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

**YEAR II SEMESTER II – INTAKE V/VI (GROUP A)
END SEMESTER EXAMINATION – JULY 2017**

AFM 20730 Audit & Assurance

Date : 17th July 2017
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. State Auditors role in providing solutions to principal agency problem. (03 Marks)
- b. Why professional skepticism is important to the auditor? (03 Marks)
- c. What is known as “contingent fees” in assurance engagements, and why practitioners are advised not to charge contingent fees from their clients? (03 Marks)
- d. Is it suitable for an auditor of a company to quote contingent fees on non-assurance work carried out for that company? Explain the reason with an example. (04 Marks)
- e. ABC International Co (ABC) is a manufacturer of electrical equipment. It has factories across the country and its customer base includes retailers as well as individuals, to whom direct sales are made through their website. The company’s year-end is 31st March 2017. You are an audit supervisor of XYZ & Co and are currently reviewing documentation of ABC’s internal control in preparation for the audit.

ABC’s finance director has expressed an interest in XYZ & Co performing other review engagements in addition to the external audit; however, he is unsure as to how much assurance would be gained via these engagements and how this differs to the assurance provided by an external audit.

Required:

Explain the finance director of ABC on the level of assurance provided by an external audit and other review engagements.

(07 Marks)

(Total 20 Marks)

Question No. 02

a. What are the benefits of risk assessment to the audit process?

(04 Marks)

b. “ABC Linea” is a long established client of your audit firm. It manufactures garments, sells to a range of wholesalers on credit. You are the audit senior and have recently been sent the following extract from the draft statement of financial position by the finance director of ABC Linea.

	Budget (Rs. 000’)	Actual (Rs. 000’)
Non-current assets	544	440
<u>Current assets</u>		
Trade receivables	1,360	1,170
Bank	-	65
<u>Current liabilities</u>		
Trade payables	1,160	1,130
Bank overdraft	11	-

During the course of your conversation with the finance director, you got to know that a major customer the company had included in its budget, went bankrupt during the year.

Required;

Identify any potential risks in the audit of ABC Linea, and give justifications for identifying them as risks.

(08 Marks)

c. You are appointed as the auditor of ABC Co for the year ended 31st March 2017. ABC Co 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 2016 is shown below together with the draft income statement for the year ended 31 March 2017.

Income Statements of ABC Co.

	31 March 2017	31 March 2016
	(Rs.000')	(Rs.000')
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	<u>(40)</u>	<u>(39)</u>
Profit before tax	<u>1,351</u>	<u>722</u>

Required;

Perform analytical procedures on the draft income statement to identify possible risk areas requiring further audit work.

(08 Marks)

(Total 20 Marks)

Question No. 03

- a. You are the audit manager of XYZ & Co currently planning the audit of ABC 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,

ABC's trading results have been rising positively 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.

Required;

- i. Describe substantive procedures the audit team should perform to obtain sufficient and appropriate audit evidences in relation to the treatment of the Rs.5 million expenditure incurred on improving the factory production process.

(05 Marks)

- ii. As a result of the increase in revenue, ABC 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 he has released the opening allowance of Rs.1.5 million to the profit and loss.

What are the substantive procedures the audit team should perform to obtain evidence related to the release of allowance for receivables?

(05 Marks)

- b. ABC Ltd is a Tea Factory, and its year end is 31st March 2017. You are the audit supervisor of XYZ & Co and are developing the audit plan for the forthcoming interim audit. The company's internal audit department has provided you with documentation relating to the non-current assets, including the related controls listed below,
- ABC has a capital expenditure committee and all purchase orders for capital items are required to be authorized by this committee.
 - On receipt, each asset is assigned a unique serial number and this is recorded on the asset and in the non-current assets register.
 - When the asset arrives, a Goods Received Note (GRN) is completed which describes the nature of the expenditure (i.e. whether it is capital or revenue), and the GRN classification is reviewed and signed by a responsible officer. Copies of the GRNs relating to capital expenditure are then submitted to the finance department for updating of the non-current assets register.
 - Periodically, internal audit undertakes a review of assets in the register and compares them to assets on the factory, using the serial numbers to confirm existence of the asset.
 - Access to the non-current assets register is restricted using passwords to a small number of staff in the finance department.

You are required to,

Describe test of controls you would perform, to assess whether or not each of the non-current asset controls listed above is operating effectively or not.

(10 Marks)

(Total 20 Marks)

Question No. 04

- a. What is the difference between an Accountant in public practice and private practice?
(04 Marks)
- b. “Lowballing” and “Opinion shopping” are practices that would create ethical threats. Explain the concepts of “Lowballing” and “Opinion shopping”.
(04 Marks)
- c. You are an audit senior of XYZ & Co and have been allocated to the audit of ABC Co., a listed company which has been an audit client for eight years and specializes in manufacturing electric equipment.

Mr. M P was the audit engagement partner for ABC 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. H A has suggested that in order to maintain a close relationship with ABC, Mr. M P should undertake the role of independent review partner this year.

In addition ABC has requested that Mr.MP to assist them by attending their audit committee meetings, because non-executive director has recently left the company.

ABC has also asked Mr. H A and the other partners at XYZ & 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 ABC this year could be greater than 16% of total fee income of the audit firm.

Further, ABC asked Mr. H A to advise them on the developments of their internal controls related to financial reporting.

Required;

- i. Identify and explain FIVE ethical threats which may affect the independence of XYZ & Co’s audit of ABC Co.
- ii. Explain for each threat how it might be reduced to an acceptable level?

(12 Marks)

(Total 20 Marks)

Question No. 05

The date is 3 June 2017. The audit of ZD Co is almost complete and the financial statements and the audit report are due to be signed next week. However, the following additional information on two material events has just been presented to the auditor. The company's year end was 31st March 2017.

Event 1 – Occurred on 10 April 2017

The springs in a new type of mattress have been found to be defective making the mattress unsafe for use. There have been no sales of this mattress; it was due to be marketed in the next few weeks. The company's insurers estimate that inventory to the value of Rs.750,000 has been affected. The insurers also estimate that the mattresses are now only worth Rs.225,000. No claim can be made against the supplier of springs as this company is in liquidation with no prospect of any amounts being paid to third parties. The insurers will not pay ZD Co. for the fall in value of the inventory as the company was under-insured. All of this inventory was in the finished goods store at the end of the year and no movements of inventory have been recorded post year-end.

Event 2 – Occurred 5 May 2017

Production at the ShamSam factory was halted for one day when a truck carrying dye used in coloring the fabric on mattresses reversed into a metal pylon, puncturing the vehicle allowing dye to spread across the factory premises and into a local river. The Environmental Agency is currently considering whether the release of dye was in breach of environmental legislation. The company's insurers have not yet commented on the event.

Required

- a. Explain for each of the two events above:
 - i. Explain whether the events are adjusting or non-adjusting according to LKAS 10 events after the Reporting Period.
 - ii. Explain the auditors' responsibility and the audit procedures that should be carried out.

(14 Marks)

- b. Assume that the date is now 20 June 2017, the financial statements and the audit report have just been signed, and the annual general meeting is to take place on 30 July 2017. The Environmental Agency has issued a report stating that ZD Co is in breach of environmental legislation and a fine of Rs. 900,000 will now be levied on the company. The amount is material to the financial statements.

Explain the additional audit work the auditor should carry out in respect of this fine.

(06 Marks)

(Total 20 Marks)

Question No. 06

ShaSha Co provides scientific services to a wide range of clients. Typical assignments range from testing food for illegal additives to providing forensic analysis on items used to commit crimes to assist law enforcement officers.

The annual audit is nearly complete. As an audit senior you have reported to the engagement partner that ShaSha is having some financial difficulties. Income has fallen due to the adverse effect of two high-profile court cases, where ShaSha's services to assist the prosecution were found to be in error. Not only that this provides adverse publicity for ShaSha, but a number of clients withdrew their contracts. A senior employee then left ShaSha, stating lack of investment in new analysis machines was increasing the risk of incorrect information being provided by the company.

A cash flow forecast prepared internally shows ShaSha requiring significant additional cash within the next 12 months to maintain even the current level of services. ShaSha's auditors have been asked to provide a negative assurance report on this forecast.

Required;

- a. Define 'going concern' and discuss the auditor's responsibilities in respect of going concern.
(05 Marks)
- b. State the audit procedures that may be carried out to determine whether or not ShaSha Co is a going concern.
(05 Marks)
- c. Explain the audit procedures the auditor may take where the auditor has decided that ShaSha Co is unlikely to be a going concern.
(05 Marks)
- d. In the context of the cash flow forecast, define the term 'negative assurance' and explain how this differs from the assurance provided by an audit report on statutory financial statements.
(05 Marks)

(Total 20 Marks)