SUGGESTED SOLUTIONS

KB4 – Business Assurance Ethics & Audit

December 2016

SECTION 1

Answer 01

Relevant Learning Outcome/s: 1.1.1, 1.3.1
Demonstrate the need to comply with the fundamental and ethical principles applicable to all members of the Institute of Chartered Accountants of Sri Lanka Demonstrate the legal and regulatory factors affecting an audit of financial statements.

(a) - Member of CA Sri Lanka
- Registered auditor

(b) **Threats to independence**

Amal has obtained a loan from Wiswin Investments. This situation may give rise to a self-interest threat, which affects independence and objectivity. However, if Wiswin Investments has loaned an immaterial amount on normal commercial terms, there is no threat to independence.

Threats to objectivity

There is a conflict of interest between Wiswin Investments and Fernando as he is the main shareholder of Central Investment Ltd, which operates in the same industry and is in competition with Wiswin Investments.

Fernando should evaluate the above threats to objectivity and independence and apply safeguards where necessary to reduce the threats to an acceptable level.

If the conflict of interest is significant, Fernando should not accept the engagement.

(Total: 10 marks)

Answer 02

Relevant Learning Outcome/s: 2.1.1, 2.2.3
Discuss the key aspects of corporate governance, including responsibilities of the Board and role of non-executive directors. Analyse design, implementation and operating effectiveness of identified controls.

(a) The deficiencies in the current board structure of SPLC

1) **Number of non-executive directors**

As per corporate governance rules, the board of directors of a listed entity shall include at least,

i. Two non-executive directors, or
ii. Such number of non-executive directors equivalent to one third of the total number of directors, whichever is higher

In this scenario there are only 2 non-executive directors, when in fact there should be 3 non-executive directors.

2) **Independence of non-executive directors**

When the constitution of the board of directors includes only 2 non-executive directors, both such non-executive directors shall be "independent".

In this scenario one of the non-executive directors of the company is the wife of the chairman (i.e. a close family member).

3) **Chairman of the audit committee**

The chairman of the audit committee should be an independent non-executive director.

In this scenario the chairman of the audit committee is also the finance director of the company.

4) **Members of the audit committee**

The audit committee of a listed entity should comprise of non-executive directors.

In this case, the appointment of the finance director (who is an executive director) to the audit committee of the company is not appropriate.

(b) **The board's responsibility**

- The ultimate responsibility for a company's system of internal controls lies with the board of directors. They should set procedures of internal control and regularly monitor that the system operates as it should.
- An important point to note is that the **effectiveness of internal controls in a company is the responsibility of the board of directors**.

The operational management's responsibility

- Management is given the delegated responsibility for designing and implementing the internal control system, and they are accountable to the board. The board delegates operational responsibility for internal control to the management, and the management should be accountable to the board for the effectiveness of internal controls.
- Management is given the delegated task of developing detailed strategies and plans for the achievement of the board's objectives, and also for managing risks.
- Responsibility of the management for internal control is to the board and not to the company's shareholders.

(c) (i) **Payroll process**

- There should be segregation of duties between the member of staff responsible for processing the payroll and the individual handling the cash.
- Payroll software should include computerised controls e.g. hierarchical password to access and carry out range checks.
- Physical controls over the use of hardware.

(ii) **Purchasing process**

- The accounts department should check the invoice details against the purchase order (PO) and goods received note (GRN). Errors should be referred back to the supplier.
- Staff receiving goods should check the goods with the PO and invoice.

(Total: 10 marks)

Answer 03

Relevant Learning Outcome/s: 3.1.2, 3.3.1
Define overall materiality, performance and materiality level. Discuss how business risk could result in risk of material misstatements in financial statements.

(a) Product quality issues
Pressure from competitor

(b)

Business risk	**Financial statement line items that could be misstated**
Product quality issues	• Inventory (NRV) • Revenue (Returns)
Pressure from competitor	• Inventory (NRV) • Revenue • Impairment of plant and equipment

(c) The business risk approach is an extension of the audit risk approach. When using an audit risk approach, the auditors focus their attention on matters that they feel are the most risky to the financial statements so that they can provide a cost effective audit.

In a business risk approach, the auditors determine the business risks that are most likely to affect the financial statements adversely. The auditor directs their testing to the business risks apparent in the business.

(d)

i. Elements of the financial statements (e.g. assets, liabilities, equity, revenue, expenses)
ii. Whether there are items on which users tend to focus
iii. Nature of the entity, industry and economic environment
iv. Entity's ownership structure and financing
v. Relative volatility of the benchmark

(Total: 10 marks)

Answer 04

Relevant Learning Outcome/s: 4.6.2, 4.6.3
Explain the meaning of audit sampling. Explain different methods used for selecting samples in audit sampling

(a) Lower the risk the auditor is willing to accept, the greater the sample size will need to be.

(b)

i. The company currently only has six construction projects with high values. The population is made up of a small number of high value transactions, where there is a high risk of material misstatements. Therefore 100% examination may be appropriate.

ii. In Jayasiri Super City (Pvt) Ltd, there is a large number of small values, since it sells goods to retail customers. In this case, statistical sampling may be appropriate. In statistical sampling, the sample is randomly selected and results are evaluated using probability theory.

(Total f: 10 marks)

Answer 05

Relevant Learning Outcome/s: 5.2.2, 5.4.1
Explain the type of modified opinion provided under SLAuS 705 Explain auditor's responsibility towards other information included in documents containing auditor's report.

(a) Types of modified opinions

Nature of circumstances	**Material but not pervasive**	**Material and pervasive**
Financial statements are materially misstated	QUALIFIED OPINION	ADVERSE OPINION
Auditor is unable to obtain sufficient appropriate audit evidence	QUALIFIED OPINION	DISCLAIMER OF OPINION

(b) **Audit of ABC Group**

In this case the auditor is unable to obtain sufficient appropriate audit evidence about the carrying value of the investment in the associate company accounted for by the equity method. The effect of misstatement, if any, would be material to the financial statements. However, it is not likely to be seen as pervasive, and therefore a qualified opinion would be appropriate.

(c) In this case, other information is disclosed in the document containing the audited financial statements and auditor’s report. The other information revealed that the company had incurred Rs. 50 million on R&D during the year. The other information contradicts the information contained in the audited financial statements. This is a material inconsistency as per SLAuS 720. If the material inconsistency is identified, the auditor shall determine whether the audited financial statements or other information needs to be revised.

- If the financial statements need to be revised but the management refuses, the auditor shall **modify** the audit opinion.
- If the other information needs to be revised but management refuses, the auditor shall **communicate** this matter to those charged with governance and,
    - Include an **emphasis of matter paragraph** describing the material inconsistency
    - **Withhold** the auditor’s report
    - **Withdraw** from the engagement (where this is legally permitted)

(Total: 10 marks)

Answer 06

Relevant Learning Outcome/s: 1.5.1, 2.2.2, 3.4.1
Discuss the different types of audit documentation which should be mentioned. Recognise the importance of IT controls in an audit, including IT general controls and IT application controls. Discuss auditor's responsibility for preventing and detecting frauds in an audit of financial statements.

(a) **ITGCs**

- ERP system is password protected and only authorised personnel to particular modules can access them.
- All changes made to the ERP system (e.g. servers, databases, applications, batch jobs and infrastructure) are documented and tracked.
- Unit price field can be edited only if it is authorised.

Application controls

- There is three-way matching in the system between the entity's purchase order, invoice (shipping documents) and good received note (GRN). Any differences are flagged via an exception report and are investigated and resolved by the accountant in a timely manner (one-for-one checking)
- All manual adjustments to inventory booked as a result of the physical inventory verification are reviewed and approved by the financial controller through the system (input authorisation)
- Unit price field can be edited only if it is authorised by the financial controller and general manager through the system (input authorisation)

(b) The audit team should select to test some or all of the ITGCs, having considered how they affect the computer applications significant to the audit. ITGCs that relate to some or all applications are usually interdependent controls (i.e. their operation is often essential to the effectiveness of application controls). As application controls may be useless when general controls are ineffective, it will be more efficient to review the design of ITGCs first, before reviewing the application controls. Therefore, the audit team should discuss with the IT specialists on interdependent ITGCs that are relevant to the audit, and the scope of testing should be agreed.

(c) **Fraud risk factors**

- High degree of competition or market saturation, accompanied by declining margins
- Negative cash flows from operations whilst reporting earnings and earnings growth
- Unreasonable demands on the auditor, such as unrealistic time constraints regarding the completion of the audit and issuance of the auditor's report
- Rapid growth or unusual profitability

(2 marks per point, maximum 4 marks)

(d) **Revenue recognition**

- Performing substantive analytical procedures relating to revenue using disaggregated data. Computer-assisted audit techniques may be useful in identifying unusual or unexpected revenue relationships or transactions.
- Confirming with customers certain relevant contract terms. For example, acceptance criteria, delivery and payment terms, the absence of future or continuing vendor obligations, the right to return the product, guaranteed resale amounts, and cancellation or refund provisions are often relevant in such circumstances.
- Inquiring from the entity's sales and marketing personnel or in-house legal counsel regarding sales or shipments near the end of the period and their knowledge of any unusual terms or conditions associated with these transactions.
- Being physically present at one or more locations during period end to observe goods being shipped or those awaiting shipment (or returns awaiting processing) and performing other appropriate sales and inventory cut-off procedures.
- For those situations where revenue transactions are electronically initiated, processed, and recorded, testing controls to determine whether they provide assurance that recorded revenue transactions have occurred and are properly recorded.

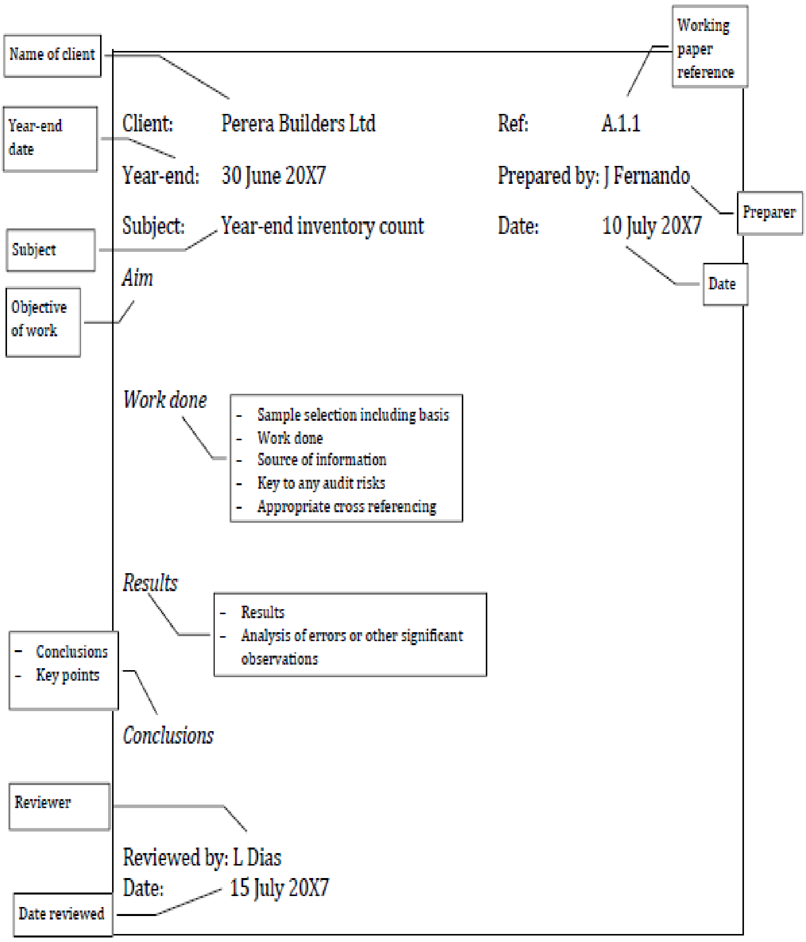
(Two procedures, 1 ½ marks each, totaling 3 marks)

Inventory

- Examining the entity's inventory records to identify locations or items that require specific attention during or after the physical inventory count.
- Observing inventory counts at certain locations on an unannounced basis or conducting inventory counts at all locations on the same date.
- Conducting inventory counts at or near the end of the reporting period to minimise the risk of inappropriate manipulation during the period between the count and the end of the reporting period.
- Performing additional procedures during the observation of the count, for example, more rigorously examining the contents of boxed items, the manner in which the goods are stacked etc.
- Comparing the quantities for the current period with prior periods by class or category of inventory, location or other criteria, or comparison of quantities counted with perpetual records.
- Using computer-assisted audit techniques to further test the compilation of the physical inventory counts – for example, sorting by tag number to test tag controls or by item serial.

(Two procedures, 1 ½ marks each, totaling 3 marks)

(e) Illustration of an audit working paper



(10 important contents in the audit working paper, each carrying ½ mark, maximum 5 marks)

(Total for Question 6: 25 marks)

Answer 07

Relevant Learning Outcome/s: 4.3.1, 4.9.1, 4.10.1, 4.13.2
Explain the use of external confirmation in gathering audit evidence. Discuss the use of written representation as audit evidence, including its limitations. Explain the difference between test of controls and substantive procedures. Outline procedures required to evaluate the validity of the going concern assumption.

(a) Based on the facts of the scenario a material uncertainty exists relating to events or conditions that may cast significant doubt on the entity's ability to continue as a going concern. Therefore the use of the going concern assumption is inappropriate. The impact on the auditor's report would be as follows.

Use of going concern assumption inappropriate	Adverse opinion (ie modified opinion)
Management unwilling to make or extend its assessment	Qualified or disclaimer of opinion (ie modified opinion)

(4 marks)

(b) The auditor shall obtain sufficient appropriate audit evidence to determine whether a material uncertainty exists by:

- Requesting management to make its assessment, where this has not been done
- Evaluating management's plans for future action
- Evaluating the reliability of underlying data used to prepare a cash flow forecast and considering the assumptions used to make the forecast
- Considering whether any additional facts or information have become available since the date that management made its assessment
- Requesting written representations from management and those charged with governance about plans for future action and the feasibility of these plans.

(2 marks each, maximum 4 marks)

(c)

- Analyse and discuss cash flow, profit and other relevant forecasts with management
- Analyse and discuss the entity's latest available interim financial statements (or management accounts)
- Read minutes of the meetings of shareholders, the board of directors and important committees
- Inquire from the entity's lawyer regarding litigation and claims
- Review events after the period-end for items affecting the entity's ability to continue as a going concern
- Obtaining and reviewing reports relating to compliance with regulations

(2 marks each, maximum 4 marks)

(d)

- Written representations are more reliable than oral representations, since oral representations can be retracted. However, although written representations are a form of audit evidence, they do have their limitations.
- They are from an internal source and on their own they do not provide sufficient appropriate audit evidence about the issues they relate to.
- The fact that management has provided reliable written representations does not affect the nature or extent of other audit evidence to be obtained by the auditor about specific assertions in the financial statements.
- Although written representations are necessary, they cannot provide sufficient appropriate audit evidence on their own.
- The information from third-party sources is stronger evidence than that gained from within the entity.
- Written representations provided by management are internal to the organisation and therefore will often need to be corroborated to sources of evidence from third parties. For example, management representations on a legal matter may be compared to the opinion of external legal advisors.

(2 ½ marks each, maximum 5 marks)

(e)

1. **Discuss** the matter with management.
2. **Re-evaluate** the integrity of management and evaluate the effect this may have on the reliability of representations and audit evidence in general.
3. Take **appropriate action**, including determining the **impact** on the auditor's report.

(2 marks each, maximum 4 marks)

(f) **A positive confirmation** is one in which the confirming party responds directly to the auditor indicating whether they agree or disagree with the information in the request or provides the requested information.

A negative confirmation is one in which the confirming party responds directly to the auditor only if they disagree with the information in the request.

(2 marks per explanation, maximum 4 marks)

(Total for Question 7: 25 marks)

Notice of Disclaimer

The answers given are entirely by the Institute of Chartered Accountants of Sri Lanka (CA Sri Lanka) and you accept the answers on an "as is" basis.

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.

The Institute of Chartered Accountants of Sri Lanka (CA Sri Lanka) makes no warranties with respect to the suggested solutions and as such there should be no reason for you to bring any grievance against the Institute of Chartered Accountants of Sri Lanka (CA Sri Lanka). However, if you do bring any action, claim, suit, threat or demand against the Institute of Chartered Accountants of Sri Lanka (CA Sri Lanka), and you do not substantially prevail, you shall pay the Institute of Chartered Accountants of Sri Lanka's (CA Sri Lanka’s) entire legal fees and costs attached to such action. In the same token, if the Institute of Chartered Accountants of Sri Lanka (CA Sri Lanka) is forced to take legal action to enforce this right or any of its rights described herein or under the laws of Sri Lanka, you will pay the Institute of Chartered Accountants of Sri Lanka (CA Sri Lanka) legal fees and costs.