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THE INSTITUTE OF CHARTERED ACCOUNTANTS OF SRI LANKA

SCHOOL OF ACCOUNTING AND BUSINESS
BSc. (APPLIED ACCOUNTING) GENERAL / SPECIAL DEGREE PROGRAMME

YEAR II SEMESTER II
END SEMESTER EXAMINATION – AUGUST 2015

AFM 20730 Audit & Assurance

Date	:	14th August 2015
Time	:	9.00 a.m. – 12.00 p.m.
Duration	:	Three (03) hours

Instructions to Candidates:

- Answer **ANY FIVE (05)** questions.
- The total marks for the paper is 100.
- The marks for each question are shown in brackets.
- Use of scientific calculator is allowed.
- Answers should be written neatly and legibly.

Question No. 01

a. Veena decides to set up a business of selling flowers. She gets up early in the morning, visits the market, and then sets up a stall by the side of the road. For the first year, all goes well. She sells all the flowers she is able to buy and she derives some income from the business.

However, Veena feels that she could sell more flowers if she was able to transport more to the place where she sells them, and she also knows that there are several other roads nearby where she could sell flowers, if she could be in two places at once. She could achieve these two things by buying a van and by employing other people to sell flowers in other locations.

Veena needs more money to achieve this expansion of her business. She decides to ask her rich friend Perera to invest in the business. Perera can see the potential of Veena's business and wants to invest, but he doesn't want to be involved in the management of the business. He also does not want to have ultimate liability for the debts of the business if it fails. He therefore suggests that they set up a limited liability company. He will own the majority of the shares and be entitled to dividends. Veena will be managing director and be paid a salary for her work.

At the end of the first year of trading as a limited company, Perera receives a copy of the Financial Statements. Profits are lower than expected, so his dividend will not be a large as he had hoped. He knows that Veena is paid a salary so does not care as much as him that profits are low. Perera is concerned by the level of profits and feels that he wants further assurance on the accounts. He doesn't know whether they give a true reflection on the last year's trading, particularly as the profits do not seem as high as those Veena had predicted when he agreed to invest.

Required:

Veena and Perera seek your advice on importance of performing assurance engagements, proposed assurance engagement to be performed in above case and its advantages and disadvantages.

(07 Marks)

b. You are an audit manager in MS Associates, a firm of Chartered Accountants. Mr. Ranasinghe, Chief Executive Officer of LMD PLC sent an e-mail asking from your firm to perform the audit for the year ended 31st March 2015. Further his E-mail describe that the LMD PLC is in the business of a manufacture and export of rubber related products.

Required:

Explain the matters that should be considered before accepting the engagement to audit the financial statements of LMD PLC for the year ended 31st March 2015.

(04 Marks)

c. Distinguish the following,

i. Interim audit and final audit

ii. Internal audit and External audit

iii. Vouching and verification

(09 Marks)

(Total 20 Marks)

Question No. 02

You as Audit Senior are planning the audit of Redsmith Co. for the year ended 31st March 2015. The company produces and sells printers and has been a client of your firm for two years; your audit manager has already had a planning meeting with the finance director. He has provided you with the following notes of his meeting and financial statement extracts.

Redsmith's management were disappointed with the 2014 results and so in 2015 undertook a number of strategies to improve the trading results. This included the introduction of a generous sales-related bonus scheme for their salesmen and a high profile advertising campaign. In addition, as market conditions are difficult for their customers, they have extended the credit period given to them.

The finance director of Redsmith has reviewed the inventory valuation policy and has included additional overheads incurred this year as he considers them to be production related. He is happy with the 2015 results and feels that they are a good reflection of the improved trading levels.

Financial statement extracts for year ended 31st March.

	Draft (Rs. Mn.) 2015	Actual (Rs. Mn.) 2014
Revenue	23	18
Cost of Sales	(11)	(10)
Gross Profit	12	8
Operating expenses	(7.5)	(4.0)
Profit before interest and tax	**4.5**	**4.0**
Inventory	2.1	1.6
Receivables	4.5	3.0
Cash	-	2.3
Trade Payables	1.6	1.2
Overdraft	0.9	-

Required:

Using the information above:

i. Perform the analytical procedures, which would assist the audit senior in planning the audit.

(10 Marks)

ii. From a review of the above information and the analytical procedures, explain the audit risks that arise and describe the appropriate response to these risks.

(10 Marks)

(Total 20 Marks)

Question No. 03

a. You are a manager in Nelson & Co, a firm of Chartered Accountants, with three offices and 12 partners. About one third of the firm's clients are audit clients, the remainder are clients for whom Nelson & Co performs tax, accounting and business advisory services. The firm is considering how to generate more revenue, and you have been asked to evaluate two suggestions made by the firm's business development manager.

i. An advertisement could be placed in national newspapers to attract new clients. The draft advertisement has been given to you for review:

> Nelson & Co is the largest and most professional accountancy and audit provider in the country. We offer a range of services in addition to audit, which are guaranteed to improve your business efficiency and save your tax.
> If you are unhappy with your auditors, we can offer a second opinion on the report that has been given.
>
> Introductory offer: for all new clients we offer a 25% discount when both audit and tax services are provided. Our rates are approved by Chartered Accountants of Sri Lanka.

(12 marks)

ii. A new partner with experience in the banking sector has joined Nelson & Co. It has been suggested that the partner could specialize in offering a corporate finance service to clients. In particular, the partner could advise clients on raising debt finance, and would negotiate with the client's bank or other provider of finance on behalf of the client. The fee charged for this service would be contingent on the client obtaining the finance with a borrowing cost below market rate.

Required:

Evaluate each of the suggestions made above, commenting on the ethical and professional issues raised.

(08 marks)

(Total 20 Marks)

Question No. 04

Sitting Pretty Co is a small, family-run company that makes plastic chairs in a variety of shapes and colours for children and 'fun at heart' adults. It buys plastic sheets (which can be cut and bent into the correct shape) and plastic leg which is custom made by another company to Sitting Pretty's requirements. All off-cut plastic is sent back to the supplier who melts it down and re-uses it, for which Sitting Pretty receive a 10% discount off their purchase price.

For the inventory count, the factory manager ensures that no work-in-progress is outstanding. Further production is stopped on the date of inventory count. The factory workers come in early on the day of the inventory count to count the inventory, and they are entitled to go home as soon as inventory count is over. Good controls have always been maintained over the inventory count in previous years. There are no perpetual inventory records. Raw materials are kept in the stores and are only taken out when they are required for production.

You are the audit senior assigned to attend the inventory count. You have just been informed by the factory manager that on the day of the inventory count a large consignment of plastic is going to be delivered. It is the only day that his supplier can make the delivery, and he needs the material to continue with production on the day after the count.

The audit engagement partner has told you that he is aware that Sitting Pretty changed the specification of their customised leg recently, after a series of complaints over the stability of their chairs. Last year's inventory was valued at Rs.200,000 in the statement of financial position, of which Rs.30,000 related to raw material inventory.

Finished goods are carried at the same valuation as each other as there is very little difference between the inventory ranges. Planning materiality for this year has been set at Rs.5,000 on the grounds, at this stage, that the figures are expected to be similar to last year.

Required:

a. Explain the importance of the inventory count in this situation.

(05 Marks)

b. Prepare notes for your audit supervisor detailing the procedures you propose to undertake in relation to your inventory count attendance.

(05 Marks)

c. State the procedures which should be perform in relation to cut-off at the final audit.

(05 Marks)

d. List the audit procedures you would carry out check the accuracy of valuation of inventory at the final audit.

(05 Marks)

(Total 20 Marks)

<u>Question No. 05</u>

a. You are the manager responsible for the audit of Ben Co, a company which designs and manufactures motor vehicles engine parts. The audit of the financial statements for the year ended 31 March 2015 is nearing completion and you are reviewing the working paper of the going concern section of the audit file. The draft financial statements showed a loss of Rs.500,000 (2014 – profit of Rs.760,000), and total assets of Rs.13.8 million (2014 – Rs.14.4 million).

The audit senior has left the following note for your attention:

'I have performed analytical review on Ben Co's year-end financial statements. The current ratio is 0.8 (2014 – 1.2), the quick ratio is 0.5 (2014 – 1.6). The latest management accounts show that ratios have deteriorated further since the year end, and the company now has a cash balance of only Rs.25,000. Ben Co has a long-term loan outstanding of Rs.80,000 with a covenant attached, which states that if the current ratio falls below 0.75, the loan can be immediately recalled by the lender.'

You are also aware that one of Ben Co's best-selling products, the Quick Fire, has become technically obsolete during 2013 as customers now prefer more environmentally friendly engine parts. Historically, the Quick Fire has generated 45% of the company's revenue. In response to customers' preference, Rs.1.3 million has been spent on designing a new product, the Green Fire, due for launch in May 2015, which will be marketed as an environmentally friendly product.

A cash flow forecast has been prepared for the year to 31 March 2016, indicating that based on certain assumptions, the company's cash balance is predicted to increase to Rs.520,000 by the end of the forecast period. Assumptions include:

1. The successful launch of the Green Fire product,

2. The sale of plant and machinery which was used to manufacture the Quick-fire, generating cash proceeds of Rs.50, 000, forecast to take place in April 2015,

3. A reduction in payroll costs of 15%, caused by redundancies in the Quick-fire manufacturing plant, and

4. The receipt of a grant of Rs.300, 000 from a government department which encourages innovation in environmentally friendly products, scheduled to be received in February 2016.

Required:

i. Identify and explain the matters which cast doubt on the going concern status of Ben Co.

(07 Marks)

ii. Explain the audit evidence you would expect to find in your working paper file in respect of the cash flow forecast.

(07 Marks)

b. During the year the internal auditor of MDT Co discovered several discrepancies in the inventory records. In a statement made to the board of directors, the internal auditor said: ‘I think that someone is taking items from the warehouse. A physical inventory count is performed every three months, and it has become apparent that about 200 boxes of flat-packed chairs and tables are disappearing from the warehouse every month. We should get someone to investigate what has happened and quantify the value of the loss.

Required:

Explain the role of the external auditor under this circumstance.

(06 Marks)

(Total 20 Marks)

<u>Question No. 06</u>

Your firm acts as auditor of Wise guys Bakeries Co. The finance director has prepared financial statements of the company for year to 31 March 2015 which show a pre-tax profit of Rs.4.5 million. You have been advised that the board of directors has approved the financial statements and decided that no amendments should be made thereto.

You have noted the following matters during your review of the financial statements and the audit working papers:

a. The freehold property which was included at cost in previous years' statement of financial position, has now been stated at valuation of Rs.12.5 million. A valuation was carried out during the year by a professional valuer and you are satisfied with the valuation. Further the relevant figures have been correctly adjusted and the necessary information disclosed in the notes to the financial statements.

(05 Marks)

b. An amount of Rs.2.5 million due from a customer in respect of sales during the year is included in receivables. But from information made available to you, you conclude that no part of this debt will be recovered. No allowance has been made against this debt in the financial statements.

(05 Marks)

c. A substantial claim has been lodged against the company by a major customer. The matter is fully explained in the notes to the accounts. But no provision has been made in the financial statements for legal costs or Compensation payable. The directors have received legal advice which appears to be reliable in indicating that the claim has to be paid.

(05 Marks)

d. Wise guys Bakeries Co has in place a defined benefit pension plan for its employees. An actuarial valuation on 31st March 2015 indicated that the plan is in deficit by Rs.2.5 million. The deficit is not recognized in the statement of financial position.

(05 Marks)

Required

Explain how you would consider each of the above in compiling auditor’s report for wise Guys Bakeries & Co.

(Total 20 Marks)