SUGGESTED SOLUTIONS

23404 – Advanced Audit and Assurance

CA Professional (Strategic Level II) Examination

JUNE 2013

THE INSTITUTE OF CHARTERED ACCOUNTANTS OF SRI LANKA

Answer No. 01

1.

(a) and (b)

Significant matter (State)	Significant matter (Explain)	Specific focus
i. RHP has taken the deemed cost option to state the PPE at the transition date.	Deemed cost determination requires use of judgment and FV calculations	**a.** Deemed cost should be fair value at a date close to the date of transition **i.e.** broadly comparable to FV. b. FV should be as determined by an external valuer for it to be reliable.
ii. Company has re-assessed useful life and identified components	Re-assessment of useful lives and determination of components require use of judgment and estimations	a. Has an expert been involved in determining components**?** b. Are the useful lives of components fair or as determined by an expert**?** c. Reasonableness of the useful life in the light of replacement life cycle.
iii. Question refers to a refurbishment experience that leads to component identification	Identification of components requires use of judgment	a. Has the Company derecognized the previous significant components replaced by the refurbishment? b. Appropriateness of determination of carrying value of derecognized/items. c. If the company did not have details of previous cost of components, was estimation of carrying value of replaced items determined using current replacement cost?
iv. Leasehold property at valuation was brought back to cost	Reliability of the basis of measuring prepaid lease rent.	a. Did the company provide reliable details about the original cost 1 mark)of lease rent prepaid at the inception? b. Has the Company removed the revaluation surplus remaining from leased property and from equity c. Did the company recalculate amortization based on cost of prepaid lease rent over lease period?

Significant matter (State)	Significant matter (Explain)	Specific focus
v. Intangibles written off at the date of transition	Judgment required in determining that GW is non-existent	a. Is the explanation for write off reliable based on auditors judgment/recognition criteria as per SLFRS? b. Special representation from the management and those who are charged with governance (e.g. Audit Committee) may be required.
vi. Available for sale investment	AFS has a FV loss in OCI.	a. How has FV been established? Is the FV loss indicative of significant and prolonged dip in the price? b. Judgment is required to assess significant (say 20% or more of value) and prolonged (say 6 to 9 months or more) FV loss. c. Review of financials of the investee company.
vii. Creditors	Have been measured at present value	a. Appropriateness of discount rate that has been used b. Fairness of cash flow and PV calculations c. Appropriateness classification
		Marks can also be given (subject to maximum marks) to the following: Audit Committee or those who are charged with governance has approved the judgments and estimates employed in the exercise of transition to SLFRS
Reclassified treasury bills and short term investments as Held to maturity	Intention and ability to hold to maturity.	Classification of investments as HTM means that if they are sold prior to maturity, the rules pertaining to point will apply. Whether these instruments satisfied the criterion required to be classified as HTM.

c)

i. Cut off testing can be done as a test of control or as a substantive procedure or as a mix.

ii. By examining compliance with appropriate cut off point at the date of balance sheet, we can employ a test of control. To do this last few and first few transactions in sales and purchases (tool and beverages) can be examined.

iii. As a substantive test last and first sales and purchases transactions above an identified threshold can be examined rather than ii above.
iv. Comparison of revenue in general ledger during cut-off period with details recorded in front office register.

d)

i. As the inventory amounts can be significant consider attending a stock take or obtain another auditor's certificate on existence of stocks.
ii. Inspect documents at warehouse related to existence of stocks e.g. warehouse receipts.
iii. Call for third party stock confirmations from third party warehouses

e)

i. Areas to be considered Potential financial consequence of non-compliance (e.g fines, enforced business cessation)
ii. Whilst the potential financial consequences, require disclosure
iii. Is the financial consequence so serious, that the financial statements are grossly misleading with the non- compliance and its effect

f)

i. Based on the assessed risk of material misstatements, determine if payroll can be audited based on substantive procedures only
ii. If testing of controls is required, determine which of type 1 or 2 is appropriate in the circumstance

Following can also be considered

- Evaluate the design and implementation of relevant controls relating to the payroll by the user entity.
- Visiting the service provider and perform procedures.

(Total 32 marks)

Answer No. 02

The answers should cover all areas of discussion- (i)why the matter is significant, (ii) the conclusions reached, and (iii) significant professional judgment made in reaching the conclusion (SLAuS 230- para 8 c) Marks can be awarded for either a memorandum style answer or bullet point list that covers the above aspects. Only the main elements of the answers are underlined, only for which marks can be given.

a)
- Item not quantitatively material**,** but material due to nature which requires appropriate disclosure
- Require audit evidence to conclude, which could not be obtained
- Require disclosure as appropriate under LKAS 24 (Related Party Disclosures)
- Absence of audit evidence for a significant matter is a scope limitation Discuss further with the CFO of the above and take action to notify the Partner in charge

b)

- Objective of test of controls is to understand with the control identified is in operation or not, hence even 1 instance of deviation requires consideration.
- Consider the reason for deviation and determine if it is an isolated instance.
- Determine whether the deviation indicates a control failure or is proof that the control is not in place as intended
- Income sample (students are not required to state by how many samples) and determine if tests of control prove satisfactory in the increased sample.
- Determine if compensating controls exist that mitigates the effect of the lapse of control over the assertions regarding the related account balances
- If above last two points are not met, revisit the risk assessment of the balance concerned and carry out substantive procedures.

c)

- Funds collection campaign income is likely to be unpredictable.
- It can lead to understatement of or incomplete income and is also prone to misappropriation as not only employees but others who are not directly under the control of the company, are involved.
- Analytical procedures may not suffice and the controls may not be reliable.
- Should such proceeds be a part of the income of the company?**:** This is a matter to be concluded on.

d)

i. Inventory in the third party location is significant as it carries approximately 1/5 of the total inventory.
ii. Consider the results of test carried out on IT controls.
iii. Third party confirmation tallies with the ledger, but audit procedures resulted in inconsistent findings that can be expected to create a difference between the ledger and confirmation. However, the confirmation tallies with the ledger.
iv. Internal audit findings also indicate differences which could reasonably by expected to lead to errors and differences
v. Hence, above 2 events (iii and iv create doubt about the reliability of the third party confirmation (SLAuS 500 para 11)
vi. Consider performing other audit procedures over existence of inventories at the third party location. Such procedures include:
    - Attending a physical count at a subsequent date and rolling back the quantities of a sample
    - Obtaining a special audit report from another auditor , if practicable, on the existence of inventory at the third party location.
    - Inspecting documentary evidence for existence of inventory at the third party location.

(Total 18 marks)

Answer No. 03

GUIDANCE NOTE ON DISCLOSURE OF REMUNERATION OF KEY MANAGEMENT PERSONNEL (KMP)

SCOPE

This guidance note is based on the requirements of the Companies Act and other regulatory requirements.

KMP DEFINITION AND DISCLOSURE REQUIREMENTS

COMPANIES ACT, NO. 07 OF 2007

Section 529 – "Director" includes-

(a) a person occupying the position of director of the company, by whatever name called ;

(b) for the purposes of sections 187 , 188 , 189 , 190 , 197 , 374 and 377 –

- (i) a person in accordance with whose directions or instructions a person referred to in paragraph *(a)* may be required or is accustomed to act ;
- (ii) a person in accordance with whose directions or instructions the board of the company may be required or is accustomed to act ; and
- (iii) a person who exercises or who is entitled to exercise or who controls or who is entitled to control the exercise of powers which, apart from the articles of the company, would be required to be exercised by the board ; and

(c) for the purposes of sections 187 to 195 (both inclusive), 197 , 374 and 377 , a person to whom a power or duty of the board has been directly delegated by the board with that person's consent or acquiescence, or who exercises the power or duty with the consent or acquiescence of the board.

The provisions of paragraphs *(b)* and *(c)* shall not apply to a person to the extent that the person acts only in a professional capacity;

Disclosure requirement

Section 168 (1) (f)

The annual report of the board shall be in writing and be dated, and subject to subsection (2), shall-

State the remuneration and other benefits of directors during the accounting period ;

SRI LANKA ACCOUNTING STANDARDS

LKAS 24- Related Party Disclosures

Key management personnel are those persons having authority and responsibility for planning, directing and controlling the activities of the entity, directly or indirectly, including any director (whether executive or otherwise) of that entity.

Remuneration of Key Management Personnel

Compensation includes all employee benefits (as defined in LKAS 19 *Employee Benefits*) including employee benefits to which SLFRS 2 *Share-based Payment* applies. Employee benefits are all forms of consideration paid, payable or provided by the entity, or on behalf of the entity, in exchange for services rendered to the entity. It also includes such consideration paid on behalf of a parent of the entity in respect of the entity.

Paragraph 16 of LKAS 24 *Related Party Disclosures* based on IFRS 2011 version applicable for financial periods beginning on or after 1st January 2012, requires disclosures about the compensation of key management personnel in total and for each of the following categories:

(a) short-term employee benefits such as wages, salaries and social security contributions, paid annual leave and paid sick leave, profit-sharing and bonuses (if payable within twelve months of the end of the period) and non-monetary benefits (such as medical care, housing, cars and free or subsidised goods or services) for current employees;

(b) post-employment benefits such as pensions, other retirement benefits, post-employment life insurance and post-employment medical care;

(c) other long-term benefits including long service leave or sabbatical leave, jubilee or other long service benefits, long-term disability benefits and, if they are not payable wholly within twelve months after the end of the period, profit-sharing, bonuses and deferred compensation;

(d) termination benefits comprising of lump sum payment made on retirement; and

(e) €share-based payment comprising of equity compensation benefits under the company's share option scheme and long term incentive plans.

Key management personnel compensation should be presented in the notes to the financial statements as follows:

1.1 Directors (Executive, Non-Executive and Managing Director – if he/she is a member of the board)	(a) short-term employee benefits (b) post-employment benefits (c) other long-term employee benefits (d) termination benefits (e) share-based payments
1.2 Other KMPs excluding Executive, Non-Executive and Managing Director – if he/she is a member of the board)	(a)short-term employee benefits (b) post-employment benefits (c) other long-term employee benefits (d) termination benefits (e) share-based payments

It should be noted that for the KMPs included under sections 1.1 and 1.2 as stated above, the compensation information required under categories (a) to (e) should be disclosed in total and for each of such categories.

Disclosures required by code on corporate governance can also be considered.

(Total 15 marks)

Answer No. 04

(a) **Retention not receivable**

The audit report should be modified on the grounds of disagreement as the retentions that cannot be recovered should be charged to the Income statement. Although the amount of the retention is not very material by size (as it is only 6.6% of profit after tax), it is material by nature as it affects the requirement for the award of the directors' bonuses. The modification would take the form of an "except for" qualification as it is unlikely to be pervasive. The opinion section of the report should include an explanation detailing the amount by which receivables are overstated.

Amount due from Related Party

As SDL has not been able to secure the land concerned, and SDL has not carried out any other transactions it appears that SDL will not be in a position to repay the funds borrowed to pay for its expenses.

If the management does not agree to provide for possible losses that may arise from SDL not being able to repay its dues, the audit report should be modified stating that the recoverability of the amount due form SDL is doubtful and adequate provision has not been made in the Income statement against possible losses that may arise there from. The modification would take the form of an "except for" qualification as it is unlikely to be pervasive. The opinion section of the report should include an explanation detailing the amount by which receivables and net profit are overstated.

(b) The directors' behaviour is dishonest as they are deliberately overstating profits in order to preserve their bonus. This demonstrates a lack of integrity. The directors are putting their own interests before that of the company. They are not acting in a way most likely to promote the success of the company for the benefit of its members as a whole. This lack of integrity casts doubt on the reliability that can be placed on their representations and could be indicative that there are other areas of criminal activities. It increases the possibility of misstatement in the financial statements and consequently the risk of forming an inappropriate audit opinion.

Their offer of employment also needs to be considered as it may have been made as an incentive to obtain a favourable report. The Code of Ethics for Professional Accountants issued by the Institute of Chartered Accountants states the following in relation to Employment with Assurance Clients,

The independence of a member of the assurance team may be threatened when an individual participates in the assurance engagement knowing, or having reason to believe, that he or she is to, or may, join the assurance client sometime in the future.

The significance of the threat should be evaluated and, if the threat is other than clearly insignificant, safeguards should be considered and applied as necessary to reduce the threat to an acceptable level. Such safeguards might include:

- Considering the appropriateness or necessity of modifying the assurance plan for the assurance engagement;
- Assigning an assurance team to the subsequent assurance engagement that is of sufficient experience in relation to the individual who has joined the assurance client;
- Involving an additional professional accountant who was not a member of the assurance team to review the work done or otherwise advise as necessary; or
- Carrying out a quality control review of the assurance engagement.

In addition the firm should have policies and procedures to require the individual to notify the firm when entering serious employment negotiations with the assurance client and the removal of the individual from the assurance engagement.

In addition, consideration should be given to performing an independent review of any significant judgments made by that individual while on the engagement.

Sri Lanka Auditing Standard 220 Quality Control for an Audit of Financial Statements requires firms to consider the integrity of the principal owners, key management and those charged with governance when deciding whether to continue an existing engagement. This is also required by SLSQC 1 Quality Control for Firms that Perform Audits and Reviews of Financial Statements, and Other Assurance and Related Service Engagements (SLSQC 1).

(Total 20 marks)

Answer No. 05

Second Opinions

Threats
This may give rise to threats to compliance with the fundamental principles. For example, there may be a threat to professional competence and due care in circumstances where the second opinion is not based on the same set of facts that were made available to the existing auditor, or is based on inadequate evidence. The significance of the threat will depend on the circumstances of the request and all the other available facts and assumptions relevant to the expression of a professional judgment. The fact that the management is thinking of switching the audit to you needs to be considered as it may appear that they expect an opinion in their favour.

Safeguards
When asked to provide such an opinion, you should evaluate the significance of the threats and, if they are other than clearly insignificant, safeguards should be considered and applied as necessary to eliminate them or reduce them to an acceptable level. Such safeguards may include seeking client permission to contact the existing auditor, describing the limitations surrounding any opinion in communications with the client and providing the existing auditor with a copy of the opinion.

If ISL will not permit communication with the existing auditor, you should consider whether, taking all the circumstances into account, it is appropriate to provide the opinion sought.

Providing External audit and Company Secretarial services (through network firm)
Threats
Generally this position is seen to imply a close degree of association with the entity and may create self-review and advocacy threats.

Safeguards
If a network firm serves as Company Secretary for a financial statement audit client the self-review and advocacy threats created would generally be so significant, no safeguard could reduce the threat to an acceptable level. When the practice is specifically permitted under local law, professional rules or practice, the duties and functions undertaken should be limited to those of a routine and formal administrative nature such as the preparation of minutes and maintenance of statutory returns.

Routine administrative services to support a company secretarial function or advisory work in relation to company secretarial administration matters is generally not perceived to impair independence, provided client management makes all relevant decisions.

Providing Internal and external audit services

Threats

The provision of internal audit service causes a self-review threat to the external auditor. The external audit staff members may overlook errors made by their internal audit colleagues or may place too much reliance on their work.

In evaluating any threats to independence, the nature of the service will need to be considered. For this purpose, internal audit services do not include operational internal audit services unrelated to the internal accounting controls, financial systems or financial statements.

Safeguards

self-review threat created may be reduced to an acceptable level by ensuring that there is a clear separation between the management and control of the internal audit by client management and the internal audit activities themselves.

(i.e-
- The audit client designates a competent employee, preferably within senior management, to be responsible for internal audit activities.
- the audit client, the audit committee or supervisory body approves the scope, risk and frequency of internal audit work.
- The audit client evaluates the adequacy of the internal audit procedures performed and the findings resulting from the performance of those procedures by, among other things, obtaining and acting on reports from the firm)

Additional safeguards include separate engagement partners, separate engagement letters and different teams for the two respective roles.

Finally, the directors must confirm in writing that they are responsible for establishing, maintaining and monitoring the overall system of internal control including the work of internal audit, and that they are responsible for determining which recommendations of internal audit should be implemented.

Being the External Auditor and Attending the company's monthly Board meetings

Threats

This may be a threat to *independence in appearance* ('being seen as independent'). In some cases, for example when management representations are discussed, it may be desirable for the auditor to attend board meetings. However, an auditor must not under any circumstances make management decisions. Attending board meetings is allowed if the auditor is acting in an advisory capacity only or is reporting the results of audit work. But if the auditor is to attend all monthly board meetings it may appear as if he is a part of the board's decisions.

Safeguards

To safeguard against this threat, the auditor should ensure that there is "informed management" at the company. The auditor should inform the directors that they alone are responsible for decision making. In the interests however of being "seen to be independent" it may be best to decline the offer of attendance at monthly board meetings.

(Total 15 marks)

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They are not intended as "Model answers', but rather as suggested solutions.

The answers have two fundamental purposes, namely:

1. to provide a detailed example of a suggested solution to an examination question; and

2. to assist students with their research into the subject and to further their understanding and appreciation of the subject.

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