# KB 4 – Business Assurance, Ethics and Audit

# Suggested Answers and Marking Guide

# SECTION 1

**Question 01**

1.

| Relevant learning outcome/s: |
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| 1.2.1 Analyze threats in complying with fundamental and ethical principles, including independence of auditors in an audit of financial statements. |

Ethical threats to independence

I. Gifts and hospitality

According to the code of ethics, the offer made to the audit team to purchase computers on concessionary terms may create self-interest threats to objectivity. Intimidation threats to objectivity may result from the possibility of such offers being made public.

However, as per the code of ethics the significance of such threats depends on:

- The significance of the offer.
- Whether the offer is made in the normal course of business without the specific intent to influence decision making or to obtain information.

The offer appears to be significant in monetary terms and is unlikely to be made in the normal course of business. The audit team would be perceived as employees of the Company and the offer would have been made to influence the professional judgment of the audit team during the physical stock count and the audit.

II. Long association of senior personnel with assurance clients

Using the same senior personnel on an assurance engagement over a long period of time may create a familiarity threat.

The significance of the threat as per the code of ethics will depend upon factors such as:

- The length of time that the individual has been a member of the assurance team.
- The role of the individual in the assurance team.
- The nature of the assurance engagement.

This is a financial statement audit client. Mr. Rajeev has served the audit client for more than nine years and as the main person who makes key engagement decisions he could be biased due to his long association with senior personnel of the client.

| Marking Guide |
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| 1 mark each for explaining the requirements of the code of ethics in each ethical threat.<br>2 marks each for applying the requirements to the scenario.<br>Total 6 marks |

2.

| Relevant learning outcome/s: |
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| 1.2.2 Outline safeguards to mitigate threats in complying with fundamental and ethical principles. |

Safeguard - Gifts and hospitality

- Audit staff should be educated not to accept hospitality from audit clients which could affect both actual independence and the appearance of independence of the firm.
- Allocate different members to the audit who did not enjoy the client's hospitality.

Safeguard - Rotation of engagement partner

- Rotate the engagement partner and the team members who have served the client for a significant period.
- Appoint an independent professional accountant to review the key engagement decisions made by the engagement partner.

| Marking Guide |
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| 1 mark for each point covered under both Gifts and hospitality and Rotation of engagement partner.<br>Total 4 marks |

**Question 02**

1.

| Relevant learning outcome/s: |
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| 2.1.2 Explain the need for an audit committee, including the benefits of an audit committee to the shareholders of a listed entity. |

- The audit committee is an important aspect of a good corporate governance system which is particularly relevant for a listed company due to its public interest. Steel Made is in the process of becoming a listed company and shall also comply with the listing rules of the Colombo Stock Exchange which make an audit committee mandatory.

- The size and the complexity in terms of risk of the Company have increased, requiring more focus on governance.

| Marking Guide |
|---|
| 1 mark for each point. |

2.

| Relevant learning outcome/s: |
|---|
| 2.1.2 Explain the need for an audit committee, including the benefits of an audit committee to the shareholders of a listed entity. |

- Enables the board to discharge their responsibility with respect to the adequacy and effectiveness of internal controls.

- Oversight responsibility of financial reporting including compliance with technical standards.

- Improves the independence of auditors (both external and internal auditors).

| Marking Guide |
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| 1 mark for each point. |

3.

| Relevant learning outcome/s: |
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| 3.4.2 Discuss the factors or conditions generally present in a fraud situation. |

i) Incentive to overstate financial position

Revaluation of property has resulted in a significant increase in the asset value and this may be motivated by the impending IPO to improve the asset base. There is clearly an incentive to overstate asset value by inappropriately changing assumptions/ data or by influencing the valuer.

ii) Lack of segregation of duties in master data and payroll processing

This provides <u>opportunities</u> for the payroll officer to make unauthorized changes to master data and process salary. E.g. activating resigned employees and processing salary.

*Alternative answers on weak payroll controls*

*(iii) Lack of monitoring controls or mitigating controls*

*The Company does not seem to have exercised any monitoring controls or mitigating controls to address unrestricted authority given to the payroll officer. Such controls could include review of payroll reconciliation and review of audit trail on changes to master data.*

*iv) Weak system controls*

*The system appears weak in its design with respect to the integration of all 3 modules of a payroll system (attendance, master data and payroll processing). It shows that the payroll system has calculated salary for resigned employees without attendance being recorded for them.*

| Marking Guide |
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| 2.5 marks for each point, 0.5 mark for identifying the point and 2 marks for explanation. |

**Question 03**

1.

| Relevant learning outcome/s: |
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| 4.1.2 Discuss how auditors consider relevance and reliability of audit evidence.<br><br>4.5.1 Discuss the responsibility of an auditor in the verification of physical inventory. |

- Appropriateness and the impact of the change in inventory valuation have not been ascertained. This could represent a policy change which requires retrospective application.

- No procedures have been performed to ensure the completeness of the expired drug schedule provided by the client.

- Overstatement of stock due to the expired drug has been identified as a significant risk and therefore auditors should design procedures whose nature, timing and extent are responsive to such risk. This is not evident in the working paper.

- Adequate procedures have not been performed on the difference between the general ledger stocks and ageing. Instead, reliance seems to have been placed on the CFO's assertion without performing further audit testing on manual journal entries and their impact.

- Sufficient appropriate evidence has not been obtained on the physical inventory count. Whether the client has a perpetual or periodic stock system, attending the client inventory count and performing certain procedures are required by SLAuS 501.

| Marking Guide |
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| 1.5 marks for each point. |

2.

| Relevant learning outcome/s: |
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| 1.5.2 Assess the adequacy of audit documentation in a given scenario. |

- The working paper has not been dated.
- Reviewer has signed the working paper after the date of the opinion, this raises the question as to whether adequate review was carried out before arriving at the audit opinion.
- Audit objectives have been limited to accuracy and valuation and other assertions such as completeness, cut- off, and existence, have not been identified.
- The conclusion provided is inappropriate given the issues noted by the team such as inability to attend the stock count, un-reconciled differences etc.

| Marking Guide |
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| 1 mark for each point. |

**Question 04**

1.

| Relevant learning outcome/s: |
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| 4.12.1Outline procedures required to identify events occurring between the date of financial statements and the date of the audit report. |

According to SLAuS 560, the auditor shall perform audit procedures designed to obtain sufficient and appropriate audit evidence that all events occurring between the date of financial statements and the date of the auditor's report that require adjustments of, or disclosure in financial statements have been identified.

The bankruptcy of the customer was announced after the date of the financial statements but before the date of the audit report. The declaration that the customer was bankrupt after the balance sheet provides evidence that the recoverability of debt at the date of the balance sheet date was in doubt and thus requires adjustments of the financial statements as at 31/03/2014

The amount receivable from the customer represents 2% of the total assets and 40% of the reported net profit and therefore adjustments to trade receivables are material to the financial statements.

| Marking Guide |
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| 6 marks in total for an appropriate answer as above. |

2.

| Relevant learning outcome/s: |
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| 4.11.1Outline substantive audit procedures to be performed in relation to account balances and classes of transactions. |

- Confirming the amount due from the customer on invoices raised prior to the year end, and if possible obtaining a positive confirmation from the customer.
- Confirming with the receiver of the debtor whether the recovery of debt is possible.
- Checking the journal entry relevant to recognition of impairment on uncollectible debt.
- Obtaining a management representation letter to confirm no other amounts are due from the customer.

| Marking Guide |
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| 2 marks each for any two of the above procedures. |

**Question 05**

1.

| Relevant learning outcome/s: |
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| 5.3.1 Explain the differences between an emphasis of matter and other matters. |

| **Emphasis of Matter paragraph** | **Other Matters paragraph** |
|---|---|
| Refers to a matter appropriately presented or disclosed in the financial statements. | Refers to a matter other than those presented or disclosed in the financial statements. |
| In the auditor's judgment, is of such importance that it is <u>fundamental to users' understanding</u> of the financial statements.<br>E.g. Going concern. | In the auditor's judgment<u>, is relevant to users'</u> understanding of the audit, the auditor's responsibilities or the auditor's report.<br>E.g. Restriction on distribution or use of the Auditor's Report. |

| Marking Guide |
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| 1.5 marks for each explanation. |

2.

| Relevant learning outcome/s: |
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| 5.5.1 Analyze a non-complex audit engagement and propose appropriate modifications, with sufficient justification. |

**Key issues**

**Explanation of the issue**

The issue relates to valuation of stocks held in two containers. These stocks have not moved for more than 13 months and may not be in a suitable condition to utilize for a different order. The Company has not received a new order from the buyer up to the time of the audit.

Since this fabric had not met the required specifications of the buyer, it is unlikely to receive a new order from the same buyer and it is unlikely to receive an order from an alternative customer as the fabric is customized. Further, there may be restrictions on disposal of the product locally due to the proprietary design of the fabric.

Therefore, stock amounting to Rs. 3.5 million may be written off.

**Materiality and pervasiveness**

The value of the stock to be written off represents 2% of the total assets and 18% of profit before tax and therefore is material to the financial statements. The issue is not considered to be pervasive as it is confined only to inventory and does not represent a substantial proportion of the financial statements in terms of SLAuS 705.

Therefore, a modified opinion is appropriate where there is a qualification on the inappropriate stock valuation which affects the fair presentation of the financial statements.

| Marking Guide |
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| 2 marks for each of the above two points under the explanation of the issue.<br>3 marks for commenting on materiality and pervasiveness and drawing the conclusion with regard to the audit opinion. |

# SECTION 2

**Question 06**

1.

| Relevant learning outcome/s: |
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| 3.6.2 Analyze financial and non-financial information of a given engagement, to identify risk of material misstatements (inherent and control risk). |

- Investment property

Lands purchased for developing dairy cows do not meet the definition of investment property as the land is held for business use and thus meets the definition of property plant and equipment in terms of LKAS 16.

Therefore, it is not appropriate to recognize the fair value change in the land in profit and loss.

- Selective revaluation of assets

It appears that the Company has only revalued land and building relating to liquid plant and the land and building in the blending plant have not been revalued. This may be motivated by results of the fair valuation and management bias to selectively revalue assets. This is a departure from LKAS 16, which requires the entire class of property to which the asset belongs to be revalued.

- Provision

According to LKAS 37, provision is a liability of uncertain timing or amount. Expenditure incurred to operate in a particular manner in future will not constitute a provision as the Company can avoid the future expenditure by its actions e.g. replacing the machine. Such future expenditure has no legal or constructive obligation to meet the definition of a liability and thus cannot be recognized as a provision.

- Retirement benefit obligation

The Gratuity Act stipulates the basis on which the retirement benefit obligation is established at the end of the service period and it does not deal with how the retirement benefit obligation is recognized in the financial statements in each period. In terms of LKAS 19, the retirement benefit obligation shall be <u>established using projected unit credit method and actuarial assumptions</u> such as future salary increment, expected employee turnover, and discounting rate used to fair value the obligation.

Other financial reporting issues

- Prepayment does not represent a contractual right to receive cash or other financial assets but it is a payment made in respect of future services. Therefore, prepayment does not meet the definition of a financial asset in terms of LKAS 39.

- A Treasury bond may be classified as an instrument held to maturity instrument or an instrument available for sale. Depending on the classification it should be measured either at amortized cost (if it is classified as held to maturity) using effective interest rate, or at fair value (if it is classified as available for sale).

| Marking Guide |
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| 2 marks for each of the four main findings. |

2.

| Relevant learning outcome/s: |
|---|
| 3.6.2 Analyze financial and non-financial information of a given engagement, to identify risk of material misstatements (inherent and control risk). |

Key ratios

| | 2013 | 2012 |
|---|---|---|
| **Profitability** | | |
| Gross profit margin | 13% | 32% |
| Net profit margin | -5% | 23% |
| **Working capital** | | |
| Inventory days | 156 | 70 |
| Receivable days | 176 | 49 |
| Payable days | 118 | 60 |
| **Liquidity** | | |
| Current ratio | 1.69 | 2.05 |
| Quick ratio | 1.1 | 1.4 |
| **Solvency** | | |
| Long term debt to equity | 31% | 25% |

| Key area | Unusual relationship that should be considered in audit planning | Marks |
|---|---|---|
| Revenue | • There is a significant decline of 51% in revenue from the previous year. This requires further analysis. Since 60% of the revenue is derived from distributors a disaggregated | Up to 1.5 marks for a well |

| | | |
|---|---|---|
| | analytical review based on the dealer, product category and month could be performed to identify the likely cause.<br>• Although the potential food safety issue was publicly announced in July 13, there would have been bad publicity/ customer complaints during the year. This may also be due to significant sales returns from distributors who take goods on consignment basis<br>• Revenue attributable to distributors from goods taken on consignment basis may not be appropriately recognized at the time of transfer of risk and rewards from the Company. | explained point |
| Gross profit margin | • GP margin has significantly reduced from 32% to 13%. This may be due to the price pressure from the Consumer Affairs Authority and the increasing cost of raw materials.<br>• This may be indicative of selling some product categories at a price which is lower than the cost which may in turn affect the stock valuation at cost or NRV whichever is lower. This requires further analysis. | Up to 1.5 marks for a well explained point |
| Inventory days | Inventory days have increased more than 100%. This may be due to non-moving stocks held due to safety issues which became apparent subsequent to the financial year. Further, this may reflect the cost of products which are affected by the safety issues and returned by the distributors which are to be written off. | 1 mark |
| Debtors days | There is a significant increase in debtors collection days. This may be due to extended credit given to distributors or non-payment due to product safety issues. Debtors may be overstated unless it is tested for impairment. | 1 mark |
| Liquidity issues | There is a significant deterioration of the Company's liquid assets as indicated by the decline in quick ratio and cash position. This may cause potential liquidity issues where the Company may not be able to fund its working capital requirements. | 1 mark |
| Net profit margin | The Company has incurred a net loss from a net profit margin of 23% during the previous year. | 1. 5 marks for |

| | | |
|---|---|---|
| | This significant deterioration of profitability along with the working capital and liquidity issues raise concern about the Company's ability to continue as a going concern. Furthermore, the product recall may result in further reduction in sales in future and create an uncertain business environment. | explaining with going concern risk |
| Other matters | • Significant increase in other income.<br>• Distribution cost increase is not in correspondence with sales movement.<br>• Finance charges appear to be unusual given the movement in borrowings.<br>• Any other relationship which appears to be unusual. | ½ for each valid point |

| Marking Guide |
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| Note: Separate marks will not be allocated for ratio calculation but it is nevertheless to be used in the analysis. Marks are allocated for explanation of the likely risk reflected in the ratio. |

3.

| Relevant learning outcome/s: |
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| 3.3.1 Discuss how business risk could result in risk of material misstatements in financial statements. |

(i) Product recall

The main business risk is the food safety issue which will affect the Company's reputation, brand image and potential sales. Many financial statements items could be affected due to the product recall. These include valuation of stock on account of product retuned, recoverability of receivables, potential litigation and claims and eventually the validity of the going concern assumption.

(ii) Price pressure

There is price pressure from the Consumer Affairs Authority on the one hand and the rising cost of raw materials on the other. This may create temptation to understate expenditure and to achieve expected profitability. Financial statement risk is the fraud risk.

| Marking Guide |
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| 2 marks for each discussion point. |

4.

| Relevant learning outcome/s: |
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| 4.11.1 Outline substantive audit procedures to be performed in relation to account balances and classes of transaction. |

- Obtain evidence of product recall (e.g. press release/ correspondence from Consumer Affairs Authority)
- Identify details of all batches of products affected by safety issue and ascertain the volume of sale of such products and the amount of stock held as at 31 March 2013.
- Design a specific confirmation providing the details of batch numbers affected by the safety issue and request dealers to confirm the volume of products returned under each batch.
- Check with entity's legal counsel whether there are litigation and claims against the Company following the product recall.
- Assess whether there may be regulatory action such as suspension of operation by the Consumer Affairs Authority, by directly confirming with the authority or by examining the correspondence between the Company and the authority
- Ensure that product returned had been valued at NRV most likely such stocks need to be fully written off.
- Obtain a written representation stating that all uncertainties and associated liabilities arising from the product recall are appropriately reflected in the financial statements and communicated to auditors.

| Marking Guide |
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| 1 mark for each point.<br>Maximum 5 marks |

**Question 07**

1.

| Relevant learning outcome/s: |
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| 2.1.1 Discuss the key aspects of corporate governance, including responsibilities of the board and role of non-executive directors. |

The main responsibility for design, implementation and operating effectiveness of the internal control system lies with those charged with governance to enable the preparation of financial statements that are free of material misstatements due to fraud or errors.

| Marking Guide |
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| 2 marks for an appropriate answer as above. |

2.

| Relevant learning outcome/s: |
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| 2.2.2 Recognize the importance of IT controls in an audit, including IT general controls and IT application controls. |

General IT controls are policies and procedures that relate to many applications and support the effective functioning of application controls. If general IT controls are weak it may not be possible to place a reliance on application controls. E.g. if access to program and data has not been restricted or unauthorized modification to a program could be effected, the integrity of data processed by the computer information system is in doubt.

| Marking Guide |
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| 3 marks for an appropriate answer as above. |

3.

| Relevant learning outcome/s: |
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| 2.2.1 Analyze non-complex business processes and identify the internal controls in place in the context of the main business, such as<br>– Order to receipt<br>– Procurement to pay<br>– Payroll<br>– Cash management and investment<br>– PPE and inventory management |

| | Potential risk | Mitigating controls |
|---|---|---|
| 1 | Recognition of revenue without delivery being made.<br>Under the current system, confirmed customer orders are transferred to the general ledger as a batch irrespective of whether the order is delivered or not. This is because there is no direct integration between the distribution center software and the sales order modules and both systems work in isolation. | Monitoring of pending order file by the sales manager.<br>The link between the sales order module and the distribution center software is established through the pending order file which is updated when the customer keys in the order ID on receipt of the ordered items. The mitigating control is the <u>monitoring of the pending order file by the sales manager</u> to ensure that deliveries are made for confirmed orders which have already been recognized as sales. |
| 2 | Confirmed order details may not be accurately and completely transferred to GL.<br>Speedy Food does not have a fully integrated ERP solution; instead the sales module is linked to the GL through an interface where a connection is established between two databases. <u>If there is a failure in the interface it may affect the accuracy and completeness of sales.</u> | Review of exception report and batch controls.<br>Any error in transmitting sales information to the GL is captured in an exception report. However, this by itself is not a control. It becomes a control only if a <u>responsible person reviews the exception reports and corrects the exceptions detected in the system.</u><br>Furthermore, <u>batch control</u> is an effective application control to ensure that a <u>batch is accurately and completely transferred to the general ledger.</u> (This involves a comparison of batch totals such as record counts, control totals and hash totals before the transfer and after the transfer). |
| 3 | 20% discount is inappropriately granted to customers (fraud risk).<br><u>Unauthorized changes to customer master data</u> may be initiated to change the customer status to VIP and apply the special discount. | Access to customer master data is restricted only to authorized personnel.<br>Classification of a customer from a normal customer to VIP is done automatically through the system and thus could be considered as an IT application control and can be relied upon provided that the program logic |

| | | |
|---|---|---|
| | | for this had been properly designed, tested and implemented (ITGC).<br><br>Explanatory note:<br>Note that this system change has been initiated during the current year and therefore the audit team will not be able to rely on the controls in particular ITGC that were tested during the last year. An important aspect of this year's audit is to ensure that program change (ITGC) has been properly done. If the IT general controls are weak a substantive audit approach should be followed. |
| 4. | Possibility of making payments to fake claims (fraud risk).<br>Certain claims processed may not actually exist. This doubt is further evident by the 100% increase in claims during the current year compared to the previous year. The current year claim % is also above the average claim % based on past experience (2% to 4%). | The case does not make it clear that there is an effective control to ensure that only valid claims are being processed.<br>If the auditor cannot identify an effective control and considers this as a fraud risk, testing of details such as substantiating selected claims for their validity should be performed. |
| 5 | Misappropriation of cash (fraud risk).<br>There is an inherent risk that the cash collected may be misappropriated e.g. teaming and leading. | Auditor should check whether the Company has controls such as immediate banking, periodic physical count and reconciliation, etc. |

| Marking Guide |
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| 3 marks each for identifying the risk and mitigating controls, marks distributed equally for risk and control.<br>Total 12 marks |

4.

| Relevant learning outcome/s: |
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| 4.11.1 Outline substantive audit procedures to be performed in relation to account balances and classes of transactions. |

Risk of overstatement of revenue- result of analytical review

Explanatory note:

*Average revenue per customer has increased from Rs. 3,700 to Rs. 4,500. This increase is questionable due to the fact that more than 75% of the increase in sales orders has been directly attributable to the new discount scheme. With the new discount scheme average revenue per customer may reduce by 20% or below. If this is considered as a significant risk (fraud risk), then substantive procedures specifically designed to address such risk should be undertaken.*

Substantive procedures - Revenue

The auditor may use substantive analytical procedures as predictive analytics to establish the reliability of reported revenue. E.g. current year sales can be derived by predicting the increase in sales compared to the previous year. For the prediction (expectation) the auditor may use the increase in the number of orders and apply past average sales per customer ( Rs. 3,500) adjusted by the discount rate.

- Call direct confirmation from credit card companies.
- Check subsequent realization of receivables after deducting credit card commissions.
- Check selected customer orders with dispatch details, etc.

Substantive procedures - Claims

- Check whether each claim logged has a corresponding confirmed order for which the delivery is completed as per pending order file.
- Check the time of placing the order, departure time of the driver and the time that customer acknowledges the delivery by entering order ID to determine whether there had <u>been a delay in distribution.</u>
- Check the possibility of confirming material claims directly by contacting customer or calling confirmation.

Substantive procedures- Cash

- Check cash collected with bank statements.
- Perform surprise cash count and reconcile with records.

| Marking Guide |
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| 1.5 to 2 marks for each point depending on importance.<br>Total 8 marks |