



No. of Pages - 08

No. of Questions - 05

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

**CA PROFESSIONAL (STRATEGIC LEVEL – II) EXAMINATION**

**EFFECTIVE FROM DECEMBER-2012**

**23404 – ADVANCED AUDIT & ASSURANCE  
PILOT PAPER**

Time allowed: 3 hours

Reading time: 15 minutes

Marks: 100 marks

**Instructions to candidates:**

- (1) Answer **all questions**.
- (2) Begin each answer on a **separate page**. Submit **all workings**.
- (3) All answers should be in **English language**, in the **answer booklets** provided.
- (4) The examination will be conducted as an open book examination and the following publications of CA Sri Lanka will only be permitted to be used at the examination hall.
  - Sri Lanka Auditing Standards & Sri Lanka Standard on Quality Control 1-2011
  - Code of Ethics
  - Sri Lanka Other Audit Pronouncement -( Sri Lanka Auditing Practice Statement, Sri Lanka Standards on Assurance Engagement, Sri Lanka Standards on Review Engagement, Sri Lanka Standards on Related Services)
  - Sri Lanka Accounting Standards – 2011
  - Open Book Referential-Student edition (*Code of Best Practice on Corporate Governance, Sri Lanka Accounting Standards- changes with effect from 1/1/ 2012, IFRICs and SICs applicable for financial period beginning on or after 1/1/2012*)
- (5) Students are allowed to bring permitted publications which are highlighted, sidelined, underlined. And also short notes written on the permitted publications will be allowed. Page tabs may be used to refer the pages.
- (6) Candidates should not **include any pre-prepared papers, for example, annotated exhibits with answers, as those materials will not be marked by the examiner.**

### **Question No.01**

Hiru PLC engages in the design, development, and marketing of apparel products worldwide. Its product line comprises of women's and men's denim jeans, pants, shirts, sweaters, jackets, and its new line of other products such as footwear.

The product line of the company has two target markets. The "Comfy" brand which targets the everyday consumer offering family orientated products at mid market prices; and "HI-FI" brand which targets the specialist market for the serious outdoor consumer offering more technical clothing and footwear at a higher price, although sales in this line is not so fast moving. Many sales are based on cash terms.

Hiru PLC sources its products from suppliers based in Europe and, more recently, China. The company sells its products through its own retail outlets and also wholesales to independent retailers.

You being the senior in charge of the audit are preparing for your planning meeting with the Finance Director of the company and have obtained, in advance of the meeting, a copy of the draft financial statements for the year ended 31<sup>st</sup>March 2012. Following your preliminary review, you have identified the following extracts from the financial statements as matters of significance to discuss with the management.

#### **Income statement extracts for Years ended 31<sup>st</sup>March**

	2012 Draft LKR Mn	2011 Actual LKR Mn
<i>Revenue:</i>		
Own retail outlets	530	320
Wholesale	<u>500</u>	<u>430</u>
	<u>1030</u>	<u>750</u>
Cost of sales	(510)	(410)
Gross profit	520	340
Expenses	<u>(460)</u>	<u>(310)</u>
Profit/ (Loss) before tax	60	30
	==	==

### Statement of Financial Position extracts as at 31<sup>st</sup>March

	2012 Draft LKR Mn	2011 Actual LKR Mn
Non-Current assets		
Property plant & equipment	330	200
Investment property	50	50
Current assets		
Inventories	160	150
Trade receivables in wholesale business	50	40
Current liabilities		
Trade payables	70	60
Bank overdraft	78	40

The following information has already been gathered by the audit team.

- As a result of the success of the retailing business, the company has expanded its operations and opened ten additional retail outlets during the year 2012. The overdraft facility was increased to help to fund the expansion.
- The company is currently using upto its overdraft limit as a result of the increased volume of business. The directors are seeking to increase the facility and are negotiating with the company's bankers.
- During the year the company replaced its computer system in order to accommodate the retailing activities and loss in closing inventory. It installed a central computer at head office linked to terminals at its warehouses and retail outlets. The software is an integrated standard package, which includes an inventory control system modified by the supplier to the company's requirements.
- Two buildings owned by the company were revalued during the year 2012, and the results of which were as follows.

	<b>Building A</b> Rs. 150Mn	<b>Building B</b> Rs. (50Mn)
Revaluation surplus/ (deficit)		

Loss on revaluation of building B amounting to Rs.50 Mn has been charged to expenses of the company.

The above two buildings were first revalued in 2009 and a revaluation surplus of Rs.100 Mn (building A) and Rs.20 Mn (building B) was reported then and appropriately recorded in the financial statements.

Further, certain motor vehicles owned by the company have not been depreciated during the year as their fair values exceed carrying amounts due to the recent increase in custom duty on motor vehicles, by the government.

- The investment property (building) shown in the balance sheet was acquired in 2011 and shown at fair value in the 2011 financial statements of the company. During the year a significant portion of the building was taken back from the tenant and a new retail outlet was declared open.
- Trade payables shown above represent the amount payable to main the supplier in China and this amount is to be settled in May 2012. Since the items were purchased from this supplier in January 2012 the resulting liability has been recorded based on the exchange rate prevailed for \$ in January 2012. It was noted that the exchange rate prevailed in the month of January 2012 for \$ was Rs.112, while at the end of the year it was Rs.125. During the period after the date of statement of financial position, exchange rate was approximately Rs.135.

**Requirements:**

(a) Using the above information, identify and explain the key audit issues that should be considered when planning the audit of Hiru PLC. (You are required to provide reasons for considering them as key audit issues. You may consider the business risk affecting the financial statements, risk at the financial statement level and risk at assertion level as well)

(20 marks)

(b) Explain the main audit procedures that you propose to carry out in respect of the key audit issues identified by you.

(15 marks)

(Total 35 marks)

## **Question No.02**

New Concepts PLC has participated in many rounds of discussions about whether to re-appoint a current auditor or adopt a rotation policy. It being a listed company, finally decided to have a policy of putting its audit and related services out to tender every five years. This decision was taken in order to at least bring pressure on an audit fee reduction on the current auditor, whilst keeping the options open for a change in the auditor.

In response to the request for proposals, a number of firms of Chartered Accountants sent in their promising audit and related service proposals. The audit committee of New Concepts PLC recommended that your firm who has now been selected be appointed to provide the following services.

- The statutory annual audit of the annual financial statements
- A limited review of the interim financial information which will be circulated to shareholders together with your firm's independent review report. These statements will be for publication as per the requirements of the Colombo Stock Exchange.
- Consultancy services in respect of the implementation of a new IT system.
- To determine fair value of the financial instruments of the company.

Your firm has not been the auditor of New Concepts before, but does act as auditor for one of its major competitors.

### **Requirements:**

- (a) Identify and explain the *professional and ethical issues* in terms of the Code of Ethics that should have been identified by your firm in relation to the provision of the services, outlined above, to New Concepts PLC. (8 marks)
- (b) Outline the safeguards that should be in place in order to address these issues. (7 marks)

(Total 15 marks)

## **Question No.03**

- (a) You are the senior in charge of the audit of Luxury Cabs (Pvt) Ltd. Luxury Cabs (Pvt) Ltd is based in Colombo and hires luxury motor vehicles to individuals and corporates for short term/ long term periods. The majority of receipts are in cash, with some customers paying by account payee cheques. The main non current assets held by the company are motor cars & motor jeeps.

The company is run by three directors who are also the major shareholders of the company.

The following issue was identified during the audit.

Audit tests on sales indicate a weakness in the internal control system, with a potential understatement of revenue by about Rs. 50 Mn.(approx.) This weakness occurred because sales invoices are not serially numbered, allowing one director to remove cash sales prior to recording them in the books of accounts. This was identified during the analytical procedure for sales, when the audit senior noted, on the days this director was working, sales were always lower than on the days when the director was not working.

- (b) Tharu PLC manufactures and sells Agro Chemicals. You have completed the audit of accounts of Tharu PLC., for the year ended 31<sup>st</sup> March 2012 on April 20<sup>th</sup> 2012 and the audit report will be ready for signature early next week. However, the following additional information on two material events has now been presented to you by the Accountant of the company.

Event 1 - 25<sup>th</sup> April 2012

Inventory valued at Rs. 15,000,000/= has been damaged due to a flood occurred on 25<sup>th</sup> April 2012. According to the insurers damaged inventory is now only worth Rs. 450,000/=. The insurance company has refused to pay the compensation for the damage on the basis that the inventory of the company was underinsured. This entire inventory was in the finished good store as at 31<sup>st</sup> March 2012 and no issues have been made post year end.

Event 2 - 2<sup>nd</sup> May 2012

A bowser carrying chemicals used in the production of agro chemicals has met with an accident and fallen into the nearby river. The Environmental Authority is currently considering whether the release of chemical into the river water was in breach of environmental regulations. The company's insurer has not yet commented on the issue.

For each of the issues above (a and b),

- i. List the audit procedures you would carryout to reach a conclusion on these issues. (12marks)
  - ii. Assuming that you have performed all the audit procedures that you can, the issues are still unresolved, explain the potential effect on the audit report. (8 marks)
- (Total 20 marks)

#### **Question No.04**

You are a partner in a mid tier audit firm located in Colombo. The firm mostly conducts audits of private limited liability companies and partnerships engaged in manufacturing, trading or providing services. The clients mostly use manual accounting systems and basic off the shelf accounting packages.

All partners of the firm have completed their training in the firm, and do not have an extensive knowledge in computer systems and controls. The firm to date has not undertaken an audit of a bank.

You are currently in the process of submitting a fee quotation for the external audit of a large bank listed in the Colombo Stock Exchange. The bank has many branches located across the island and relies heavily on its computer system to handle the volume of transactions. The branches operate independently with deposits and loan files being located at the branch.

The audit has to be completed within 2 months from the year end as the bank has to submit its financial statements to the Regulators.

- (a) Based on the facts given above list the matters of concern that the firm needs to address in undertaking the bank audit. (You may consider the provisions of Sri Lanka Auditing Standards and Code of Best Practice, central bank regulations and any other applicable regulations.) (9 marks)
- (b) State alternate measures the firm could take to overcome the matters of concern listed above. (6 marks)

(Total 15 Marks)

#### **Question No.05**

“Save the poor” (SOP) is a well-known non-profit oriented NGO. It was established in 2008. The SOP’S main aim is to provide support for the poor people affected by the war. SOP has a detailed constitution which explains how the SOP’S income can be spent. The constitution also notes that administration expenditure cannot exceed 20% of the income in any given year. The SOP’S income is derived wholly from the local and international donations. Sources of donations include,

- Cash collected by volunteers asking the public for donations.
- Cheques and the bank drafts sent by international donor agencies.
- Donations from generous individuals and corporate bodies.

Some of these international donations have specific clauses attached to them indicating that the initial amount donated cannot be spent and that the income (interest) from donation must be spent on specific activities.

Cheques received are deposited to the SOP'S bank account and cash collected are not banked and used to meet day to day expenses of the Charity. Occasionally the SOP receives cash cheques and those are encashed by the Accountant. The SOP does not raise receipts for the cash/cheques received.

The Charity does not make cheque payments. All payments are made by cash cheques. The field officers working for the charity are being given advances to make the payments for the projects undertaken by the SOP. Whenever the advance given is finished, field officers visit the head office and collect another advance to be used for the next project. Field officers are supposed to spend the money as per the plan given to them. The programme manager occasionally checks whether the field officers have spent money as per the programme given to them.

**You are required to,**

- (a) Identify the inherent risk in the SOP charity and explain the effect of each of these risks on the audit approach. (12 marks)
- (b) Explain why the control environment may be weak at the SOP. (3 marks)

(Total 15 marks)