THE INSTITUTE OF CHARTERED ACCOUNTANTS OF SRI LANKA

SUGGESTED SOLUTIONS

KE4 – Processes, Assurance & Ethics

September 2018

SECTION 01

Answer 01

1.1

Learning Outcome/s: 1.1.3 Define the elements of the external environment that affect business organisations such as political, legal technological, economic etc.
Study text reference: Pages 15-17
Correct Answer: A

1.2

Learning Outcome/s: 1.7.1 Discuss the inherent limitations of an internal control system.
Study text reference: Page 66
Correct Answer: C

1.3

Learning Outcome/s: 2.1.1 Identify activities connected with the procurement process, such as : Vendor selection and evaluation Budgetary controls Placing orders Receiving Payment
Study text reference: Pages 88-89
Correct Answer: D

1.4

Learning Outcome/s: 2.4.1 Identify activities connected with PPE management, including, CAPEX budgeting and approval Vendor selection and lender procedures Capitalisation and depreciation Fixed assets register Physical controls Disposal
Study text reference: Page 170
Correct Answer: D

1.5

Learning Outcome/s: 2.6.3 Assess the business risks connected with activities relating to the sales and receivable process.
Study text reference: Page 10 -12 (sales management)
Correct Answer: B

1.6

Learning Outcome/s: 3.1.1 Recognise the importance of design effectiveness of control in achieving the objectives of a given business process.
Study text reference: Pages 226,230
Correct Answer: A

1.7

Learning Outcome/s: 4.2.1 State the importance of ethical behaviour for a professional accountant.
Study text reference: Page 252, Additional study support material page 74
Correct Answer: D

1.8

Learning Outcome/s: 5.3.2 Explain the need to conduct an audit in accordance with SLAuS.
Study text reference: Pages 299-300
Correct Answer: A

1.9

Learning Outcome/s: 5.2.1 Explain situations where assurance services can be rendered by a practitioner.
Study text reference: Pages 281-285
Correct Answer: B

1.10

Learning Outcome/s: 5.5.3 List different audit procedures used to gather audit evidence.
Study text reference: Page 311
Correct Answer: A

(2 x 10 = Total: 20 marks)

Answer 02

2.1

Learning Outcome/s: 1.2.3
Identify elements of enterprise risk management, including risk appetite
Study text reference: Page 28 -32
Fraud risk is the risk of losses due to fraudulent activity, often by an employee but possibly by someone outside the organization. Compliance risk is another aspect of operational risk. It is the risk of failure to comply with an important law or regulation.

2.2

Learning Outcome/s: 1.4.1
Identify the core techniques of mitigating risks, such as risk transfer, risk avoidance, risk reduction through internal controls, and risk acceptance.
Study text reference: Page 41
• The potential impact of the risk is low • The likelihood of an adverse risk event is low, and • As a consequence, the residual risk is within the organisation's risk tolerances and is acceptable

2.3

Learning Outcome/s: 1.6.1
Explain main control activities such as: Segregation of duties Physical controls Authorisation Business performance review Information processing controls
Study text reference: Pages 53-54

Risk	**Control**
Employees may claim more money	Employees must submit a duly prepared claim for expenses to an authorized person. These claims should be supported by invoices/bills/ receipts as evidence of the expenses incurred. The authorized claim should be approved by the Accountant, after checking the authenticity of the signature of the authorizing officer, and verifying the details and the documents attached.
Unauthorized access	• All visitors to report to the reception / security desk and sign

to the building	the visitor's book and all visitors shall be accompanied by an authorized person. • CCTV cameras can be used to monitor the movement of individuals through the building. • All side doors to the building are kept locked and may be opened only by authorized personnel with keys.

2.4

Learning Outcome/s: 1.9.1 Identify who is responsible for the introduction of controls in an organisation.
Study text reference: Pages 68-69
Internal auditors investigate control systems and report to management, the audit committee or the board about their findings and recommendations. External auditors consider the effectiveness of internal financial controls, as part of the annual audit process. They should report to management and the audit committee about any weaknesses in internal financial controls that they discover. External and internal auditors provide management with information and recommendations about internal controls, but they do not have direct responsibility for internal control.

2.5

Learning Outcome/s: 2.3.3 Assess the business risks connected with sub activities relating to the cash management process.
Study text reference: Page 148 , Additional study support material Pages 55-62
• Cash may be stolen as it is kept in a drawer. • Petty cash imprest of Rs. 200,000 is too high, whereas the reimbursement required is only for around Rs. 50,000.

2.6

Learning Outcome/s: 2.6.1 Identify activities connected with the sales process, such as order acceptance, credit evaluation, delivery, invoicing, recording and settlement of receivables.
Study text reference: Page 3 (sales management)
The information provided is <u>insufficient to assess</u> the financial conditions of the new customer. The customer's past and current financial statements, cash flow statements and business plans should be obtained to review the credit risk.

2.7

Learning Outcome/s: 3.3.1
Explain the importance of IT general controls and application controls in achieving control objectives in a given business process.
Study text reference: Page 234 -237
Internal controls in IT systems are essential to provide reasonable assurance that IT systems will function as intended and fulfil their purpose effectively. Many General IT controls are procedural in nature. They help to create risk awareness in all IT applications. They are required to ensure that IT applications are implemented with limited risks. Application IT controls are preventive or detective controls designed to ensure the integrity of the data and records in the system

2.8

Learning Outcome/s: 4.2.2
Explain integrity, objectivity, professional competence and due care, confidentiality and independence.
Study text reference: Page 258
Accountants should maintain confidentiality of information within the firm or organization that employ them. They should take all reasonable steps to ensure that staff who are under their control respect the principle of confidentiality.

2.9

Learning Outcome/s: 5.5.2
Explain the meaning and the difference between test of controls and substantive procedures.
Study text reference: Pages 304 - 307
The nature of audit testing is a combination of tests of controls and substantive procedures. Substantive Procedure – Call for confirmations/ check subsequent settlements, and any other valid points such as, cut off procedure, reconciliation, debtors' residence time etc. Test of control –All the credit notes are approved, and any other valid points such as sequential numbering of invoices and credit notes.

2.10

Learning Outcome/s: 5.5.4 Explain how an auditor considers the relevance and reliability of information to be used as audit evidence.
Study text reference: Page 302
The appropriateness of audit evidence looks at the quality of it, that is, its relevance and its reliability in providing support for the conclusions on which the auditor's opinion is based.

(Total: 30 marks)

SECTION 2

Answer 03

Learning Outcome/s: **1.5.2** Identify elements of internal control. **1.9.1** Identify who is responsible for the introduction of controls in an organisation.
Study text reference: Pages 50 - 51, 68

(a) The COSO internal control system framework has five components:

1. **A control environment**- This refers to the culture of the organisation and its attitude to risks. A risk-awareness culture is created by the leader of the organisation, who should provide examples to all other employees. The effectiveness of an internal control system depends on the attitudes to risk and risk awareness of the people in it.

2. **Risk assessment**- This is the process of continually identifying, analysing and evaluating risks. Internal control is concerned with operational risks.

3. **Information and communication**- Internal control systems require processes and procedures for the communication of information to relevant people about risks and control.

4. **Control activities** – There are internal controls, which are designed to fulfil a particular control objective.

5. **Monitoring** –There should be a process for regular monitoring of the effectiveness of the internal controls and other components in the internal control system.

A definition based on the Committee of Sponsoring Organisations (COSO) defines an internal control system as:

- Processes put into effect by the board of directors and management
- That are designed to provide reasonable assurance regarding the achievements of the objectives in the following areas:
  – Effectiveness and efficiency of operations
  – Reliability of financial reporting
  – Compliance with laws and regulations

(b) 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. The CEO is the head of Management

Management is responsible for introducing controls to an organisation.

- The management should approve the design of controls.
- The management should ensure that controls are implemented properly. The management should ensure that control information is communicated to relevant persons.
- The management should review the effectiveness of controls and report to the audit committee or the board.

The responsibility of the CEO for internal control is to the board, and not to the company's shareholders.

(Total: 10 marks)

Answer 04

Learning Outcome/s: **3.4.1** Explain deficiencies in internal controls in a given business process. **4.2.3** Explain the ethical issues (such as conflict of interest, accepting and making offers) that an accountant may encounter.
Study text reference: Pages 262, 237-239

(a) Deficiencies in internal controls

(i) Lack of segregation of duties– the sales manager approves the sales orders, credit limits of the dealers. This may result in undetected errors, and there is an opportunity for fraud.

(ii) The long outstanding dealer amounts are not being monitored and followed up. There is no control to prevent those dealers being invoiced until the settlement of long dues.

(iii) The goods dispatched are not being checked by an authorized person with the Good Issue Note (GIN) to see whether the quantities are in agreement with the invoiced quantities.

(iv) There is no control to confirm whether the sales executive has raised the invoice for the ordered quantities. This may result in under invoicing or over invoicing.

(b) (i) Self- interests threat

This involves a <u>self-interest threat</u>. This occurs when the personal interest of an individual may differ from the individual's employer or client. If Suraj is part of the evaluation committee, to evaluate the tenders submitted, he will be biased towards his friend. Then he would have two different loyalties or commitments i.e. one to his employer and the other to his friend. These may conflict with each other.

(ii) Acceptance of gifts

Acceptance of gifts will <u>have an impact to the objectivity of the Finance manager</u>. It is a common threat to independence of an accountant. The foreign buyer may <u>have made an expensive offer to Suraj with an attempt to influence the objectivity of Suraj's decisions or to make him do/not to do</u> something. Gifts are an inducement that can give rise to <u>self-interest and intimidation threats</u>.

(Total: 10 marks)

Answer 05

Learning Outcome/s:
5.3.1 Discuss the general principles governing an audit of financial statements, such as professional scepticism, professional judgments, etc. **5.4.2** Identify factors that affect auditors' judgment as to what constitutes sufficient appropriate evidence.
Study text reference: Pages 298,302

(a)

Area	**Example**
Deciding the nature, timing and extent of audit procedures: in other words, reaching a view about what work should be done in the audit	Deciding on the audit procedures on sales, number of audit procedures and the sample size to be checked and whether to check during the interim audit or at the final audit
Judging whether sufficient appropriate audit evidence has been obtained	The auditor did not receive bank confirmations but only the bank statements were available as audit evidence. Auditor decided that it is not an appropriate and sufficient audit evidence.
Evaluating management's judgements in applying the applicable financial reporting framework	Management has depreciated buildings over 5 Years. The auditor evaluates and decides whether the useful lifetime of a building is more than 5 years.
Drawing conclusions based on the audit evidence obtained: reaching an audit opinion	Auditor discovers a material difference between the balance confirmed by the debtor and the ledger balance and decides to qualify the audit report.

(b)

- Confirmations by third parties
- Minutes of meetings
- Information from audit procedures such as inquiry, observation and inspection
- Comparable data about competitor companies

(Total: 10 marks)

Answer 06

Learning Outcome/s:
2.2.1 Identify activities connected with the payroll process, such as recruitment, preparation and payment of salaries. **2.2.3** Assess the business risks connected with sub activities relating to the payroll process.
Study text reference: Page 122-129, Additional study support material pages 47-57

(a) **Weakness**	(b) **Risk**
No segregation of duties. Taking attendance and distributing salary packets are done by the Supervisor.	• Workers may be over paid • Non-existent employees may be paid • Risk of incorrect information to the payroll officer
Unclaimed wages are not handed over to the Payroll Officer with the wage list signed by the workers.	• Non-existent employees may be paid • Risk of incorrect information to the payroll officer • Misappropriation of cash
Unclaimed wages list is not prepared and subsequent collection of unclaimed wages are not checked by an authorized person	• Non-existent workers may be paid • Risk of incorrect information to the payroll officer • Misappropriation of cash
The wages preparation is not authorised by the relevant authority.	• Workers may be over paid • Non-existent employees may be paid • Risk of incorrect information to the payroll officer • Misappropriation of cash
Maintenance of manual records, where there is no indication of it being checked by an authorized person for accuracy.	• Inaccurate payroll cost • Manipulation of records thereby committing a fraud • Payment to non-existing employees

(c)

- Distribution of wage packets by a responsible person other than the Supervisor.

- Unclaimed wages are handed over to the Payroll Officer with the wage sheet signed by the workers.
- Payroll officer prepares the unclaimed wage list and unclaimed wage packets are kept in a secure place.
- Unclaimed wage list is updated upon payment of subsequent claims and subsequent claims are checked by an authorized person.
- The payroll prepared shall be checked by an authorised person to ensure the accuracy.
- Weekly payroll reconciliation is to be prepared and reviewed to ensure accuracy and completeness.

(Total: 10 marks)

SECTION 3

Answer 07

Learning Outcome/s: 2.1.1 Identify activities connected with the procurement process, such as: - Vendor selection and evaluation Budgetary controls Placing orders Receiving Payment 2.1.2 Identify the documents relating to procurement cycle, point of origination, flow of documents and purpose. 2.1.3 Assess the business risk connected with sub activities relating to the procurement process. 2.5.1 Identify activities connected with the inventory management process, such as deciding optimum order quantities, physical safeguard of inventory, receiving issuing goods, etc. 2.5.2 Assess the business risks connected with sub activities relating to the inventory management process.
Study text reference: Pages 201-203, 99-101, 79-80,97 Additional study support material pages 42-46, 30-31, 71-72

(a)

The costs of holding inventory	**The costs of ordering supplies of inventory**
Interest on overdraft	Additional shipping costs
Land rent	Higher steel prices
	Additional administration costs

(b)

The economic order quantity (EOQ) is the order quantity, which minimizes inventory costs, when bulk order discounts are not available. The EOQ can be calculated using the following formula.

$$\textbf{EOQ=} \sqrt{\frac{2C_0D}{C_H}}$$

Co = the cost of making an order with a supplier
C_H = the cost of holding one unit of the store item, in store for one year
D = the demand for the store item (in units) each year

(c) **Business risk**	(d) **Control**
Physical risks to inventory	Appropriate storage facility/ insurance
Risk of running out of an important inventory item	Establishing minimum inventory levels / re order levels
Risk of excessive inventory levels	Establishing maximum inventory levels
Risk of Reputation	Maintain a standard product mix
Litigation Risk	Maintain quality of production

(e)

- Is the supplier reliable? Does it have the capability to produce steel in the quantities required?
- Is the supplier financially stable? Is there a risk that the supplier will become insolvent (and so unable to supply steel)?
- Can the supplier deliver steel to the quality standard required?

(f)

- Supplier is unable to provide the goods in required quantity
- Supplier is unable to provide the goods in required quality
- Goods may be ordered at an excessive price (e.g. exchange rate increase)
- Dependence on one supplier
- Fixing of a fixed purchase price at the beginning of the year

(g)

Bill of lading

A bill of lading is a document which is issued by a <u>carrier to the shipper</u> acknowledging that the carrier has <u>received the shipment of goods</u> and that they have been <u>placed on board a particular vessel</u>, <u>bound for a particular destination</u>.

The bill of lading does three things:

- It provides evidence that the goods described in it have been received by the carrier (and, if it is a shipped bill of lading, that they have been shipped) It either provides evidence of, or contains within it, the contract of carriage and the terms on which the goods are to be carried
- It can be a document of title to the goods being shipped

The bill of lading is therefore an important document because it is evidence of when the goods have passed to the carrier. This is a sign that the risk has passed to the buyer.

(Total: 20 marks)

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