THE INSTITUTE OF CHARTERED ACCOUNTANTS OF SRI LANKA

MOCK EXAMINATION – DECEMBER 2013

Advanced Audit and Assurance

Answer No. 01

I

Account Balance / Area	Justification
Revenue : Completeness	Lower revenue recognized in April 2013 would indicate a possible issue with completeness/ Cutoff. Significantly increased debtors collection period also indicate possible issue with revenue cutoff/ Completeness. (39 days in 2012 to 74 days in 2013)
Cost of Sales : Measurement	Lower GP margin recorded in 2013 (35% in 2013, 40% in 2012. Significant portion of purchases are in USD and LKR is depreciating against the USD throughout the year. Purchases should be recognized by using spot rate at the time of transaction.
Administration expenses : Recognition / Measurement	Significant decrease in administration expenses need to be considered.
Finance expenses : Measurement	Lower Finance expenses as % of borrowings (15% in 2013 18% in 2012). This will indicate an issue with interest accrual.
Property Plant and equipment : Valuation/ Measurement	Revaluation was recorded during the year. The surplus is significant. Auditor should pay attention on the basis of valuation and the related accounting issues.
Investment Properties :Valuation / Measurement	No valuation was carried out by the company. As the property prices were increased significantly, this could make significant misstatement in the financial statement.
Intangible assets : Recognition	Significant amount were invested in intangible assets. whether the expenses that have been capitalized are qualified to capitalize under LKAS 38 is a concern. Lower administrative expenses recorded during the year will increase the doubt.

Investment is associates : Measurement / Valuation	Lower market price per share is an external indicator for impairment. However, as per the financial statement no impairment was recognized. Auditor should pay attention on company's impairment process, judgments and assumptions used in impairment calculations, if any.
Long term current account with related entity : Measurement	This current account may be offered at off market interest rate or 0% interest. In such case day 1 difference adjustment might require.
Trade and other receivables : Measurement	Debtors' collection period has increased to 74 days from 39 days. Lower revenue recorded in Apr 2013. XYZ hospital is a major customer. The legal issue that they are facing is an objective evidence of impairment. The auditor should pay his attention to the measurement of impairment provision for trade and other receivables.
Stated Capital : Presentation	Financial statement indicate that the company has issued ordinary/ preference shares. Compliance with Companies Act and other accounting pronouncement is a concern. In case if this is preference share issue, identifying as equity or financial liability as per LKAS 32 is also a concern.
Financial Derivatives Measurement	This is the first time TPDC performing a fair value calculation for derivative product, therefore special attention on assumption, valuation model, etc is required.
Hedge accounting	TPDC has adopted hedge accounting. The hedge accounting treatment should be in compliance with LKAS 39 requirements. Formal designations , effectiveness testing , etc , need to be checked by the auditors.
Trade and other payables : Measurement	Significant USD payable in Exchange rate volatile environment require a special attention. Trade payables as % of cost of sales has also increased significantly.(28% in 2013 from 23%in 2012)

II.

Disclosure requirement	**Justification**
Related party disclosures	Possible off market transactions with related party . Identifying related parties are critical given that chairman owns 30% of TPDC and significant share holdings and other conglomerates.

SLFRS 7 : Risk management disclosures	TPDC expose with Credit risk (significant trade receivables balance) , Market risk (trade payables in USD , forward exchange contracts, hedge accounting, etc.) Qualitative and quantitative disclosures on risk exposures and management need to make under SLFRS 7.
SLFRS 7 : Hedge accounting disclosures	TPDC has cash flow hedge, therefore disclosures as required by SLFRS 7 on cash flow hedge need to be disclosed.
Operating segments	TPDC operates in two segments medical drugs and healthcare equipment. Hence, need to pay special attention on disclosure on operating segments.

III.

Analytical procedures are being based on draft projected figures up to the year end, or interim financial information, budgets and management accounts. This may make the analysis problematical for the following reasons.

a. The information will not cover the entire accounting period. Extrapolating figures to cover a 12 month period is not always easy to do, especially for a seasonal business where income and expenses do not accrue evenly throughout the year.

b. Year end close down procedures will not have occurred. For example, many entities will only account for items such as asset impairments or revisions to estimated figures such as provisions at the financial year end. Thus comparisons to figures derived from prior year published accounts may not be valid.

c. Information may be produced differently during the year, controls may be weaker, and the internal management accounts may not be produced in compliance with the same reporting framework as the year end financial statements

d. some entities, especially smaller companies, may not have a complete or formal reporting system during the year, making analytical procedures before the year end accounts have been produced difficult.

Answer No. 02

PART A

Audit team can rely on the internal controls in place for all the assertions except for measurement. Because, the final number presented in the financial statement is calculated by using EXCEL sheet and no proper controls are in place.

Therefore, minimal substantive testing is not adequate.

The following audit procedures are recommended.

1. Check whether the input used for EXCEL based calculation is in agreement with the GL and IT system

2. Assess the reasonability of the formulas used.

3. Check whether the formulas are applied correctly on a consistent basis.

4. Independently calculate a sufficient sample

5. Perform analytical review procedures (consider the reasonability of the figure based on the portfolio , average period expired , average rate offered, average tenor , e.t.c)

PART B

1. Clause to say YAM Ltd has an option to purchase the building at a price which is substantially below the market price at the time of exercise

2. Clause to say that the lease period is non-cancellable (Example. YAM cannot cancel the loan at any time or YAM can cancel the agreement by paying an additional payment to compensate future rental)

3. Clause to say the option to renew the lease is at a rate below the market rate

4. Clause to say that YAMs rental will be adjusted based on market value of the building and accordingly benefits of increased market value will be transferred to YAM and vice versa.

Answer No. 03

I.

(i) **Ethical and professional issues**

- KCL is a new audit client . Therefore, ABC & Co should have carried out customer due diligence process before accepting the audit assignment last year. After the proper due diligence process or a client acceptance, ABC & Co should have sufficient knowledge and understanding of KCL. Therefore, ABC & Co should be aware of any suspicion that the department of the Inland Revenue might have.

- The investigation has come as a surprise. Therefore ,It may result , either
  - The Inland Revenue suspicion are groundless or unproven. or
  - ABC & Co’s failure to recognize suspicious circumstances

Actions to be considered

1. Review any communication from the predecessor auditor obtained in response to its “professional inquiry”
2. Consider whether the second partner review was performed before issuing audit opinion. Second partner review was required as a quality control measure. The second partner review should be sufficiently well documented.
3. Audit working paper files and tax returns should be reviewed for any suspicion of fraud being committed by KCL or error overlooked by ABC & Co.
4. Tax advisory work should have been undertaken and/or reviewed by a manager/partner not involved in the audit work.
5. Make necessary disclosures to Inland Revenue on behalf of KCL as a tax advisor. Encourage KCL to make necessary disclosure to voluntary.
6. Consider any legal requirement of reporting suspicious transaction to any authority under Anti Money Laundering Laws.

II

1. Making arrangements so that preparation of financial statements are not performed by member of the assurance team
2. Implementing policies and procedures to prohibit the individuals providing such services from making any managerial decisions on behalf of the audit client
3. Requiring source data for the preparation of financial statements to be originated by PH Ltd (The audit client)
4. Requiring underlying assumptions to be originated and approved by PH Ltd (The audit client)
5. Obtaining audit client (PH Ltd) approval for any proposed journal entries or other changes affecting the financial statements.

III.

A self review threat may be created when a firm performs a valuation service for a financial statement audit client that is to be incorporated into the client’s financial statements.

If the valuation service involves the valuation of matters material to the financial statements and the valuation involves a significant degree of subjectivity, the self review threat created could not be reduced to an acceptable level by the application of any safeguard.

Accordingly, such valuation service should not be provided. Alternatively, the only course of action would be to withdraw from the financial statement audit engagement.

Performing valuation services for a financial statement audit client that are neither separately nor in aggregate material to the financial statements or that do not involve a significant degree of subjectivity , may create a self – review threat that could be reduced to an acceptable level by application of safeguards.

- Using separate personnel for the valuation service and the audit.
- Performing a second partner review.
- Confirming that the client understands the valuation method and the assumptions used.

The valuation of the gratuity liability is likely to involve many judgments and assumptions, and so is likely to be a subjective exercise. It is, therefore, most likely that ABC & Co should not provide the valuation services as the significance self-review threat cannot be reduced to an acceptable level

If ABC & Co decided to provide the valuation service (either the significance of self review threat is reduced to acceptable level or they will resign as auditor) , then ABC & Co consider whether they have sufficient skills and expertise to perform the valuation.

<u>Answer No. 04</u>

MIN Ltd

A letter of support from MAX Ltd together with Letter of representation from MIN Ltd may provide evidence that Min Ltd can continue its trading. However, the auditor should assess whether the letter of support provides sufficient and appropriate audit evidence on the appropriateness of the going concern assumption. (Example. MAX Ltd's ability to support Min Ltd)

If the auditor concludes that the use of the going concern assumption is appropriate in the circumstances but a material uncertainty exists, the auditor shall determine whether the financial statements:

(a) Adequately describe the principal events or conditions that may cast significant doubt on the entity's ability to continue as a going concern and management's plans to deal with these events or conditions; and

(b) Disclose clearly that there is a material uncertainty related to events or conditions that may cast significant doubt on the entity's ability to continue as a going concern and, therefore, that it may be unable to realize its assets and discharge its liabilities in the normal course of business.

If adequate disclosure is made in the financial statements, the auditor shall express an unmodified opinion and include an Emphasis of Matter paragraph in the auditor's report to:

(a) Highlight the existence of a material uncertainty relating to the event or condition that may cast significant doubt on the entity's ability to continue as a going concern; and

(b) Draw attention to the note in the financial statements that discloses the matters

If adequate disclosure is not made in the financial statements, the auditor shall express a qualified opinion or adverse opinion, as appropriate, in accordance with SLAuS 705. The auditor shall state in the auditor's report that there is a material uncertainty that may cast significant doubt about the entity's ability to continue as a going concern.

Conclusion

The audit senior's proposal is unsuitable.

The auditor's report should be unmodified if the letter of support provides sufficient and appropriate audit evidence and adequate disclosures were made .

First Plc

The application of all SLFRSs/ LKASs, with additional disclosure when necessary, is presumed to result in financial statements that achieve a fair presentation.

Therefore, in addition to the accurate figures the financial statement must provide all the disclosure required by SLFRS/LKAS and any additional disclosures where necessary.

SLFRS 1 prescribed all the disclosures to be made by a first time adopter when it is preparing a first SLFRS/LKAS compliant financial statement. Failure to disclose all the disclosures required by SLFRS 1 means that the financial statements do not comply with SLFRS 1.

Failure to make the disclosure required by SLFRS 1 may result in a qualified audit opinion, If the matter is material but clearly not pervasive , an "except for " opinion is appropriate.

If the auditor considers it necessary to draw users' attention to a matter presented or disclosed in the financial statements that, in the auditor's judgment, is of such importance that it is fundamental to users' understanding of the financial statements, the auditor shall include an Emphasis of Matter paragraph in the auditor's report provided the auditor has obtained sufficient appropriate audit evidence that the matter is not materially misstated in the financial statements. Such a paragraph shall refer only to information presented or disclosed in the financial statements. An emphasis of matter paragraph cannot therefore be used to avoid disclosures required by any SLFRS/ LKAS.

Conclusion

The audit senior's proposal is unsuitable.

An 'except for' qualification will be required on the grounds of disagreement.

Risk Bank PLC

The auditor shall form an opinion on whether the financial statements are prepared, in all material respects, in accordance with the applicable financial reporting framework and are complied with statutory requirements where applicable.

Financial statements are defined in LKAS 1 and accordingly the directors report is not a part of financial statements. SLFRS / LKAS)

As per SLAuS 720 , The auditor has responsibility to read the other information to identify material inconsistencies, if any, with the audited financial statements.

If revision of the audited financial statements is necessary and management refuses to make the revision, the auditor shall modify the opinion in the auditor's report in accordance with SLAuS 705 . However, in this matter , it was noted that the revision of the audited financial statement is not required hence the audit report should not be modified.

If revision of the other information is necessary and management refuses to make the revision, the auditor shall communicate this matter to those charged with governance, unless all of those charged with governance are involved in managing the entity; and

(a) Include in the auditor's report an Other Matter(s) paragraph describing the material inconsistency in accordance with SLAuS 706 ;4 or
(b) Withhold the auditor's report; or
(c) Withdraw from the engagement, where withdrawal is possible under applicable law or regulation.

Conclusion

An unqualified opinion on the financial statements is appropriate as the revision of financial statement is not required.

However, other matters paragraph should be included if the event is not resolved .

New Sub Ltd

The significant cash transfer is non adjusting event although significant.

However, that does not provide any evidence of New Sub Ltd existence at the balance sheet date . The oral presentation from finance director on the non existence of New Sub Ltd at the balance sheet date is not sufficient.

If New Sub Ltd was existed at the balance sheet date , its financial statements should have been consolidated.

The auditor should obtain other audit evidence such as legal papers, registration payments, etc. to verify the existence. Non availability of these evidences suggests a limitation on the scope.

The information concerning the existence of New Sub Ltd is material even though the subsequent cash transfer is not material. Therefore, adequate disclosures on the existence of New Sub Ltd should be made in the financial statements. Non disclosure may result in qualified audit opinion.

If auditor found that New Sub Ltd. were existed at the balance sheet date and its balance sheet contain material assets and liabilities then its non consolidation would have a pervasive effect. This would lead to an adverse opinion.

Further, if the limitation imposed by the entity have a pervasive effect and the auditor is suspicious that other audit evidence has been withheld , the auditor should disclaim an opinion.

Conclusion

Unqualified opinion can be given if additional evidences were obtained ,

If not disclaimer may be appropriate.

Answer No. 05

I.

a. Ensure that good financial reporting system is in place

b. The management of business risks

c. The management of internal controls

d. Ensure systems are in place to report conflict of interest situations

e. Ensuring compliance with laws and company policies

f. Assessing independence of external auditor and monitoring external audit functions

II.

a. Necessary resources for formulating and designing systems, documenting such systems and standardizing and updating where necessary

b. System to obtain feedback on satisfactory implementation and review

c. Adequate content and quality management information reports , including exception report

d. Establish financial authority limits

e. Segregated key duties and systems to safeguard asset

f. In an automated system , reviews of software hardware