Anuja Perera can hand over the audit to another partner at Anuja & Co. and stay away from being involved in matters of the said audit.  
Scenario 2 – Anuja Perera should refuse the offer and explain to the management of PIL the reasons for such refusal.

**Examiners’ comments**

This question tested the knowledge on fundamental principles to comply with in accordance with the Code of Ethics. It tested the practical knowledge. Candidates were unable to identify the requirement of informing the management if they refuse to accept the audit. Majority of the candidates got 7 marks out of 10.

**Answer No. 04**

- (a)
  - (i) Whether management has used a management's expert in preparing the financial statements
  - (ii) The nature and the significance of the matter, including its complexity
  - (iii) The risks of material misstatements in the matter
  - (iv) The expected nature of the procedures to respond to identified risks, including the auditor's knowledge of and experience with the work of experts in relation to such matters
  - (v) Availability of alternate sources of audit evidence
  
- (b)
  - (i) Test the additions and extensions of final inventory listings
  - (ii) Ascertain whether the method used to value inventories had been correctly applied in the valuation
  - (iii) Ascertain whether the method used for valuing inventory is an acceptable method of valuation under LKAS 2
  - (iv) Ascertain if the method used for valuing inventory is consistent with the method used in the previous years and the entity's accounting policy
  
- (c)
  - (i) Confirming or discussing specific aspects of the transactions with intermediaries such as banks, lawyers, guarantors or agents where practicable and not prohibited by laws, regulations or ethical rules.
  - (ii) Confirming the purposes, specific terms or amounts of the transactions with the related parties
  - (iii) Where applicable, reading the financial statements or other relevant financial information of the related parties for evidence of the accounting of such transactions in the related parties' accounting records
  
- (d)
  - (i) The objectivity of the internal audit function
  - (ii) The technical competence of the internal auditor
  - (iii) Due professional care demonstrated by the internal auditor
  - (iv) Effectiveness of communication between internal auditors and external auditors.
  
- (e)
  - (i) Examining subsequent cash disbursements
  - (ii) Examining correspondence from relevant parties
  - (iii) Examining other records such as goods received notes
  - (iv) Cutoff procedures
  - (v) Supplier's invoices and returns

### Examiners' comments

Part (a) - This part was on using an expert's work in an audit. About 25% of candidates provided good answers. Some had misunderstood the question. They had written irrelevant answers such as;

- The expert should be qualified, competent and have experience
- Internal control system should be sound
- Relationship with the management
- Time for the audit
- Confidentiality

Part (b) - This part tested the substantive procedures to verify the valuation of stock. It was poorly answered. Most of the candidates had written irrelevant answers such as;

- Physical verification of stocks
- Check GRNs
- Attend verification
- Obtain management representation

Part (c) - This part tested the substantive procedures in order to assess a significant risk that management has not appropriately accounted for or disclosed specific related party transactions. Majority of the candidates had not planned their answers. They had ignored the fact that the management has not appropriately disclosed. They had written irrelevant answers such as;

- Discuss with the management
- Inquire form the internal auditor
- Study the board minutes
- Check the accounts

Part (d) - This part tested the areas that an external auditor is required evaluate in order to determine whether the work of the internal auditor is likely to be adequate for the audit. About 50% of the candidates had answered well, but there were irrelevant answer such as;

- Independence of the internal auditor
- The status, hierarchy in the company
- Whether there are any limitations imposed by the management. Most of the candidates have written professional competence. It reflects that they are of the opinion that technical competence and professional competence are same.

Part (e) - This part tested the audit procedures that an auditor may perform if a response is not received for confirmation request for accounts payable. Majority of the candidates had answered well but there were some irrelevant answers such as;

- Check the age analysis
- Request for confirmations again
- Obtain a written representation from management
- Check records (without specifying the records)

**Answer No. 05**

- (a) Primary objective of quality control for audit work is to provide assurance that audits are conducted in accordance with generally accepted auditing standards, or that the audit complies with professional standards and applicable legal and regulatory requirements, and the report issued is appropriate in the circumstances.
  
- (b)
  - (i) Obtaining an understanding of any procedures management has established to ensure that subsequent events are identified.
  - (ii) Inquiring the management as to whether any subsequent events have occurred which might affect the financial statements.
  - (iii) Reading minutes of meetings of the entity's owners, management or those charged with governance that have been held after date of financial statements
  - (iv) Inquiring about matters discussed at any meeting held after the date of financial statements for which minutes are not yet available
  - (v) Reading the entity's latest subsequent interim financial statements
  - (vi) Reading the entity's budgets, forecasts and other related management reports for periods after the date of financial position
  - (vi) Inquire or extend previous oral or written inquiries of the entity's legal counsel concerning litigation and claims
  
- (c)
  - (i) Analysing and discussing cash flow, profit and other relevant forecasts with management
  - (ii) Analysing and discussing the entity's latest interim financial statements
  - (iii) Re-assessing the terms of debentures and loan agreements and determining if any of them had been breached
  - (iv) Reading minutes of the meetings of shareholders, those charged with governance and relevant committees for reference to financial difficulties
  - (v) Confirming the existence, legality and enforceability of arrangements to provide or maintain financial support with related and third parties and assessing the financial ability of such parties to provide additional funds
  - (vi) Requesting written representation from management, and where appropriate those charged with governance, regarding their plans for future actions and feasibility of such actions
  - (vii) Inquire the legal counsel regarding the existence of litigation and claims and the reasonableness of management's assessment of the outcomes and estimate of financial implications
  
- (d)
  - (i) Discuss the matter with management
  - (ii) Re-evaluate the integrity of the management and evaluate the effect of that on the reliability of representations and audit evidence in general
  - (iii) Take appropriate action, including determining the possible effect on the opinion in the auditor's report

- (e)
  - (i) Obtain evidence that staff only start being paid when they join the company and are removed from the payroll when they leave the company
  - (ii) Confirm that procedures are operating for authorising changes in rates of pay, overtime and holiday pay
  - (iii) Check that the wages and salary summary is approved for payment
  - (iv) Check calculation of wages and salaries are being reviewed
  - (v) For wages - check calculation of gross pay with authorised rates, production records, time cards, etc.
  - (vi) For salaries - verify that gross salaries and bonuses are in accordance with contracts of employment and increases are properly authorised
  - (vii) When overtime payments are made, check if overtime work has been authorised by a responsible officer

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### **Examiners' comments**

Part (a) - This part tested the primary objective of quality control for audit work. Although the correct answer should be that the audit complies with professional standards and applicable legal and regularity requirement and the audit report is issued in appropriate circumstance, most of the candidates had misunderstood the question and written about the overall objective of the auditor such as obtaining reasonable assurance about whether the financial statement as a whole are free from material misstatement.

Part (b) - This part tested the audit procedures that an auditor may perform in order to identify all events occurring between the date of financial statements and the date of the auditor's report that may require adjustments or disclosure in the financial statement. Most of the candidates had answered well. However, some had written irrelevant answers such as;

- Discuss with the internal auditor
- Check invoices
- Check whether included in accounts

Part (c) - This part tested audit procedures that would be performed by the senior in charge to determine whether or not material uncertainty exists for the company to continue as a going concern. As candidates were expected to state only two procedures which carried two marks each, most of the candidates were able to score marks satisfactorily. However, there were some irrelevant answers such as;

- Check operational expenses
- Check the approval from management

Part (d) - This part tested the actions that the auditor could take when management does not provide the requested written representation. This was answered well. However, some candidates had written irrelevant answers such as;

- Collect further evidence

Part (e) - This part tested the test of controls. It was disappointing that the candidates were unable to understand test of controls. They have written the audit procedure which should be carried out at the assertion level (substantive procedure). There were only a few good answers. Most of the answers were irrelevant, for example;

- Do a sample check of vouchers
- Reconcile salary payment with salary register
- Compare payroll with last year payments
- Check the payment of EPF and ETF
- Comparison of payment of salaries with control sheets

**Answer No. 06**

- (a) (i) Independence from management  
(ii) Experience and stature  
(iii) Extent of their involvement and scrutiny of activities  
(iv) Information they receive  
(v) Interaction with external and internal auditors
- (b) The auditor provides a report of factual findings of agreed upon procedures. Therefore no assurance is provided.
- (c) (i) It is a foundation for safe and sound operations of an organisation  
(ii) Contributes to the accomplishment of the organisation's goals and objectives  
(iii) Contributes to the accomplishment of organisation's long term profitability targets  
(iv) Contributes to the maintenance of reliable financial and managerial reporting  
(v) Contributes to compliance with laws, regulations, policies, plans and internal rules and procedures  
(vi) Decrease the risk of unexpected losses  
(vii) Decrease the risk of damage to the organisation's reputation
- (d) (i) Entity follows common policies and procedures for systems development  
(ii) Internal and/or external auditors are involved in the development  
(iii) Proper user, systems operator and programme documentation is provided for each application
- (e) An advanced system contains one or more of the following characteristics:
- Telecommunications
  - Extensive database systems
  - Online real time processing
  - Distributed data processing
  - Automatic transaction initiation and EDI
  - No visual audit trail

### **Examiners' comments**

Part (a) - This tested the assessment of the control environment. It was about the attributes of the board of directors. However, most of the answers were irrelevant such as;

- Organisation structure
- Management philosophy
- Human resource policies

Part (b) - This part required the candidates to explain the manner in which assurance is provided in an agreed upon procedure. Candidates had written answers with quality. Some candidates had referred the SLAuS and written relevant answers.

Part (c) - This part tested the benefits of having an internal control system. Candidates had written certain answers though relevant are not the exact answer according to the SLAuS and study text. For example;

- Safeguard of assets
- Detect frauds and errors
- Maintain accurate financial records

Part (d) - This part carried two marks and questioned the general controls expected to be seen in the development of a new EDP system. It tries to test the general knowledge and see if candidates can think out of the box. Majority of the candidates had not answered well.

Part (e) - This part required candidates to list characteristics of an advanced EDP system. About 5% of the candidates had answered well. The rest of the answers were very poor.

### Answer No. 07

- (a)
  - (i) The auditor's assessment of risk is judgmental and so may not identify all risks of material misstatements
  - (ii) There are inherent limitations to internal control including management override
  
- (b)
  - (i) The auditor's conclusion whether sufficient appropriate audit evidence has been obtained
  - (ii) The auditor's conclusion whether uncorrected misstatements are material individually or in aggregate
  - (iii) The auditor's evaluation whether the financial statements are prepared in all material respects in accordance with the requirements of the applicable financial reporting framework
  - (iv) The auditor's evaluation whether the financial statements adequately refer to or describe the applicable financial reporting framework
  
- (c)
  - (i) Inspecting the documents of title (e.g. patent, license, etc.)
  - (ii) Examining evidence of expenditure incurred such as purchase details
  - (iii) Reviewing board minutes – inquire from reliable sources.
  - (iv) Performing a search for unrecorded liabilities
  - (v) Assessing whether there was any expenditure that should have been capitalised as intangible assets but expensed to the income statement
  
- (d)
  - (i) Report by management or those charged with governance
  - (ii) Financial summaries or highlights
  - (iii) Employment data
  - (iv) Planned capital expenditure
  - (v) Financial ratios
  - (vi) Names of officers and directors
  - (vii) Selected quarterly data
  
- (e)
  - (i) Evaluate whether the summary financial statements adequately disclose their summarised nature and identify the audited financial statements
  - (ii) When summary financial statements are not accompanied by the audited financial statements, evaluate whether they describe clearly from whom or where the audited financial statements are available
  - (iii) Evaluate whether the summary financial statements are prepared in accordance with the applied criteria
  - (iv) Evaluate whether the summary financial statements adequately disclose the applied criteria
  - (v) Compare the summary financial statements with the related information in the audited financial statements to determine if the summary financial statements agree
  - (vi) Evaluate whether the audited financial statements are available to the intended users of summary financial statements without undue delay

### **Examiners' comments**

This question was not attempted by many candidates. The answers of the candidates who did answer, were of poor quality.

Part (a) – This part tested the reason as to why substantive procedures are required. It was poorly answered. Some candidates had written,

- To identify risk of material misstatement

They were unable to write the important item that the auditor's assessment of risk is judgmental and because of that, substantive procedures are required to identify material misstatements.

Part (b) - This part tested the factors that may be taken into account by the auditor in determining whether financial statements are free from material misstatements. This is based on the auditor's evaluation and conclusion.

Part (c) – This part required the candidates to explain substantive procedures to ensure existence and the completeness of intangible assets. The candidates had not answered well they had written about checking of fixed assets, such as physical verification.

Part (d) - This question was on the other information to be contained in the document containing financial statements. Candidates had written irrelevant answers. It reflects that they had not seen an annual report of an entity. As the area is covered in the end of syllabus, candidates would not have studied this section.

Part (e) - The objective of this question is to test the knowledge of the candidates on the audit procedure in collecting evidence to support the opinion on the report on summary financial statements. This is also covered in the syllabus in the latter part. Majority of the candidates were unaware of summarised financial statements. It reflects that they had not seen the annual reports of entities.

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