



No. of Pages - 10  
No of Questions - 07

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

**YEAR II SEMESTER II – INTAKE VI (GROUP B)**  
**END SEMESTER EXAMINATION – AUGUST 2017**

**AFM 20730 Audit and Assurance**

Date : 5th August 2017  
Time : 1.00 p.m. - 4.00 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 sheet provided.  
Section B – Answer any **FOUR (04)** questions out of the six questions given.
- The total marks for the paper is 100.
- The marks for each question are shown in brackets.
- Use of non-programmable calculator is allowed.
- Answers should be written neatly and legibly

## Section A

Answer **ALL** the questions

### **Question No. 01**

Select the most suitable answer.

1. The auditor's determination of materiality is a matter of,
  - a. Professional skepticism.
  - b. Professional judgment.
  - c. Professional behavior.
  - d. Professional competence and due care.
  
2. If misstatements, individually or in the aggregate, could reasonably be expected to influence the economic decisions of users taken on the basis of the financial statements, they are identified as,
  - a. Significant misstatements.
  - b. Considerable misstatements.
  - c. Material misstatements.
  - d. Moderate misstatements.
  
3. Amount set by the auditor for the financial statements as a whole to reduce the probability that the financial statements are materially misstated, is known as,
  - a. Overall materiality.
  - b. Procedure materiality.
  - c. Transaction materiality.
  - d. Performance materiality.
  
4. All the information used by the auditor, in arriving at the conclusions on which the audit opinion is based, are known as,
  - a. Financial information.
  - b. Data collected.
  - c. Audit evidence.
  - d. Material misstatements.

5. Which of the following can be identified as a source of audit evidence?
  - a. Cheques and records of electronic fund transfers.
  - b. Invoices.
  - c. Contracts.
  - d. All of the above sources.
  
6. 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.
  
7. Which of the following is **not** a fact that influences reliability of audit evidence,
  - a. Source of evidence.
  - b. Size of the figures in financial statements.
  - c. Nature of evidence.
  - d. Circumstances under which evidence obtained.
  
8. What is the auditor's responsibility on going concern of the business of a client?
  - a. To certify the going concern of the business to users of financial statements.
  - b. To consider the appropriateness of management's use of the going concern assumption in the preparation of the financial statements.
  - c. To provide an opinion on the going concern of the business in audit report.
  - d. To forecast the future of the business and identify any going concern issues of the business.
  
9. Intentional misstatements including omissions of amounts or disclosures in financial statements to deceive financial statement users is known as,
  - a. Misleading stakeholders.
  - b. Fraudulent financial reporting.
  - c. Management fraud.
  - d. Misappropriation.

10. Manipulating reported profits, with the intention of misleading financial statement users, by influencing their perceptions as to the entity's performance and profitability is named as,
- a. Earnings management.
  - b. Earnings manipulation.
  - c. Profit appropriation.
  - d. Performance management.

**(Total 20 marks)**

### **Section B**

Answer **any Four (04)** questions

#### **Question No. 02**

- i. 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 provided by practitioners and the assurance levels provided by them in respect of the identified services.

(06 marks)

- ii. Assume you are the senior partner of a reputed audit firm in Sri Lanka. Management of ABC International, a large Public Listed Company with extensive overseas interests, has asked you to accept the audit of the company. So that they can replace the present auditor at the next annual general meeting of the company.

**Required:**

Explain **Legal**, **Ethical** and **Practical** circumstances where you should not accept this appointment.

(07 marks)

- iii. During the year the internal auditor of Mulligan 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.

(07 marks)

**(Total 20 marks)**

**Question No. 03**

You are the audit senior of WP & Co and are planning the audit of Romesh PLC for the year ended 31<sup>st</sup> March 2017. The company produces printers and has been a client of your firm for two years. Audit Manager of WP & Co 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.

Management of Romesh PLC were disappointed with the 2016 results and so in 2017 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 Romesh PLC has reviewed the inventory valuation policy and has included additional overheads incurred this year as part of cost of inventory, as he considers them to be production related. He is happy with the 2017 results and feels that they are a good reflection of the improved trading levels.

**Financial statement extracts for the year ended 31<sup>st</sup> March 2017**

	<b>2017</b>	<b>2016</b>
	Rs. Mn.	Rs. Mn.
Revenue	23·0	18·0
Cost of Sales	(11·0)	(10·0)
	————	————
Gross profit	12·0	8·0
Operating expenses	(7·5)	(4·0)
	————	————
Profit before interest and taxation	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 above information:

- a. Calculate FIVE ratios, for BOTH years, which would assist the audit senior in planning the audit;

(10 marks)

- b. From a review of the above information and the ratios calculated, explain the audit risks that arise and describe the appropriate response to these risks.

(10 marks)

**(Total 20 marks)**

\

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

S & P Co. is a firm of Chartered Certified Accountants which has seen its revenue decline steadily over the past few years. The firm is expecting to increase its revenue and client base and so has developed a new advertising strategy where it has guaranteed that its audits will minimize disruption to companies as they will not last longer than two weeks. In addition, S & P Co. has offered all new audit clients a free accounts preparation service for the first year of the engagement, as it is believed that time spent on the audit will be reduced if the firm has produced the financial statements.

The firm is seeking to reduce audit costs and has therefore decided not to update the engagement letters of existing clients, on the basis that these letters do not tend to change much on a yearly basis. One of S & P Co.'s existing clients has proposed that this year's audit fee should be based on a percentage of their final pre-tax profit. The partners are excited about this option as they believe it will increase the overall audit fee.

S & P Co. has recently obtained a new audit client, Cinnamon Brothers Co. (Cinnamon), whose year end is 31st December. Cinnamon requires their audit to be completed by the end of February; however, it will be a very busy time for S & P Co. Therefore the company intends to use more junior staff in this audit as they are available. Additionally, in order to save time and cost, S & P Co. have not contacted Cinnamon's previous auditors.

#### **Required:**

- i. State four (04) matters that should be included within an audit engagement letter.  
(06 marks)
- ii. Identify and explain five (05) ethical risks which arise from the above actions of S & P Co.  
(07 marks)
- iii. For each ethical risk identified above, explain the steps which S & P Co. should adopt to reduce the risks identified.  
(07 marks)

**(Total 20 marks)**

### **Question No. 05**

- i. “The auditor should obtain sufficient appropriate audit evidence, to draw reasonable conclusions”. Explain the terms “sufficiency” and “appropriateness” in audit evidence and the relationship between those two terms.

(06 marks)

- ii. ABC Motor Co (ABC) manufactures a range of motor cars and its year end is 31<sup>st</sup> March 2017. You are the audit supervisor of MP & Co, currently preparing the audit programme for the year-end audit of ABC. You have had a number of issues identified during the audit risk assessment process.

**Land and buildings:** ABC has a policy of revaluing land and buildings, this is undertaken on a rolling basis over a five-year period. During the year ABC requested an external valuer to revalue a number of properties, including a warehouse purchased in July 2016. Depreciation is charged on a ‘pro rata basis’.

**Work in progress:** ABC undertakes continuous (24/7) production of cars. An inventory count is to be undertaken at the year end and MP & Co will attend. You are responsible for the audit of work in progress (WIP) and will be part of the team attending the count as well as the final audit. WIP constitutes the partly assembled cars at the year end and this balance is likely to be material. ABC values WIP according to percentage of completion, and standard costs are then applied to these percentages.

#### **Required:**

Describe the substantive procedures the auditor should perform to obtain sufficient and appropriate audit evidence in relation to:

- a. The revaluation of land and buildings and the recently purchased warehouse

(08 marks)

- b. The valuation of work in progress.

(06 marks)

**(Total 20 marks)**



### **Question No. 06**

- i. Auditor does not have any personal interest on a business but has a greater concern on the 'going concern' of the business. Explain why?

(06 marks)

- ii. LMN PLC (LMN) manufactures Tyres for motor cars and the company has a diverse customer base but seven significant customers. The company's year-end was 31<sup>st</sup> March 2017. You were appointed as the audit supervisor for the audit of LMN PLC, and following issues were identified in the audit.

During the year, a number of the company's significant customers have experienced a fall in sales, and consequently they have purchased fewer items from LMN. As a result, LMN has paid a number of its suppliers later than usual and some of them have withdrawn credit terms meaning the company must pay cash on delivery.

One of LMN's main suppliers is threatening legal action to recover the sums owing. As a result of the increased level of payables, the company's current ratio has fallen below 1 for the first time.

LMN has produced a cash flow forecast to 31<sup>st</sup> December 2018 and this shows net cash outflows until November 2018. LMN has a loan of Rs.2.3 million which is due for repayment in full by 31<sup>st</sup> March 2018.

The finance director has just informed you, that there is a possible change in legislation which will result in one of LMN's top product lines becoming obsolete as it will not comply with the proposed law. The prepared cash flow forecasts do not reflect this possible event.

#### **Required:**

- a. Explain potential indicators that LMN Co is not a going concern.
- (07 marks)
- b. Describe the audit procedures which auditor should perform in assessing whether or not LMN Co is a going concern.

(07 marks)

**(Total 20 marks)**

### **Question No. 07**

- i. Business has over the last few years become more complex, and financial reporting has had to evolve, increasing the judgement, estimates and uncertainty underlying the financial statements. The auditor's report, being the key deliverable addressing the output of the audit process, has up until now been a standard pass/ fail report with limited, if any, information that relates specifically to the entity, while providing no indication of the complexities relating to the entity or the audit. Since auditing is a profession that goes about its work behind the scenes, investors and other financial statements users have demanded more transparency and insight into the audit.

#### **Required:**

Explain briefly the elements of new auditor's report.

(08 marks)

- ii. You are the audit manager in charge of several audits running concurrently, all are in final stage.
- a. Your audit team was unable to obtain sufficient appropriate audit evidence regarding an investment in a foreign affiliate of Mega (Pvt.) Ltd. The possible effects of the inability to obtain sufficient appropriate audit evidence are deemed to be material to the financial statements.
- (4 marks)
- b. The Alpha PLC audit, the age analysis shows that Rs. 50 million worth of debtors have been outstanding for more than a year, of which only Rs. 2 million was paid in the subsequent period. The management has explained that due to economic situation they have experienced slow payments from most debtors in general, but your team has concluded that the bad debt allowances are not adequate.
- (4 marks)
- c. In ABC PLC audit, the team has mentioned that the company has lost access to the market in which they have been selling their products for a long time. Arising from this, the company has made a loss for the year and the management is of the view that due to losing of the main market, they may incur losses in the future. The budgets

made internally by the company indicate significant drop in net income for the next few years indicating impairment of assets.

(4 marks)

**Required:**

Explain your proposed course of action and nature of the audit opinion the auditor would express, with reasons for each of the above issues.

**(Total 20 marks)**