



No. of Pages - 12

No of Questions - 08

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

**INTAKE II/III/IV – GROUP B**  
**END SEMESTER EXAMINATION – JULY 2016**

**AFM 20730 Audit and Assurance**

Date : 23rd July 2016  
Time : 9.00 a.m. – 12.00 p.m.  
Duration : Three (03) hours

**Instructions to Candidates:**

- This paper consists of two sections (A and B).
- **Section A** – Compulsory. Answer **ALL** the questions in the separate sheet provided
- **Section B** - Answer any **Four (04)** questions
- The marks for each question are shown in brackets.
- The total marks for the paper is 100.
- Non programmable calculators are allowed.
- Answers should be written neatly and legibly

## Section A

Answer **ALL** the questions

Mark the most suitable answer.

1. Which of the following is not an inherent limitation of internal control systems?
  - a. Insufficient segregation of duties.
  - b. Possibility that employees may collude together fraudulently.
  - c. Power failure in equipment used in control systems.
  - d. Possibility of human error in undertaking tasks.
  
2. The procedure of tracing transactions through the information system relevant to financial reporting, is known as,
  - a. System checking.
  - b. Walk-through test.
  - c. Test of controls.
  - d. Information system test.
  
3. Which of the following procedures are “Test of Controls” an auditor should perform in testing the inventory cycle of their client whilst attending the inventory count?
  1. Observe whether the client’s staff are following the inventory count instructions.
  2. Review inventory present in the warehouse for evidence of damage or obsolescence.
  3. Obtain a sample of the last goods received notes and goods dispatched notes and follow through to ensure inclusion in the correct accounting period.
  4. Inspect and review management’s inventory count instructions.
  - a. 2 and 3
  - b. 1 and 4
  - c. 1 and 2
  - d. 3 and 4

4. Which two (2) of the following controls of a sales system ensure that all goods dispatched are completely and accurately invoiced?
1. Good dispatched notes are matched to sales invoices.
  2. Sales invoices are sequentially numbered.
  3. Sales invoices are matched to customer orders.
  4. Regular review of unfulfilled orders.
- a. 1 and 2  
b. 2 and 4  
c. 2 and 3  
d. 1 and 4
5. The auditor's determination of materiality is a matter of,
- a. Professional skepticism.
  - b. Professional judgment.
  - c. Professional behavior.
  - d. Competency and due care.
6. Which of the following is a substantive audit procedure for wages and salaries?
- a. Inspect a sample of clock cards for evidence of authorization by a responsible official.
  - b. Try to add a new employee card to the payroll system.
  - c. Recalculate a sample of payroll deductions such as employment taxes to confirm accuracy.
  - d. Attempt to access and make changes to the payroll master file using the log on for a junior clerk.
7. Which of the followings is not a way that, analytical procedures are carried out.
- a. Compare financial results with prior period results.
  - b. Compare financial results with other divisions of the company.
  - c. Compare financial results with similar industry results.
  - d. Compare financial results with budgeted/anticipated information.

8. Which of the following statements relating to internal/ external auditors is correct?
- a. Internal auditors are required to be members of a professional body.
  - b. Internal auditors' scope of work should be determined by those charged with governance.
  - c. External auditors report to those charged with governance.
  - d. Internal auditors can never be independent of the company.
9. Inspection of records and documents related to the collection of receivables after the period end may provide audit evidence regarding,
- a. Existence and valuation.
  - b. Cut-off and classification.
  - c. Completeness and occurrence.
  - d. Completeness and allocation.
10. Audit procedures performed for the purpose of detecting material misstatements, including tests of details of classes of transactions, account balances and disclosures are known as,
- a. Audit procedures.
  - b. Substantive procedures.
  - c. Financial procedures.
  - d. Analytical procedures.

**(Total 20 Marks)**

## **Section B**

Answer **any four (04)** questions

### **Question No. 01**

You are the audit manager of Perera & Co a firm of Chartered Accountants and currently planning the audit of Sevone PLC. You attended the planning meeting with the engagement partner and finance director last week and recorded the minutes from the meeting which contains following information.

Sevone's trading results have been strong this year and the company is forecasting revenue of Rs.85 million, which is a significant increase from the previous year. The company has invested significantly in the production process at the factory. This resulted in expenditure of Rs.5 million on updating, repairing and replacing a significant amount of the machinery used in the production process.

As a result of the increase in revenue, Sevone PLC has recently recruited a new credit controller to chase outstanding receivables. The finance director thinks it is not necessary to continue to maintain an allowance for receivables and so has released the opening allowance of Rs.1.5 million.

#### **Required:**

- I. "A few appropriate audit evidence will be sufficient for the auditor, but many inappropriate evidence will not be sufficient". Comment on this statement.  

(05 Marks)
- II. Explain substantive procedures the audit team should perform to obtain sufficient and appropriate audit evidence in relation to the treatment of the Rs.5 million expenditure incurred on improving the factory production process.  

(07 Marks)
- III. Explain the substantive procedures the audit team should perform to obtain evidence related to the release of allowance for receivables?  

(08 Marks)

**(Total 20 Marks)**

## **Question No. 02**

You are the audit supervisor of Fernando & Co and are currently planning the audit of your existing client, Heaters PLC, for the year ending 31 December 2015.

Heaters has experienced increased competition and as a result, in order to maintain its current levels of sales, it has decreased the selling price of its products significantly since September 2015.

The finance director has informed your audit manager that he expects increased inventory levels at the year end. He also notified your manager that one of Heater's key customers has been experiencing financial difficulties. Therefore, Heaters has agreed that the customer can take a six-month payment break, after which payments will continue as normal. The finance director does not believe that any allowance is required against this receivable.

In October 2015 the financial controller of Heaters was dismissed. He had been employed by the company for over 20 years, and he has threatened to sue the company for unfair dismissal. The role of financial controller has not yet been filled and so his tasks have been shared between the existing finance department team. In addition, the purchase ledger supervisor left in August and a replacement has been done in the last week of December. However, for this period no supplier statement reconciliations or purchase ledger control account reconciliations were performed.

You have undertaken a preliminary analytical review of the draft year to date statement of profit or loss, and you are surprised to see a significant fall in administration expenses.

### **Required:**

- I. Explain the effect of Inherent risk, Control risk and Detection risk on Audit risk.  
(05 Marks)
  - II. Identify five audit risks faced by Fernando & Co in conducting the audit of Heaters PLC.  
(08 Marks)
  - III. Explain the auditor's response to each risk, in planning the audit of Heaters PLC.  
(07 Marks)
- (Total 20 Marks)**

### **Question No. 03**

You are an audit senior of Surasena & Co and have been allocated to the audit of Dino PLC, a listed company which has been an audit client of Surasena & Co for eight years which specializes in manufacturing electric equipment. Mr. Amal was the audit engagement partner for Dino and as he had completed seven years as the audit engagement partner, he has recently been rotated off the audit engagement.

The current audit partner, Mr. Sarath has suggested that in order to maintain a close relationship with Dino, Mr. Amal should undertake the role of independent review partner this year.

In addition Dino has requested that Mr. Amal to assist them by attending their audit committee meetings, in place of a non-executive director who recently left the company.

Dino has also asked Mr. Sarath and the other partners at Surasena & Co to help them in recruiting a new non-executive director.

The current year's audit fee has not yet been confirmed, but along with taxation and other possible non-audit fees the total income from Dino, this year could be greater than 16% of total fee income of the firm.

Further, Dino asked Mr. Sarath to support them to develop their internal controls related to financial reporting.

#### **Required:**

- I. "Opinion shopping" is considered unethical for an entity, and will create a conflict of interest to practitioners. Elaborate this statement.  
(05 Marks)
- II. Identify and explain five ethical threats which may affect the independence of Surasena & Co's audit of Dino Co.  
(08 Marks)
- III. For each threat explain how it might be reduced to an acceptable level.  
(07 Marks)

**(Total 20 Marks)**

#### **Question No. 04**

Odesk Computers Ltd is a computer hardware specialist and has been trading for over five years. The company is funded partly through overdrafts and loans and also by several large shareholders. The financial year of the company ends on 31<sup>st</sup> March.

A new competitor, Desk Ltd, has entered the market and through competitive pricing has gained considerable market share from Odesk. One of Odesk's larger customers has stopped trading with them and has moved its business to Desk Ltd.

In addition, a number of Odesk's specialist developers have left the company and joined Desk Ltd. Odesk has found it difficult to replace these employees due to the level of their skills and knowledge. Odesk has just received notification that its main supplier who provides the company with specialist electrical equipment has ceased to trade.

Odesk is looking to develop new products to differentiate itself from the rest of its competitors. It has approached its shareholders to finance this development but they declined to invest further. The overdraft has increased significantly over the year and the directors have informed you that the overdraft facility is due for renewal next month, and they are confident it will be renewed by the bank.

The directors have produced a cash flow forecast which shows a significantly worsening position over the coming 12 months. They are confident with the new products being developed will be a success and believe it is unnecessary to make any disclosures in the financial statements regarding going concern.

#### **Required:**

- I. Even though auditor does not have a personal interest of a business, they are concerned on the 'going concern' of the client's business. Explain why?  
(05 Marks)
- II. Explain five potential indicators that Odesk Computers Ltd is not having a going concern.  
(07 Marks)
- III. Describe the audit procedures you should perform in assessing whether Odesk Computers Ltd is a going concern or not.  
(08 Marks)

**(Total 20 Marks)**



### **Question No. 05**

You are appointed as the auditor of Tasty PLC for the year ended 31 March 2015. Tasty PLC is a chain of food outlets operating in 6 locations in Sri Lanka. The food outlets sell a range of pastry items and drinks which customers purchase for cash.

Management of the company explains it as a challenging financial year, and is renegotiating its bank overdraft facility with its bank. The income statement for the year ended 31 March 2014 is shown below together with the draft income statement for the year ended 31 March 2015.

<b>Income statements of Tasty PLC.</b>		
	<b>31 March 2015</b> <b>(Rs.000')</b>	<b>31 March 2014</b> <b>(Rs.000')</b>
Revenue	3,364	3,011
(-) Cost of sales	(1,101)	(1,244)
Gross profit	2,263	1,767
(-) Operating expenses		
Administrative	(534)	(638)
Selling and distribution	(338)	(368)
Interest expense	(40)	(39)
Profit before tax	<b>1,351</b>	<b>722</b>

#### **Required:**

- I. Explain the difference between overall materiality, performance materiality and tolerable error in a set of financial statements.  

(05 Marks)
- II. Calculate the useful ratios on given financial information, to support your analytical procedures.  

(07 Marks)
- III. Identify possible risk areas in the draft income statement which require further audit work.  

(08 Marks)

**(Total 20 Marks)**

### **Question No. 06**

You are the audit manager of Silva & Co and close to the completion of the audit of Lexico PLC. The audit senior has produced below extracts from the draft audit report for Lexico, which he feels as not appropriate.

- Our responsibility is to express an opinion on all pages of the financial statements based on our audit. We conducted our audit in accordance with most of the Sri Lankan Auditing Standards.
- Those standards require that we comply with ethical requirements and plan and perform the audit to obtain maximum assurance as to whether the financial statements are free from all misstatements whether caused by fraud or error.
- We have a responsibility to prevent and detect fraud and error and to prepare the financial statements in accordance with Sri Lanka Accounting Standards.
- An audit involves performing procedures to obtain evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the availability and experience of audit team members. We considered internal controls relevant to the entity, and express an opinion on the effectiveness of these internal controls.
- We did not evaluate the overall presentation of the financial statements, as this is management's responsibility. We considered the reasonableness of any new accounting estimates made by management.

#### **Required:**

- I. Describe five elements included in an unmodified audit report, with the reason why they are included.  
(05 Marks)
  - II. Identify six inaccurate statements in the draft audit report extracts, which need to be amended.  
(06 Marks)
  - III. Explain the amendments that should be done for identified inaccurate statements in the draft audit report of Lexico PLC.  
(09 Marks)
- (Total 20 Marks)**

### **Question No. 07**

- a. Bush-Baby Hotels Co operates a chain of 18 hotels located across the country. Each hotel has bedrooms, a restaurant and leisure club facilities. Most visitors to the restaurant and leisure club are hotel guests; however, these facilities are open to the public as well. Hotel guests generally charge any costs to their room but other visitors must make payment directly to the hotel staff. During the year, senior management noticed an increased level of cash discrepancies and inventory discrepancies, and they suspect that some employees have been stealing cash and goods from the hotels. They are keen to prevent this from reoccurring and are considering establishing an internal audit department to undertake a fraud investigation.

**Required:**

Explain the role of the **internal** and **external** auditor under this circumstance.

(10 Marks)

- b. You are an audit manager in MSK Associates, a firm of Chartered Accountants. Mr. Perera, Chief Executive Officer of MD PLC sent an e-mail asking from your firm to perform the audit for the year ended 31<sup>st</sup> March 2016 and for the following years. Further his E-mail describe that the MD PLC is a manufacture and exporter of electric equipment.

**Required:**

Explain the matters that should be considered before accepting the engagement to audit the financial statements of MD PLC for the year ended 31<sup>st</sup> March 2016.

(05 Marks)

- c. Financial statements are ordinarily prepared and presented annually and are directed toward the common information needs of a wide range of users. Many of those users rely on the financial statements as their major source of information because they do not have the power to obtain additional information to meet the specific needs. Accordingly, professional auditors perform different types of auditing and related services in order to meet the specific needs of different types of stakeholders.

**Required:**

Discuss the different types of auditing and related services and the assurance levels provided by the auditor.

(05 Marks)

**(Total 20 Marks)**