

## **Business Level**

### **Business Assurance, Ethics and Audit**

#### **(Pilot Paper)**

#### **Instructions to candidates**

- (1) Time allowed: 3 hours
- (2) Section 1: 5 questions – **all questions are compulsory**  
Section 2: 2 questions – **both questions are compulsory**
- (3) Answers to questions should be in the answer booklet provided to you. Begin each answer on a separate page.
- (4) All answers should be in **English**.

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June 2015

## SECTION 1

*All five questions are compulsory.  
Total marks for Section 1: 50 marks.  
Recommended time for the Section is 90 minutes.*

### Question 01

You are the audit senior of A&W Co, a local firm of chartered accountants. You are currently assisting planning for the audit of Hi Tech PLC, which has been an audit client for the last nine years.

The principal business activity of Hi Tech is the distribution of computers and accessories. The Company has introduced a special offer to its employees where employees can purchase lap top computers at 20% below the market price and settlement can be made within a period of 2 years. The Company has 10 distribution warehouses. You were informed that three members of your staff who participated in the physical verification of stock were offered laptops at the same discount and the credit period applicable to the Company's employees. Mr. Rajeev has been the engagement partner from the inception of the audit.

#### **Required:**

- 1. Analyze** ethical threats to the independence of your firm from the above facts in relation to the audit of Hi Tech PLC.  
**(6 marks)**
  - 2. Outline** 3 safeguards that can reduce the above threats to an acceptable low level.  
**(4 marks)**
- (Total 10 marks)**

### Question 02

Steel Made (Pvt.) Limited is a 50 year old company that manufactures and distributes stainless steel cookware for both local and export markets. The Company has 3 manufacturing locations and employs more than 5,000 employees. Mr. Demin Fernando, a visionary entrepreneur and the founder of the Company, is determined to double the size of the Company during the next ten years. It is expected to expand the Company's manufacturing capacity and establish its own retail distribution outlets. Funds for the expansion will be mainly sought from the public via an Initial Public Offer which is expected to be made during early 2015. The Company has revalued its properties for the year ended 31/03/2014 which resulted in a significant revaluation surplus.

At a recent management meeting, the finance director presented an investigation report conducted by the internal audit division highlighting fraudulent transactions relating to payroll processing. According to the internal audit report, the payroll clerk whose primary responsibility is to process salaries had misappropriated cash by activating resigned employees records in the computer system, processing salary for the resigned employees and changing bank accounts of such employees.

At the meeting, the finance director explained the need to strengthen the internal controls and governance practices of the Company.

**Required:**

1. **Discuss** two main reasons for establishing an audit committee for Steel Made. **(2marks)**
  2. **Explain** two benefits of establishing an audit committee for Steel Made. **(3 marks)**
  3. **Discuss** based on the above scenario, two main fraud risk factors that could constitute risk of material misstatements in financial statements. **(5 marks)**
- (Total 10 marks)**

**Question 03**

The audit working paper given below relates to the audit of HelaOsuPharma (Pvt.) Limited for the financial year ended 31/03/2014. The audit report was signed off on 17/08/2014.

## HelaOsuPharma (Pvt.) Limited

Prepared by: SXdeS

10/07/14

Reviewed by: PPD

19/07/14

Lead Schedule		
Inventory "000"	2013/14	2012/13
Total cost as per GL	835,000	520,000
As % of total assets	6%	4%
Cost as per age analysis	785,000	510,000

*Note: The significant increase in the inventory balances due to the new method of valuation used.*

**Audit Objectives:** Accuracy and valuation

**Risk identified at planning stage:**

High risk of overstatement due to expired drugs, considered to be a significant risk.

**Audit procedures performed:**

- Physical count was not carried out, as the Company has a perpetual inventory system.
- According to the schedule provided by the client, expired stock is not significant.

**Result and Conclusion:**

The difference between the age analysis and the GL is due to some journal entries passed directly in to the system. The finance manager stated that the GL balance is accurate and the difference has no P&L impact. No other exceptions were noted.

**Required:**

1. **Discuss** whether sufficient and appropriate evidence have been obtained in relation to the audit of inventory of HelaOsuPharma.  
**(6 marks)**
2. **Assess** the adequacy of audit documentation in relation to audit of inventory.  
**(4 marks)**

**(Total 10 marks)**

#### Question 04

You are the senior auditor assigned to Design World, a limited liability company that manufactures furniture. Audit for the financial year ended 31/03/2013 was performed by another firm of chartered accountants and your firm was appointed as the external auditor for the year ended 31/03/2014. The Company's total assets as of 31/03/2014 amounted to Rs. 150 Mn and the Company has reported a net profit before tax of Rs. 7.5 Mn for the year then ended. The information given below relates to the audit of Design World for the year ended 31/03/2014.

Date	Event
10/04/2014	Bankruptcy of a major distributor with an outstanding balance of Rs. 3 Mn on the balance sheet.
25/05/2014	Financial statements are approved by directors.
27/05/2014	Auditor's report is signed.

#### Required:

- 1. Analyze** the above scenarios to determine whether they constitute adjusting events or not. **(6 marks)**
  - 2. Outline** two procedures that you would perform with regard to the bankruptcy of the distributor. **(4 marks)**
- (Total 10 marks)**

#### Question 05

You are the senior auditor responsible for finalising the audit of Star Limited, a large cotton mill which produces knitted fabric from imported yarn. Star Limited reported a net profit before tax of Rs. 20 Mn for the financial year ended 31/03/14 (Rs. 18 Mn in 2013). Total assets of the Company as at 31/03/14 stood at Rs. 150 Mn (Rs. 138 Mn in 2013).

During the course of physical verification of inventories, you noted that there were two containers containing fabric located outside the warehouse. Further inquiry from the warehouse assistant revealed that these stocks were produced 13 months before for a major buyer and the order was cancelled due to a difference in the required product specification. The accountant stated that the Company is expecting a future order from the buyer for this stock and it had been valued at a cost of Rs. 3.5 Mn. The accountant agreed to provide a written representation from the CEO that the stock will be sold to the customer during the next six months.

**Required:**

1. **Explain** the main difference between an emphasis of matter and other matter.

**(3 marks)**

2. **Analyze** the above information in arriving at whether the audit opinion on Star's financial statements for the year ended 31<sup>st</sup> March 2014 should be modified.

**(7 marks)**

**(Total 10 marks)**

## SECTION 2

*Both questions are compulsory.*

*Total marks for Section 2: 50 marks.*

*Recommended time for the Section is 90 minutes.*

### Question 06

You are the audit senior responsible for the audit of Milk Made Lanka (Pvt.) Limited, a leading manufacturer and distributor of milk products. Approximately 80% of the Company's revenue is derived from sale of milk powder whilst the balance represents other dairy products such as milk packets, set yoghurt, stirred yoghurt, curd, and fruit yoghurt which are made from local milk processed in the Company's liquid plant. Milk powder for branded products is imported from the parent company in Australia and processed in the packing and blending plant. More than 60% of sales are made through a network of distributors who take the Company's products on consignment basis.

During the kick-off meeting with the audit partner, the following points were discussed. Most of these matters came to light from the meeting the partner conducted with the CEO Mr. Ernest Perera.

- The Company is under intense pressure in selling its products at the prevailing prices controlled by the Consumer Affairs Authority (CAA) given the increased cost of sourcing and processing its products.
- During July 2013, the Company publicly announced a potential food safety issue with several batches of milk products and initiated a precautionary product recall. All distributors were requested to take the recalled products to their custody.

Draft financial statements of the Company for the year ended 31/03/2013 are given below.

<b>Income statement</b>			
	Notes	<b>2013 Draft</b>	<b>2012 Actual</b>
		<b>Rs.'000</b>	<b>Rs.'000</b>
Revenue		200,750	413,850
Cost of sales		(175,450)	(280,450)
Gross profit		25,300	133,400
Other income		17,800	7,200
Administration expenses		(18,100)	(16,900)
Distribution expenses		(28,150)	(30,300)
Finance expenses		(6,150)	(10,450)
Profit before tax		(9,300)	82,950
Income tax expense		(22,200)	(23,850)
<b>(Loss)/ Profit for the period</b>		<b>(31,500)</b>	<b>59,100</b>

<b>Balance sheet</b>			
	Notes	<b>2013 Draft</b>	<b>2012 Actual</b>
		<b>Rs.'000</b>	<b>Rs.'000</b>
Assets			
Non-current assets			
Property, plant and equipment	i	317,500	296,250
Investment property	ii	30,850	20,250
		348,350	316,500
Current assets			
Inventories		75,150	53,950
Trade receivables		96,550	55,150
Other financial assets	iii	22,009	18,000
Cash and cash equivalents		25,700	43,000
Total current assets		219,409	170,100
<b>Total Assets</b>		<b>567,759</b>	<b>486,600</b>
Equity and Liability			
Stated capital		150,000	150,000
Revaluation		25,000	
Retained earnings		43,750	134,350
		218,750	284,350
Non-current liabilities			
Provisions	iv	50,050	20,700
Gratuity	v	23,400	28,500
Loan payable		96,509	70,000
Total non-current liabilities		169,959	119,200
Current liabilities			
Trade payables	vi	66,750	45,900
Tax payable		15,200	12,150
Other financial liabilities		97,100	25,000
Total current liabilities		179,050	83,050
<b>Total equity and liabilities</b>		<b>567,759</b>	<b>486,600</b>

#### Notes

- i. Investment property consists of land purchased in February 2013 for developing dairy cows which is expected to take place in the near future. The board has performed a valuation and the land is recognized at fair value as at 31/03/2013.
- ii. Revaluation represents the market value of land and building relating to liquid plant.



- iii. Other financial assets include prepayments and investments in Treasury bonds.
- iv. Provision has been made for expected machine overhaul cost which is approved by the board as a part of the annual budget.
- v. Gratuity provision is estimated by the accountant based on the provisions of the Gratuity Act.

**Required:**

In assisting in the planning of the audit of Milk Made Lanka (Pvt.) Limited:

1. **Outline** four possible departures from financial reporting frameworks which could materially affect the financial statements.  
**(8 marks)**
  2. **Analyze** the financial statements of Milk Made using analytical procedures to identify a minimum of four unusual relationships which are to be addressed in audit planning.  
**(8 marks)**
  3. **Explain** two business risks which could result in risk of material misstatements.  
**(4 marks)**
  4. **Outline** a minimum of three audit procedures to be performed on the precautionary product recall.  
**(5 marks)**
- (Total 25 marks)**

**Question 07**

You are the audit senior responsible for evaluation of the internal controls of Speedy Food (Pvt.) Limited. Speedy Food offers a variety of food and beverages through its online business where customers can directly select their menu from the website or via phones. Customers can choose to pay online by credit card or by cash on delivery. Approximately 90% of the sales consist of web orders. If customers are paying by cash, they can pay the amount to the driver on delivery.

When the customer places an order, order information including price, item and quantity required are stored in the orders pending file. Orders placed via phones are updated manually in the pending order file.

### **Online ordering**

The website ordering system is a locally developed one and is linked to the sales and inventory modules which are linked to the general ledger through an interface. At the time of placing an order the customer is given a unique reference number (Order ID) which needs to be keyed in by the customer at the time of accepting the delivery as evidence of acknowledgement of the ordered items.

Once the credit authorization is obtained the sales amount is transferred to the computerized confirmed customer order book. Reimbursement of the sales amount is obtained from each credit card company on a monthly basis, less the appropriate commission charged by the credit card company.

During this year, the web order system has been modified to identify customers who have placed orders exceeding Rs. 100,000 during the previous two months. Such customers are automatically categorized as VIP and a 20% discount is applied at the time of processing the invoice.

### **Updating the ledger**

At the end of each day the total from the confirmed customer order book is transferred to the general ledger as a batch process. An exception report is generated when there is an error in transferring sales information to the general ledger. Furthermore, batch controls are in place to ensure the accuracy and completeness of information transferred.

### **Distribution centre**

Speedy Food has a distribution centre which is open 24 hours. Employees in the distribution centre are committed to make their deliveries within an hour, if the customer is located within 20 Kms of the distribution centre. The distribution centre uses a separate application system which is linked to the sales order system from which online transfer of confirmed order information takes place. One powerful advertising slogan of the Company is “delivering on time or return 200%” where the Company has undertaken to refund 200% if the delivery is not made within half an hour.

Customers can directly enter their claims in the online claim register. Past experience shows that the actual claims represent 2 to 4% of sales. Once the goods are delivered the customer has to key in the order ID at the point-of-sale input device that the driver carries. When the correct order ID is entered the pending order file is updated as delivery completed. The sales manager monitors the pending order files for completeness of deliveries.

The audit team is satisfied with the entity level controls and most of the IT controls have been tested during the previous year. According to the meeting held with the

head of marketing an average customer order brings about Rs. 3,500 net revenue. More than 75% of the increase in new orders is directly attributable to the discount scheme introduced for online orders during the year.

Key financial information relating to revenue and refunds are given below.

<b>Item</b>	<b>2012 Rs.'000</b>	<b>2013 Rs.'000</b>
Revenue	166,500	270,000
Number of online orders	45,000	60,000
Refunds	4,995	16,200

**Required:**

1. **Explain** responsibility of the governance regarding internal controls. **(2 marks)**
  2. **Discuss** the importance of IT general controls in evaluating application controls of a system. **(3 marks)**
  3. **Analyze** the business process of Speedy Food (Pvt) Limited to identify potential risks which could affect the financial statements and related mitigating controls which the auditor could rely on. **(12 marks)**
  4. **Outline** a minimum of four substantive procedures to be performed for revenue, receivables and other related areas. **(8 marks)**
- (Total 25 marks)**