THE INSTITUTE OF CHARTERED ACCOUNTANTS OF SRI LANKA

# SUGGESTED SOLUTIONS



## KB4 – Business Assurance Ethics & Audit

## December 2018

# SECTION 1

**Answer 01**

| **Relevant Learning Outcome/s: 1.4.1 and 1.5.1**<br>1.4.1 Explain the type of matters that should be communicated through an engagement letter.<br>1.5.1 Discuss the different types of audit documentation which should be maintained. |
|---|
| Study text reference: Pages 56, 57, 65, 66, 70 and 71 |

(a)

- During the year there was a management buyout. This would have resulted in a **significant change in ownership of the audit client**.

- Furthermore, this may have also resulted in a **change** in **senior management**, as the former management have now become the owners.

- Accordingly, it would be **appropriate to send a new engagement letter** for this year to **remind** J&J of the **existing terms and conditions of the engagement**.

(b) (i)

- It provides **evidence** of the **auditor's basis for a conclusion** in order to achieve the overall objectives.
- It enables to confrim that the **audit was planned and performed in accordance with SLAuSs** and other legal and regulatory requirements.
- It **assists** the engagement team to **plan and perform the audit**.
- It **assists** team members responsible for supervision to **direct, supervise and review audit work**.
- It enables the team to be **accountable for its work**.
- It allows a **record** of the **matters** of **continuing significance** to be **retained**.
- It helps to **conduct of quality control reviews** and for **inspections** (both internal and external).

(b) (ii)

**Permanent audit files** contain information of **continuing importance** to the audit. For example, they would contain:
- Engagement letters
- New client questionnaire
- The memorandum and articles
- Other legal documents such as prospectuses, leases and sales agreements
- Details of the history of the client's business
- Board minutes of continuing relevance
- Previous years' signed accounts, analytical reviews and management letters
- Accounting systems notes, previous years' control questionnaires

**Current audit files** contain information of **relevance** to the **current year's** audit. These should be compiled on a **timely basis after completion of the audit**. For example, they would contain:

- Financial statements
- Accounts checklists
- Management accounts details
- Reconciliations of management and financial accounts
- Summary of unadjusted errors
- Reports to partners including details of significant events and errors
- Review notes
- Audit planning memorandum
- Time budgets and summaries
- Representation letter
- Management letter
- Notes of board minutes
- Communications with third parties such as experts or other auditors

**(Total: 10 marks)**

**Answer 02**

| **Relevant Learning Outcome/s: 3.3.1**<br>Discuss how business risk could result in risk of material misstatements in financial statements. |
|---|
| Study text reference: Pages 214 – 221 |

(a)

**Business risk approach**

- In a business risk approach the auditors beleive that the risks which are most likely to affect the financial statements adversely. As such, Auditor direct their testing to the business risks apparent in the business.

  OR

- This approach to the audit is called a top-down approach because it starts with the business and its objectives, and works back down to the financial statements.

**Audit risk approach**

- When using an audit risk approach, the auditors focus their attention on matters that they feel are the most significantly risky to the financial statements so that they can provide a cost-effective audit.

  The business risk approach is an extension of the audit risk approach.

(b)

- Operations which are exposed to high competition in the market – in light of the increased competition and reduction in selling price there is an increased risk that TL is facing going concern difficulties.
- Sales-related bonus – a sales-related bonus scheme was introduced in the year for sales staff, with a significant number of new customer accounts on extended credit terms being opened. This resulted in an 8% increase in revenue. When sales staff seek to maximise their current year bonus, it may result in new accounts being opened even for those with poor credit ratings, which could lead to irrecoverable trade receivables.
- Extended credit terms to customers – this will result in new accounts being opened for those with poor credit ratings, which could lead to irrecoverable trade receivables.
- Product halting and recalling – TL has halted further sales of its new Product A, and a product recall has been initiated for any goods sold. When there are issues with the quality of Product A, inventory may be overvalued as its NRV may be below its cost. Additionally, any of Product A sold within the last five months are being recalled, and this will result in TL paying customer refunds. The sale will need to be removed, a refund liability be recognised along with the reinstatement of inventory, although the NRV of this inventory could be of a minimal value. Failing to account for this correctly could result in overstated revenue and understated liabilities and inventory.
- Since Product A received negative feedback from customers, its sales have been halted, and this could indicate an impairement of the machinery used to produce it.
- Defective products and legal action – customers of TL have complained that they intend to commence legal action for losses incurred as a result of the defective product sold to them. If it is probable that the company will make payment for the losses to customers, a legal provision is required. If the payment is possible rather than probable, a contingent liability disclosure would be necessary. If TL has not done this, there is a risk regarding the completeness of any provisions or the necessary disclosure of contingent liabilities.

**(Total: 10marks)**

## Answer 03

| Relevant Learning Outcome/s: 2.1.1 |
|---|
| Discuss the key aspects of corporate governance, including responsibilities of the Board and role of non-executive directors. |
| Study text reference: Pages 82 – 112 |

| (a) Weakness | (b) Recommendation |
|---|---|
| **Number of non-executive directors**<br>Non-executive directors in the board are not in line with the requirements of the Code.<br><br>*(The board of directors of a listed entity shall include at least:*<br><br>*– three non-executive directors; or*<br>*– such number of non-executive directors equivalent to one third of the total number of directors, whichever is higher)* | The board of HPLC should consider recruiting and appointing additional NEDs to satisfy this requirement. |
| **Independent NEDs**<br>As the chairman and the NED acted as executive directors of HPLC prior to its listing, non-executive directors on the board are not independent per the requirements of the Code.<br>*(Where the constitution of the board of directors includes only two non-executive directors, both such non-executive directors shall be 'independent'. In all other instances two or 1/3 of non-executive directors appointed to the board of directors, whichever is higher, shall be independent).* | Non-executive directors who are not independent should ideally be replaced or supplemented by independent NEDs. |
| **Audit committee composition**<br>HPLC's audit committee only has two NEDs whereas the Code requires having a minimum of three NEDs.<br><br>There are executive directors in the audit committee.<br><br>*(The board should establish an audit committee exclusively of non-executive directors with a minimum of three non-executive directors of whom at least two should be independent. If there are more non-executive directors, the majority should be independent).* | The board of HPLC should consider appointing additional NEDs to the Audit Committee to satisfy this requirement.<br><br>Comply with the corporate governance principles. |
| **Audit committee**<br>The chairman of the audit committee is an ED. The audit committee is supposed to be chaired by a non-executive director. | Audit committee should ensure that there is an effective internal audit function in para. |
| **Audit committee**<br>All four members of the audit committee were previously involved in marketing and production-related roles. At least one member of the audit committee should have recent and relevant financial experience. In this case none of the audit committee members possess the required financial experience. | At least two non-executive directors in the audit committee should be independent. At least one member of the audit committee should have recent and relevant experience in financial reporting and control. |

| | |
|---|---|
| **Remuneration committee**<br>The remuneration for the directors is set by the finance director and chairman. No director should be involved in setting their own remuneration. | There should be a fair and transparent policy in place for setting remuneration levels. The board should appoint a sub-committee remuneration committee to give proposals, recommendations on remuneration of board members. |
| **Internal audit function**<br>HPLC has not established an internal audit function. The Code of Best Practice on Corporate Governance 2017 states that companies following it should have an internal audit function. | Where there is no internal audit function, the audit committee is required to annually consider the need for one. |
| **Appointment and remuneration of external auditors**<br>Appointing and deciding on the remuneration of external auditors is not a duty of the finance director and the chairman. | The audit committee should make recommendations to the board pertaining to the appointment and remuneration of external auditors. The company should appoint an auditor at the annual general meeting and the remunaration should be decided at the meeting. |

**(Total: 10 marks)**



**Answer 04**

| **Relevant Learning Outcome/s: 2.2.3 and 2.2.4**<br>2.2.3 Analyse design, implementation and operating effectiveness of identified controls.<br>2.2.4 Outline both significant and minor deficiencies in control activities. |
|---|
| Study text reference: Pages 117 – 125, 177 – 185 |

(a)

- Smaller entities have **simple** internal control systems. The most important form of internal control is generally the **close involvement** of the **proprietors.** Close involvement by the management will enable them to **override controls** and, if they wish, to **exclude transactions** from the **records.**

- Further, **documentary evidence** on control operations and completeness is typically **insufficient** as controls are normally operated informally.

- **Segregation of duties** will often appear **inadequate** in enterprises having a small number of staff.

- The **costs** of implementation may **outweigh** the **benefits** of a formal internal control system.

(b)

- Cash counted by the cashier – collection of cash from customers and counting of cash (at end of the day) is performed by the same person.
- Counting of cash before accepting it from the cashier – Silva does not perform an independent count of the cash prior to accepting it from the cashier.
- Reconciliation of physical cash to the cash receipts summary – the cashiers reconcile the physical cash total only with the cash receipts summary generated from the cash register. The physical cash and the cash receipts summary are not reconciled with the cash sales for the day.
- Reconciliation of total sales with cash in hand and credit card slips only – the total sales need to be reconciled not only with cash in hand and credit card slips, but also with information on discounts offered to customers (e.g. if a sale is Rs. 100 but only Rs. 95 is accounted for).
- Non-segregation of duties – the reconciliation is also performed by cashier. This should be performed by a person not related to the function.
- Review of reconciliation and investigation of differences – the reconciliation is not checked by another individual (preferably the owner). There is no proper procedure in place to ensure any differences are investigated promptly.
- Minimal checking by Silva – Silva does not independently verify the cash handed over to the reconciliations performed, or test whether reconciliations are complete and accurate by test checking to cash records and credit card slips.
- Cash is not kept under lock and key (not in the safe).
- Cash is not counted prior to banking.
- Cash records (i.e. cash receipts summaries) are not reconciled with bank pay-in slips (bank deposits).
- No segregation of duties between updating of cash book and updating of sales journal.
- Accounting entries are not reviewed at least on a periodic basis.
- Preparation of bank reconciliations on a monthly basis may not be adequate due to the significance of the cash volumes. Frequency of preparation should be more regular.
- Bank reconciliations are not reviewed, and no proper procedure is in place to ensure differences are investigated promptly.

(c)

- Cash count should be performed by a separate person other than the cashier.
- Physical cash counts should be performed by Silva prior to accepting cash from the cashier.
- Reconciliations should ideally not be performed by cashiers themselves. Reconciliations should to be performed by a person unrelated to the function.
- Reconciliation of physical cash to the cash receipts summary – the physical cash and cash receipts summary should also be reconciled with cash sales for the day.
- Reconciliation of total sales with cash in hand and credit slips – the total sales need to be reconciled not only with cash in hand and credit card slips, but also with information on discounts offered to customers.
- All reconciliations should be reviewed, and any differences should be promptly investigated.
- Silva should check the completeness and accuracy of reconciliations prepared. He should check physical cash received with the reconciliations and physical supporting documents.
- Cash received should be kept under lock and key (safe). Only the proprietor should have access to the locked box key.
- Comparison of cash records with bank pay-in slips should be performed daily. Any differences should be promptly investigated.

- Prepare and review bank reconciliation on a more frequent basis (e.g. weekly).
- Bank reconciliations should be reviewed and any differences should be investigated promptly.

**(Total: 10marks)**

**Answer 05**

| **Relevant Learning Outcome/s: 4.9.1 and 5.6.1**<br>4.9.1 Discuss the use of written representation as audit evidence, including its limitations.<br>5.6.1 Analyse non-complex audit engagements and determine whether emphasis of matter or other matter should be included. |
|---|
| Study text reference: Pages 480, 481, 484, 484, 515 and 516 |

(a)

- That all liabilities, both actual and contingent, have been recognised/disclosed in the financial statements and to the auditors.
- Significant assumptions used in estimating the provision (e.g. probabilities of outcomes) for the penalty are reasonable and appropriate.
- Representations from the lawyer on the **management's assessment** of the outcome of the investigation and **reasonableness** of the management's assessment and further information (where necessary) about the penalty.
- Management's **mitigation plans for future action** to address the material uncertainty that arises as a result of the above events, and the **feasibility** of those plans (e.g. modifications to the water treatment plant).
- The provision for penalty reflects the **management's best estimate** of the expenditure required to settle the obligation at the end of the reporting period.
- That **disclosures** related to the provision for penalty are **complete** and **appropriate** under the applicable financial reporting framework.
- **All subsequent events** related to the above scenario that either require adjustment or disclosure have been adjusted or disclosed appropriately.
- The management has **disclosed all instances** of **non-compliance** or **suspected non-compliance** with **laws or regulations applicable** to its operations**.**
- All aspects of laws, regulations and contractual agreements that may affect the financial statements with regard to the above matter have been disclosed.

(b)

Auditor has to determine whether financial statements:

- **Adequately disclose** the details related to non-compliance and action by the CEA that is casting significant doubt on the company's ability to continue as a going concern and the management's plans to deal with these events/conditions.
- **Disclose clearly that there is a material uncertainty** related to these events /conditions and therefore that it may be unable to realise its assets and discharge its liabilities in the normal course of business.

If **adequate disclosure has been made**, express an **unmodified opinion**. However, **users' attention needs to be drawn to the material uncertainty**, as it is **fundamental** to **their**

**understanding** of the financial statements. Accordingly, include an **emphasis of matter** paragraph in the auditor's report.

If **adequate disclosure** has **not** been made, express a **qualified or adverse opinion** as appropriate.

**(Total: 10 marks)**

# SECTION 2

**Answer 06**

| **Relevant Learning Outcome/s: 1.2.1, 1.2.2, 4.8.1, 4.8.2 and 4.12.1** |
|---|
| 1.2.1 Analyse threats in complying with fundamental and ethical principles, including independence of auditors in an audit of financial statements.<br>1.2.2 Outline safeguards to mitigate threats in complying with fundamental and ethical principles.<br>4.8.1 Explain how related party transactions can affect the true and fair view of the financial statements.<br>4.8.2 Explain procedures that should be performed to reduce the risk arising from related party transactions.<br>4.12.1 Outline procedures required to identify events occurring between the date of financial statements and the date of the audit report. |
| Study text reference: Pages 26 – 46, 458 – 463 and 471 – 475 |

(a)

| (i) **Adjustment to the financial statements** | (ii) **Auditor's responsibilities and additional procedures** |
|---|---|
| **Trade receivables**<br>A customer owing Rs. 230 million at the year-end is experiencing significant going concern difficulties. This information was received after the year-end but provides further evidence of the recoverability of the receivable balance at the year-end. Under LKAS 10 *Events after the Reporting Period*, if the customer is experiencing cash flow difficulties just a few months after the year-end, then it is highly unlikely that the Rs. 230 million was recoverable as at 31 March 2018. Further, there is no security against this balance. The receivables balance is overstated and through the use of a provision for receivables or by it writing off, the amount should be adjusted to the recoverable amount. | The auditor has a responsibility for identifying and evaluating events up until the date of the auditors' report. This is a subsequent event affecting the value of a receivable's balance at the year-end that will require adjustment to the provision for doubtful debts (unless it has already been included). The auditor will have to get confirmation of the balance at the year-end and the fact that no other sales were made since the year-end. The auditor should also get a management representation letter on this issue. |

| | |
|---|---|
| **Lawsuit**<br>Neighbourhood land owners have sued Foot Star and the management has made a contingent liability disclosure. However, subsequent to the year-end the neighbours agreed to settle for Rs. 45 million and it is likely the directors will agree. Although the settlement was agreed after the year-end, it provides further evidence that the company had a present obligation as at 31 March 2018.<br><br>The financial statements should be <u>adjusted</u> with the <u>contingent liability disclosure being removed</u> and instead a <u>provision of Rs. 45 million</u> being recorded.<br><br>The sum being claimed is Rs. 58 million but the probable payment is Rs. 45 million. This is material and the management should provide for this amount. | This is a subsequent event occurring after the date of the auditor's report but before issuance of the financial statements (SLAUS 560). The auditor has no obligation to look for these events but must consider them if he or she becomes aware of them. This is a subsequent event that relates to conditions that existed at the balance sheet date. The auditor should consider and discuss with the management, the need to amend the financial statements by including the lawsuit in a note. If the financial statements are amended, the auditor must carry out necessary auditing procedures, including extending the review of events after the balance sheet date, and reissue the auditor's report at the date of approval of the amended financial statements. |
| **Warehouse**<br>A fire destroyed 40% of inventory and the company had insurance cover in place. This event occurred after the year-end. The fire would not have been in existence at 31 March 2018, and hence this event indicates a <u>non-adjusting event</u>. The amount of damaged inventory is likely to be material; however, the company has insurance cover and the loss after the insurance claim receivable is below performance materiality. | The auditor was made aware of this event after the financial statements were issued. In this case the event occurred after the auditor's report was signed and issued, so the auditor has no responsibility in relation to the event. No disclosure is required. |

| (b) **Possible threat** | (c) **Safeguard** |
|---|---|
| ***Familiarity threat***<br>Audit partner of S&S Associates, Perera, has been the partner in charge of the audit of Foot Star since 2005. | • Periodic rotation of key members of the audit team.<br>• Have a professional accountat in the audit firm who was not a member of the audit team of FSP to review the work.<br>• Regular independent internal or external quality reviews of the engagement partner rotation (per CA Sri Lanka Code of Ethics for Professional Accountants, the key audit partner should be rotated after seven years). |
| ***Self-interest threat/Familiarity threat***<br>The former audit manager becoming the finance manager of Foot Star may impair judegements in favour of personal objectives. | • Modifying the audit plan.<br>• Assigning individuals to the audit team who have sufficient experience in relation to the work of the former audit manager who has joined the client. |

| | |
|---|---|
| | • Having an independent professional accountant review the work of the former manager of the audit firm. |
| ***Self-review threat***<br>Providing non-assurance (non-audit) services to audit clients may create threats to the independence of the firm or members of the audit team. | • Use different teams for non-audit services.<br>• Independent partner review of audit and non-audit services.<br>• Ensure that an employee of the client is designated to take responsibilty for all the management decisions for payroll activities activities.<br>• Ensure that the management of Foot Star approves all the work that payroll staff of S&S Associates does.<br>• Ensure that the payroll function does not include any financial statement impact. |
| ***Self-interest or intimidation threat***<br>When a firm receives a high proportion of its fee income from Foot Star, there is a self-interest or intimidation threat, as S&S Associates will be concerned about losing the client. | • Reduce the dependency on the client.<br>• Carry out external quality control reviews.<br>• Consult a third party, such as a professional regulatory body or a professional accountant, with similar experience in relation to the work of the former audit manager, on key audit judgments. |
| ***Self-interest or intimidation threat***<br>When the previous audit manager who trained the current audit manager is also his friend, it could lead to impaired judegements in favour of personal objectives through self-interest or intimidation. | • Replace the current year audit manager.<br>• Assign a more senior audit team member to review the work of the current audit manager. |

(d) (ii)

- The sale of the building should be considered a related party transaction.
- The finance director, who is a key management personnel and approved the sale of the building, has a substantial equity interest in VS Rubber Products Ltd (the buyer of the building). As such, VS Rubber Products Ltd falls within the criteria of a related party under LKAS 24.

(d) (ii)

- **Enquire management** and the directors whether transactions have taken place with related parties that require to be disclosed by the disclosure requirements that are applicable to the entity.
- **Review prior-year working papers** for names of known related parties
- **Review minutes** of meetings of shareholders and directors and other relevant statutory records such as the register of directors' interests.
- **Review accounting records** for large or unusual transactions or balances, in particular transactions recognised at, or near, the end of the financial period.
- **Review confirmations of loans receivable** and payable, and confirmations from banks. Such a review may indicate the relationship, if any, of guarantors to the entity.
- **Review investment transactions**, for example purchase or sale of an interest in a joint venture or other entity.

- **Enquire** the **names** of all pension and other trusts established for the benefit of employees, and the names of their management and trustees.
- **Enquire** on the **affiliation** of directors and officers with other entities.
- **Review the register of interests in shares** to determine the names of principal shareholders.
- **Enquire other auditors** currently involved in the audit, or previous auditors, their knowledge of additional related parties.
- **Review the entity's returns** made under statute and other information supplied to regulatory agencies for evidence of the existence of related parties.
- **Review invoices.**
- **Check/peruse the correspondence** from lawyers for any indication of the existence of related parties or related party transactions.

**(Total: 25 marks)**

**Answer 07**

| **Relevant Learning Outcome/s: 3.1.4, 3.2.1, 4.7.1, 4.11.1 and 5.4.1**<br>3.1.4 Identify the procedures used in risk assessment.<br>3.2.1 Demonstrate the difference between risk of material misstatements at assertion level and risk of material misstatements at financial statement level.<br>4.7.1 Explain how the auditor obtains sufficient and appropriate evidence on accounting estimates.<br>4.11.1 Outline substantive audit procedures to be performed In relation to account balances and classes transactions<br>5.4.1 Explain auditor's responsibility towards other information included in documents containing auditor's report. |
|---|
| Study text reference: Pages 231 – 241, 323 – 326, 344, 377 – 382 and 519 – 521 |

(a)

- Identify risks throughout the process of obtaining an understanding of the entity and its environment.
- Assess the identified risks and evaluate whether they relate more pervasively to the financial statements as a whole.
- Relate the risks to what can go wrong at the assertion level.
- Consider the likelihood of the risks causing a material misstatement.

(b)

- Risk of material misstatement at the financial statement level refers to a risk that relates pervasively to the financial statements as a whole and potentially affect many assertions. Risks of this nature are not necessarily risks identifiable with specific assertions at the class of transactions, account balance, or disclosure level. Rather, they represent circumstances that may increase the risks of material misstatement at the assertion level, for example, through management override of internal controls.

- Risks of material misstatement at the assertion level may particularly affect assertions about classes of transactions, account balances, and disclosures.

(c)

- **Risk that inventory has a lower net realisable value (NRV) than cost and is therefore overstated**
  GC has imported a stock of specialised glass bottles amounting to Rs. 5,000 million to cater to a supplier order. However, the bottle stock imported did not meet the customer specifications. Further, GC has no other alternative use for the stock other than to use it as scrap for production. However, GC estimated the value of the stock at the year-end to be Rs. 4,500 million, whereas the scrap value was only Rs. 1,000 million. It is possible that the price may have fallen so that the net realisable value (NRV) of the inventory is below cost. LKAS 2 *Inventory* requires inventory to be stated at the lower of cost and NRV. Hence it is possible that the inventory is overvalued.

- **Depreciation of furnace upgradation**
  The furnace was ready for use from 1 June 2018 after the upgradation. The upgradation resulted in an enhancement of capacity by 20%. Further, the furnace upgradation is usually a capital expenditure that meets recognition criteria under LKAS 16 *Property, Plant and Equipment*. GC obtained Rs. 2 billion for the project. However, the depreciation expense has decreased by Rs. 30 million. This indicates that the cost of the furnace expansion has not been depreciated. This will lead to overstatement of profits and PPE.

(d)

**Inventory**

- Examine the instructions to identify slow-moving inventory lines when attending the inventory count.
- Increase the emphasis on reviewing the year-end inventory age analysis for evidence of slow-moving inventory.
- Compare the cost and NRV.
- Examine the computerised inventory control system and list items showing an unacceptably low turnover rate. An unacceptable rate of turnover may be different from item to item, but inventory representing more than six months' sales is likely to qualify.
- In order to identify where there are any factory seconds or damaged items in the inventory list.
- Discuss with management the current position regarding slow-moving inventory and their plans and expectations in respect of products that may be discontinued. At the physical inventory count, look for inventory that is dusty, inaccessible as well as non-moving items, and note them down in the inventory sheets.
- Find out whether any machinery used in the productions lines is dependable or not, or whether it needs frequent repairs.
- Review the trade catalogues or other sources to see whether any of the equipment is outdated.

**NRV**

- Find the actual selling prices from the latest sales invoice. A provision has to be made for slow-moving and obsolete items. Estimate the value of marketing expenses using previous values for the categories of finished goods as a base. Update and review for reasonableness against the most recent accounting records.
- Discuss with the management what the selling prices are likely to be where there is little past evidence. Costs to completion will be questioned where these are difficult to estimate and where there are any unusual assembly, selling or distribution problems.

**Depreciation**

- Review depreciation rates applied in relation to:
  – Lifespan of the asset
  – Residual values
  – Replacement policy
  – Past experience of gains and losses on disposal
  – Consistency with prior years and accounting policy
  – Possible obsolescence
- Review the non-current assets register to ensure that depreciation has been charged on all assets.
- For revalued assets, ensure that the charge for depreciation is based on the revalued amount by recalculating it for a sample of revalued assets.
- Re-perform the calculation of depreciation rates to ensure they are correct.
- Compare ratios of depreciation to non-current assets (by category) with:
  – previous years
  – depreciation rates
- Review draft accounts to ensure that depreciation policies and rates are disclosed in the accounts.

(e)

The chairman's message would appear to represent a material inconsistency with the audited financial statements in accordance with SLAuS 720 (Other Information in Documents Containing Audited Financial Statements).

The chairman's message says that the profit for the year improved from 18% to 22%. However, the net profit has increased only from 5% to 6%. The chairman's statement suggests that gross profit represents the true level of performance. Therefore, that statement could undermine the credibility of the financial statements.

The audit team should discuss and request the chairman to amend the information in his statement to avoid the apparent inconsistency. If the chairman/management refuses, you should consider taking appropriate action. One possibility is the inclusion of an emphasis of matter paragraph immediately after the unmodified opinion paragraph in the auditor's report. If the matter is considered to be more serious you could refuse to issue the auditor's report or withdraw from the engagement subject to receiving appropriate legal advice.

(f) Inventory obsolescence/depriciation/valuation

(g)

- Evaluate whether the accounting estimates are either reasonable or misstated.
- Obtain sufficient appropriate audit evidence about whether the disclosures are correct.
- For accounting estimates that give rise to significant risks, evaluate the adequacy of the disclosure of their estimation uncertainty.
- Review the judgements and decisions of management in making the accounting estimates to identify if there are indications of possible management bias.
- Obtain written representations from management on whether they believe the significant assumptions used are reasonable.

**(Total: 25 marks)**

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