

CA



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

# **SUGGESTED SOLUTIONS**

**KE4 – Processes, Assurance & Ethics**

**March 2017**

# SECTION 1

## Answer 01

1.1

<b>Learning Outcome/s: 1.1.3</b>
Define the elements of the external environment that affect business organisations such as political, legal technological, economic etc.
<i>Study text reference: page 18</i>
<b>Correct answer: C</b>

1.2

<b>Learning Outcome/s: 1.2.1</b>
Define the term "risk".
<i>Study text reference: page 27</i>
<b>Correct answer: D</b>

1.3

<b>Learning Outcome/s: 1.5.3</b>
Identify the role of the internal control system in an entity in mitigating risk at the business process level.
<i>Study text reference: page 50/51</i>
<b>Correct answer: A</b>

1.4

<b>Learning Outcome/s: 2.1.1</b>
Identify activities connected with the procurement process, such as vendor selection and evaluation, budgetary controls, placing orders, receiving, payment.
<i>Study text reference: page 78/79/80</i>
<b>Correct answer: A</b>

1.5

<b>Learning Outcome/s: 2.4.1</b>
Identify activities connected with PPE management including: CAPEX budgeting and approval, vendor selection and tender procedures, capitalisation and depreciation, fixed assets register, physical controls, disposal.
<i>Study text reference: page 165</i>
<b>Correct answer: A</b>

1.6

<b>Learning Outcome/s: 2.1.1</b>
Identify activities connected with the procurement process, such as vendor selection and evaluation, budgetary controls, placing orders, receiving, payment.
<i>Study text reference: page 88</i>
<b>Correct answer: D</b>

1.7

<b>Learning Outcome/s: 3.1.1</b>
Recognise the importance of design effectiveness of control in achieving the objectives of a given business process.
<i>Study text reference: page 228</i>
<b>Correct answer: C</b>

1.8

<b>Learning Outcome/s: 4.2.1</b>
State the importance of ethical behaviour for a professional accountant.
<i>Study text reference: page 253</i>
<b>Correct answer: A</b>

1.9

<b>Learning Outcome/s: 5.1.1</b>
Explain the concept of assurance.
<i>Study text reference: page 272/273</i>
<b>Correct answer: C</b>

1.10

<b>Learning Outcome/s: 5.3.1</b>
Discuss the general principles governing an audit of financial statements, such as professional skepticism, professional judgments etc.
<i>Study text reference: page 299</i>
<b>Correct answer: C</b>

**(Total: 20 marks)**

## Answer 02

### 2.1

<b>Learning Outcome/s: 1.1.2</b>
Identify the key business processes in a business organisation.
<i>Study text reference: page 11</i>
<ul style="list-style-type: none"><li>• Inbound logistics (receiving goods)</li><li>• Operations (selling through outlets)</li><li>• Outbound logistics (storing and dispatching to outlets)</li><li>• Marketing and sales</li></ul>

### 2.2

<b>Learning Outcome/s: 1.2.2</b>
Define "enterprise risk management".
<i>Study text reference: page 29</i>
<p>(a) Negative risk – risk that actual events or results will be worse than expected</p> <p>(b) Possible examples: A computer system failure causing unexpected downtime and bringing operations to a halt, labour strike causing a halt of production/operations which will result in losses, quality failure of a product resulting in lower sales</p> <p><i>examples given by candidates)</i></p>

### 2.3

<b>Learning Outcome/s: 1.2.3</b>
Identify elements of enterprise risk management, including risk appetite
<i>Study text reference: page 32/33</i>
<p>(a) Operational risk</p> <p>(b) Compliance risk</p> <p>(c) Reputational risk</p>

### 2.4

<b>Learning Outcome/s: 2.1.2</b>
Identify the documents relating to the procurement cycle, point of origination, flow of documents and purpose.
<i>Study text reference: page 87</i>
<p>(a) Document: Goods received note (GRN)</p> <p>(b) Purpose: This is used to record the goods received/delivered if the delivery is acceptable by the storekeeper</p>

## 2.5

<b>Learning Outcome/s: 5.4.2</b>
Identify the factors that affect auditors' judgment as to what constitutes sufficient appropriate evidence
<i>Study text reference: page 303</i>
The quantity of audit evidence required is affected by the level of risk in the area being audited. It is also affected by the quality of the audit evidence obtained. If the evidence is of high quality, the auditor may need less evidence than if it was of poor quality. However, obtaining a high quantity of poor quality evidence will not compensate for its poor quality.

## 2.6

<b>Learning Outcome/s 1.5.2</b>
Identify the elements of internal control.
<i>Study text reference: page 51</i>
<ol style="list-style-type: none"> <li><b>1. Control environment:</b> This refers to the culture of the organisation and its attitude towards risks. A risk awareness culture is created by the leaders of an organisation who provide an example to all other employees. The effectiveness of an internal control system depends on the attitude to risk and the risk awareness of the people in it.</li> <li><b>2. Risk assessment:</b> This is a process of continually identifying, analysing and evaluating risks. Internal control is concerned with operational risks.</li> <li><b>3. Information and communication:</b> Internal control systems require processes and procedures for the communication of information to relevant people about risks and controls.</li> <li><b>4. Control activities:</b> These are the internal controls that are designed to fulfill a particular control objective.</li> <li><b>5. Monitoring:</b> There should be a process for regular monitoring of the effectiveness of the internal controls and other components in the internal control system.</li> </ol>

## 2.7

<b>Learning Outcome/s: 2.2.2</b>
Identify the documents relating to the payroll process, point of origination, flow of documents and purpose.
<i>Study text reference: page 117</i>
<ol style="list-style-type: none"> <li>1. Leavers form is completed by the line manager and submitted to the HR department.</li> <li>2. The HR department enters the details given in the leavers form to the employee records, and transfers the employee records to the 'former employee' category.</li> <li>3. The HR department forwards a copy of the leavers form to the payroll officer to remove the employee from the payroll system.</li> <li>4. The payroll officer prepares a form for the leaver, providing details of pay and tax deductions for the year to date.</li> </ol>

## 2.8

<b>Learning Outcome/s: 4.1.1</b>
Identify differences between law, ethics and morality.
<i>Study text reference: page 248</i>
<p>Laws and regulations establish ways in which the government requires us to behave. Many laws and regulations apply to business activity. Company law, contract law, employment law and so on are all features of business life. Business organisations and their employees must comply with laws and regulations, or face the threat of judicial or regulatory action if their breach of rules is discovered.</p> <p>Morality and moral codes are personal senses of right and wrong and how the individual should behave. Morality has nothing to do with the law, although most people may regard most laws as fair. However individuals often consider some laws to be wrong and immoral.</p>

<b>Learning Outcome/s: 5.2.1</b>
Explain situations where assurance services can be rendered by a practitioner.
<i>Study text reference: page 273</i>
<p><b>Reasonable assurance:</b> this is a fairly high level of assurance, but it is not 100% absolute assurance. With reasonable assurance, the practitioner reduces the risk of expressing an incorrect opinion to an acceptably low level. By reducing the risk of an incorrect opinion to such a low level, the practitioner is able to express the opinion in a positive form.</p> <p>E.g. report of an external auditor on the financial statements of an entity.</p> <p><b>Limited assurance:</b> this is a lower level of assurance than reasonable assurance. It allows for a lesser amount of testing and evaluation. As a consequence, there is a greater risk (assurance engagement risk) that the auditor may give an incorrect opinion. As a result the practitioner does not form the opinion in a positive form (negative opinion). E.g. review engagement.</p>

<b>Learning Outcome/s: 5.5.1</b>
Explain the concepts and meanings of: <ul style="list-style-type: none"> <li>- Sufficient and appropriate audit evidence</li> <li>- Nature, timing and extent of audit procedures.</li> </ul>
<i>Study text reference: page 304</i>
(a) Test of controls (TOC) and substantive procedures (SP)  (b) TOC – Checking critical controls in procedures SP – Any test of details such as analytical procedures, checking samples of vouchers/ invoices

**(Total: 30 marks)**

## SECTION 2

### Answer 03

<b>Relevant Learning Outcome/s:</b>
<b>3.4.1 Explain deficiencies in internal controls in a given business process</b>
<i>Study text reference: page 230/240</i>

- (a) Proper segregation of duties has not been done in designing the internal controls. Segregation of duties reduces the risk of frauds. However, if two or more employees decide to perpetrate fraud by collusion, or if a senior manager commits fraud by overriding system controls, controls in the accounting system will not be able to prevent fraud.
- (b) A mitigating control is a type of control that is designed to discover or prevent failures in controls, and to correct them before the control failure has serious consequences. A mitigating control might be to check an audit trail produced by the IT system, which provides a record of all the changes that have been made to the suppliers file in a given period of time. Checks on this list should reveal any unauthorised changes that have been made.
- (c)
- (i) Recommendations to upgrade the system to be obtained from appropriate authority levels
  - (ii) Entries to the module to be checked and approved by an authorised person
  - (iii) Debtor reconciliations to be checked and approved by an authorised person
- (d)
- Potential for human error
  - Collusion
  - Management override of controls
  - Software failures or successful hacking

**(Total: 10 marks)**



## Answer 04

Relevant Learning Outcome/s:
4.2.2 – Explain integrity, objectivity, professional competence and due care, confidentiality and independence.
5.3.1–Discuss general principles governing an audit of financial statements, such as professional skepticism, professional judgement etc.
<i>Study text reference: page 258/259/298</i>

- (a) The principle of 'confidentiality' imposes an obligation on a professional accountant to refrain from:
- Disclosing to anyone outside the firm any confidential information that is acquired as a result of professional and business relationships, without proper and specific authority.
  - Using confidential information to their personal advantage or the advantage of a third party.
- (b) Exceptions to the rule of confidentiality:
- Where disclosure is permitted by law and is authorised by the client or employer
  - Where disclosure is required by law; for example to provide documents or other evidence for legal proceedings
  - Where disclosure is required by law due to actual or suspected money laundering or terrorist financing
  - Where there is a professional right or duty to disclose information, which is in the public interest and not prohibited by law
- (c) Professional judgment is required in:
- Deciding the nature, timing and extent of audit procedures (i.e. reaching a view about what work should be done in the audit. This judgment needs to be made after considering many factors that would affect the engagement, and the understanding of the risks of the client).
  - Judging whether sufficient appropriate audit evidence has been obtained. Yet again, this will be based on the materiality and the risks identified in the engagement.
  - Evaluating management's judgment in applying the applicable financial reporting framework. For instance, in complying with the accounting standards, certain assumptions are made. The auditor needs to apply professional judgment in assessing the appropriateness of applying accounting principles.
  - Drawing conclusions based on the audit evidence obtained reaching an audit opinion.

**(Total: 10 marks)**

## Answer 05

Relevant Learning Outcome/s:
2.5.2 Assess the business risk connected with sub activities relating to the inventory management process
2.2.3 Assess the business risks connected with sub activities relating to the payroll process
<i>Study text reference: page 210/124/128</i>

(a) Missing controls:

- Count sheets should be sequentially numbered in advance of the count.
- One person should count and another person, who is independent from the stores department, should record. Segregation of duties reduce the risk of error.
- Counted items should be marked to reduce the risk of them being counted twice.
- Manager in charge of the stock count should check to ensure all the sequentially numbered and signed sheets have been returned.
- Reconciliation of the stock count should total the stock records/bin cards in the inventory system.
- Adjustments to the inventory records, if required, should be authorised.
- A knowledgeable person should be present at the stock count to identify stock items.
- Damaged stocks should be identified separately and recorded.

(b) Controls to address the risks identified:

- (i) - Segregation of duties between the HR function and the payment function  
- Personal files held for all employees
- (ii) - Verification of payroll amounts and benefits calculations  
- Payroll budgets being in place  
- Agreement of gross earnings and total tax deductions with tax returns
- (iii) - Changes to master payroll file verified through before and after reports  
- Payroll master file reconciled with the general ledger
- (iv) - Starters, leavers, changes to salaries and deductions are reported promptly to the payroll department and the changes are updated in the payroll master file promptly.

**(Total: 10 marks)**

## Answer 06

Relevant Learning Outcome/s:	
5.5.4	Explain how an auditor considers the relevance and reliability of information to be used as audit evidence.
5.5.2	Explain the meaning and the difference between test of controls and substantive procedures.
Study text reference: page 302/303/308	

- (a)
- Confirmations from third parties for the transactions that have occurred during the period with them, and the balances outstanding at the balance sheet date from those transactions.
  - Minutes of meetings (management meeting minutes, board meeting minutes).
  - Information from inquiry of management and others, observations of the procedures and inspection.
  - Comparable data on competitive companies.
- (b) **Relevant audit evidence:** This deals with the logical connection with the purpose of the audit procedure and the assertion under consideration. E.g. there is a relationship between bad debts and debtors but research and development costs have nothing to do with debtors
- Reliable audit evidence:** This is influenced by the source and nature of the information, including the controls over its preparation and maintenance. E.g. external sources of information are likely to be more reliable than internal sources.
- (c) Financial statement assertions:
- (i) Existence, rights and obligation
  - (ii) Existence
  - (iii) Accuracy
  - (iv) Completeness

**(Total: 10 marks)**

## SECTION 3

### Answer 07

Relevant Learning Outcome /s:
2.3.2 Identify documents relating to cash management (Receipts, Payment vouchers, etc.) Points of originations, flow of documents and purpose.
2.2.1. Identify activities connected with the payroll process, such as recruitment, preparation and payment of salaries.
2.2.3 Assess the business risks connected with sub activities relating to the payroll
<i>Study text reference: page 129/119</i>

(a)

- Vehicle category not mentioned in counterfoil
- Counterfoil not serially pre-numbered
- Parking fee not mentioned in the counterfoil
- Parking location not mentioned in the ticket and counterfoil
- Time-out and time-in not mentioned in counterfoil
- Signature of the issuer not mentioned in counterfoil

(b)

(i) **Business risks in payment of wages**

- The wages are based on the daily attendance record. There is a possibility of calculating the wages incorrectly as it involves a manual calculation based on the attendance register.
- There is a risk of making the wage payments to those who are not really employed (fraudulent payments).
- If there are any new recruits, they could be missed out from the payments if their details are not appropriately recorded and communicated.

(ii) Controls to be implemented:

**Inaccuracies in calculating the wages:** Amith can assign a person to prepare the payroll/wages and assign a separate person to confirm the accuracy and completeness. This person can confirm (by placing his/her signature) that the necessary checks were performed to verify the accuracy of the calculations of wages and overtime. This would ensure the accuracy of the calculations involved in payroll.

**Payment of wages to those who have not been employed:** On a periodical basis, a headcount can be taken and cross-checked with the marked attendance in the attendance register to ensure that the payments are made only to the currently employed persons. If there is a signature of an employee who was not present on that day, necessary investigation should be done.

OR

An officer can ensure that the persons who have confirmed attendance by signing the attendance register are in fact employed by the entity by referring to the employee records. These may be personal files or any other records that show the present employees of the entity. The officer can confirm (by signing) that only those employees have been included in the payroll for that month.

OR

Reconcile the active (presently employed) employee details with the payroll records to see that the included employees have actually worked during that month.

OR

Assign a person to verify the numbers signed daily with the actual employees who have worked on that particular day in order to identify whether anyone who has not been present has marked the attendance register fraudulently.

**All employees may not have been included in the payroll (employees who have been newly recruited):** Perform a payroll reconciliation to ensure that all employees have been included in the preparation of payroll. The number of employees of the previous month's payroll can be compared with the number of employees in the current month's payroll.

- (iii) **Biometric devices:** These are devices that can identify individuals by means of a physical characteristic, such as a fingerprint, palm or eye. This can be used to record the arrival and departure of employees each day. They have the added security value that the system confirms the identity of the employee.

**Swipe cards:** Employees swipe the card through a card reader when arriving at and leaving work each day. The reader automatically records the time. With the swipe card there is a risk that another individual may use the swipe card on behalf of a colleague and incorrectly record the individual's attendance.

**(Total: 20 marks)**

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