THE INSTITUTE OF CHARTERED ACCOUNTANTS OF SRI LANKA

SUGGESTED SOLUTIONS

KB4 – Business Assurance Ethics & Audit

December 2019

SECTION 1

Answer 01

Relevant learning outcome/s: 1.2.2 and 1.4.1 1.2.2 Outline safeguards to mitigate threats in complying with fundamental and ethical principles. 1.4.1 Explain the type of matters that should be communicated through an engagement letter.
Study text reference: Pages 45, 50 and 51

(a)

(i) The primary safeguard will always be to notify all known relevant parties that the member or firm is acting (or plans to act) for two or more parties in respect of a matter where their respective interests are in conflict, and then obtain their consent to act.
(ii) Using separate engagement teams.
(iii) Having procedures to prevent access to information (such as strict physical separation of teams, confidential and secure data filing, password protection).
(iv) Providing clear guidelines to members of the engagement team on issues of security and confidentiality.
(v) Using confidentiality agreements signed by employees and partners of the firm.
(vi) Regular review of the application of safeguards by a senior individual not involved in the relevant client engagements.
(vii) Advising one or more clients to seek additional independent advice.

Larger firms often apply the safeguards (ii) to (v) above by building a 'Chinese Wall' within the firm. This would mean that the respective audits are undertaken by different audit 'groups', the engagement partners are different, and all the other audit staff are allowed to work on only one of the clients. In addition, records are only accessible to the teams working on the particular client.

(b)

The nominee auditor must carry out the following procedures before accepting the nomination.
- Ensure they are professionally qualified to act – consider whether they could be disqualified on legal or ethical grounds.
- Ensure existing resources are adequate – consider available time, staff and technical expertise.
- Obtain references – make independent enquiries if directors are not personally known.
- Communicate with the present auditor – enquire whether there are reasons/circumstances behind the change which the new auditor ought to know (also as a courtesy).

(Total: 10 marks)

Answer 02

Relevant learning outcome/s: 2.1.2
Explain the need for an audit committee, including the benefits of an audit committee to the shareholders of a listed entity.
Study text reference: Pages 96 – 99

(a) Benefits of an audit committee for FPLC

(i) Enhance internal control systems *(improve the quality of financial reporting)*

The board of FPLC do not necessarily understand the work of the internal auditor, or the need for control systems. This means that internal control within FPLC may be inadequate or that employees may not recognise the importance of internal control systems within an organisation.

The audit committee can raise awareness of the need for good internal control systems simply by being present in FPLC and by educating the board on the need for sound controls. Improving the internal control 'climate' will ensure the need for internal controls is understood, and it will also reduce control errors.

(ii) Reliance on the external auditor

FPLC's internal auditor currently reports to the board of FPLC. As previously noted, the lack of financial and internal control expertise of the board will mean that the external auditor's reports and advice will not necessarily be understood – and the board may rely too much on the external auditor.

If FPLC reports to an audit committee, this will decrease the dependence of the board on the external auditor. The audit committee can take time to understand the external auditor's comments, and then via the non-executive director, ensure that the board takes action on those comments.

(iii) Appointment of the external auditor

At present, the board of FPLC appoints the external auditor. This raises issues of independence as the board may become too familiar with the external auditor and so make the appointment based on this friendship rather than merit.

If an audit committee is established, then this committee can recommend the appointment of the external auditor. The committee will have the time and expertise to review the quality of services provided by the external auditor, thereby removing the independence issue.

(iv) Corporate governance requirements – best practice

Establishing an audit committee will show that the board of FPLC is committed to maintaining appropriate internal systems in the company and provide the standard of reporting expected by listed companies.

(b) Weaknesses in the proposed audit committee

(i) The proposed audit committee comprises an executive director (finance director). The Code requires setting up an audit committee exclusively of non-executive directors.

(ii) The proposed audit committee is chaired by an executive director (finance director). The Code requires the audit committee to be chaired by an independent non-executive director.

(iii) The proposed audit committee consists of only two non-executive directors. The Code requires having a minimum of three non-executive directors in the audit committee.

(iv) The proposed audit committee consists of a non-executive director who is not independent. The Code requires setting up an audit committee exclusively of non-executive directors with a minimum of three non-executive directors of whom at least two are independent.

(Total: 10 marks)

Answer 03

Relevant learning outcome/s: 2.2.2 Recognise the importance of IT controls in an audit, including IT general controls and IT application controls.
Study text reference: Pages 137 – 142

(a) Deficiencies in IT general controls

(i) **Absence of a maintenance agreement with the IT vendor**

- The ERP application is a specially designed complex IT application. The inhouse IT team is not capable of supporting and maintaining the ERP application on their own.
- If there is no support and maintenance agreement with the external vendor, continuity of the operation of the ERP application cannot be ensured, leading to business continuity issues in the event of a system failure.

(ii) **Weak back up procedures**

- If the company does not back up data more frequently, in the event of a disaster, the financial loss to the company could be significant, and it may even result in the inability to continue operations.
- If the company does not keep a backup offsite, in the event of a disaster such as a fire, it would not be possible to retain a copy of the data and applications as the backup may also be destroyed. As such it would not be possible for disaster recovery and business continuity to occur.

(iii) **Weak password controls with respect to senior management**

- If members can log in with a common weak password, it significantly increases the ease of access to the company's IT resources by any person, even unauthorised individuals.
- Without proper access controls via a password, it would be difficult for the company to prevent unauthorised changes being made to its critical information (data). Therefore, individual employees cannot be held properly accountable for changes.

(b)

- Enter into a legally binding maintenance agreement with an external vendor for critical IT applications.
- Store extra copies of data files and programs offsite such as in a fireproof bank vault.
- Maintain a proper backup. Data and programs need to be backed up at adequate frequencies.
- Maintain good password controls with individual passwords (with appropriate complexity). Password restrictions should be applied for everyone in the organisation.

(Total: 10 marks)

Answer 04

Relevant learning outcome/s: 3.6.2 and 3.6.3 3.6.2 Analyse financial and non-financial information of a given engagement, to identify risk of material misstatements (inherent and control risk). 3.6.3 Outline the overall response of the auditor to identified risk of material misstatements.
Study text reference: Pages 229 – 240

(a) **Audit risk**	(b) **Response**
Revenue has increased by 30%, but the relative increase in cost of sales is only 15%. There could be a risk that sales are overstated or that they have not been recorded in the proper period.	• Enquire the management on possible reasons for this discrepancy. • Corroborate management responses by inspecting the new orders/documents. • Discuss the accounting policy for revenue recognition with the management in order to determine whether it is appropriate and consistent with the prior period. • For a sample of sales recognised during the period, trace the amounts back to invoices, goods dispatched notes, and sales orders in order to ensure that the sales occurred during the period and in fact relate to HL. • Test cut-off to ensure that sales have been recorded in the correct accounting period. • Perform analytical procedures, focusing on comparing revenue with expected patterns.
Gross profit margin has increased from 25% to 34%, which could indicate a risk of cost of sales being understated, or sales being overstated.	• Test whether the cut-off of sales and purchases is accurate. • Obtain a breakdown of production costs for a sample of products and compare it to the prior year, and discuss any cost savings with the management. • Check a sample of invoices to ensure that the recorded revenue is accurate. • Check the approved price lists for products and compare them with the prices that appear on invoices.
There is a significant increase (134%) in property, plant and equipment. There is a risk that additions to PPE are overstated due to the inclusion of revenue items (repair and maintenance) that should have been expensed.	• Obtain a schedule of additions, including refurbishment costs. Review the list to identify items of revenue nature that have been incorrectly capitalised, with reference to supporting invoices/contracts. • Carry out a physical verification of PPE in oder to ensure recorded assets are accurate.
The increase in trade receivables of 60% could suggest an overstatement of receivables due to cut-off errors or	• Obtain a copy of the aged receivables listing and vouch a sample of balances to invoices to ensure the report is correctly aged.

irrecoverable debts not being provided for.	• Discuss with the management the basis on which debts are written-off as irrecoverable or have an allowance made against them. • Review a sample of balances on the aged receivables listing to ensure that they are included at their recoverable amount. • Obtain confirmations from debtors. • Review the cash book after the year-end to verify that amounts outstanding at the year-end have been settled subsequently.
Trade payables have fallen by 18% despite the increase in trading activity. This could indicate payables are understated due to cut-off errors.	• Reperform a sample of supplier statement reconciliations and review the supporting documentation for the reconciling items. • Review the cash book post year-end for any significant payments made to suppliers, vouch these to supporting documentation and ensure that amounts due at the year-end are included in the payables listing (perform unrecorded liability test).
HL has introduced a new accounting system. There is an increased risk of errors in the financial statements as a result of the data migration and a lack of practice of the new system by the accounts staff.	• Discuss with the management what controls were in place over the migration of data to the new system. • Corroborate the above mentioned controls to documentary evidence if available. • Agree the amounts brought forward in the new system to the closing balances on the old system.
There is a significant increase (250%) in the bank overdraft. This may indicate going concern problems.	• Review corespondence with the bank. • Review compliance with bank covenantsand increase testing on areas where the management could manipulate performance indicaters (such as provisions). • Review post year-end results and cashflow forecasts for evidence that the company can continue as a going concern.

(Total: 10 marks)

Answer 05

Relevant learning outcome/s: 3.3.1 Discuss how business risk could result in risk of material misstatements in financial statements.
Study text reference: Pages 208 – 220

1. **Assessment of the impairment of insect-damaged mature trees**

   The insect attack on mature trees is a possible indicator of impairment. Assessment of the impairment could involve assumptions using significant judgement. Therefore, the assessment of the impairment of the mature plantation is a key area to focus on.

2. **Review of the estimated useful life of mango trees**

   Mature trees were accounted for at the depreciated cost. The management is yet to assess the full and long-term damage from the insect attack. The insect attack could have implications on the estimated useful life of 40 years. Therefore, the review of the estimated useful life of trees is a key area to focus on.

3. **Implications on going concern**

   The production manager is a key employee. There is no person with adequate expertise in his team to take up his vacated position (there is no proper succession plan). Hence, this could have implications on the going concern of the business, and is a key area to focus on.

4. **Estimating the carrying value of the immature plantation**

   Estimating the carrying value of immature plants involves significant judgement and estimation. It was noted that the cost of labour and fertilizer allocation has increased by 80%. This could be a key area to focus on.

5. **Fair valuation**

   Estimating the fair value involves significant asset judgement. Therefore determination of the fair value would be a key area to focus on.

6. **Carrying value of biological assets**

   As 80% of the assets are inventory and biological assets (since the useful life of the trees are questionable),. Therefore this is an area to focus on.

(Total: 10 marks)

SECTION 2

Answer 06

Relevant learning outcome/s: 3.3.1, 4.1.1, 4.8.1, 4.8.2, 4.11.1 and 5.4.1 3.3.1 Discuss how business risk could result in risk of material misstatements in financial statements. 4.1.1 Discuss the requirements to be considered by an auditor in an initial engagement. 4.8.1 Explain how related party transactions can affect the true and fair view of the financial statements. 4.8.2 Explain procedures that should be performed to reduce the risk arising from related party transactions. 4.11.1 Outline substantive audit procedures to be performed in relation to account balances and classes of transactions. 5.4.1 Explain auditor's responsibility towards other information included in documents containing auditor's report.
Study text reference: Pages 208 – 220, 288 – 289, 458 – 470, 340 – 356, 519 – 521

(a) Three risks of material misstatements are compliance, complexity of group structures/related parties, and fair valuation of land.

Compliance
The Bank operates is a highly regulated environment. It has multiple compliance requirements arising from being listed on the Colombo Stock Exchange, along with the regulatory requirements for banks in Sri Lanka and other statutory requirements. Therefore, there is a potential risk of non-compliance, litigation and claims that could give rise to fines and penalties during this year's audit. A further risk exists because this may have implications on the Bank's ability to continue as a going concern if regulators cancel its license to operate for an indefinite period.

Complexity of group structures/related parties
The Bank belongs to a complex group. The ultimate parent of the Group is a family-owned business where the members have established and operate their own chains of businesses. Many of these businesses are not listed. Therefore, information on them may not be readily available. The complexity of the Group and its related party relationships would give rise to a potential risk of undisclosed related party relationships, balances and transactions.

Fair valuation of land
There could be a high degree of estimation in determining the fair value of land. It has to be included in the financial statements at the appropriate amount.

(b) **Fair valuation**

- Amount of liability/provision for penalty/fines are included at the appropriate amount for non-compliance with laws and regulations.
- The value of the land is included in the financial statements at the appropriate value.

Completeness

- All provisions for penalty/fines are recorded in the financial statements.

Presentation and disclosure

- All related party transctions and outstanding balances are included in the financial statements.
- All disclosures related to land, which is held for sale, are included in the financial statements.

(c) **Compliance**

- Make appropriate enquiries from the management and others, including the in-house legal advisors, on the possible implications of non-compliance.
- Make appropriate enquiries from the management and others on the ability to continue as a going concern.
- Review minutes of meetings.
- Review correspondence between the Bank and its external legal advisors.
- Seek direct communication with clients' legal advisors via a letter of enquiry.
- Review subsequent events, which may include inspection of post year-end payments, after-date cash.
- Recalculate the provision made for fines and penalties.
- Review similar estimates made in prior periods with actual outcomes.
- Obtain written representations from the management.
- Review the management's assessment of going concern.

Fair valuation of land

- Understand the process the company's management has followed to ensure the external valuer has estimated the fair value of land according to the requirements of the relevant accounting standard. We would have to understand (among others):
  - Controls implemented by the management over this process
  - Any changes from the prior period
  - Data, assumptions and methods used in the calculation etc.
- Verify the valuation to the external valuer's valuation report.
- Consider reasonableness of the valuation by reviewing the experience of the valuer, scope of work, methods and assumptions used etc.
- Reperform calculations for the revaluation surplus.
- Test data included in the valuation report (e.g. documents of title).
- Test how the management has considered alternative assumptions to the assumptions used (e.g. can test how the management checked the sensitivity of each assumption).
- Obtain written representations from the management that confirms key assumptions are consistent with their knowledge of the business.
- Review the financial statements to ensure the disclosures required have been made and are adequate.

Complexity of group structures/related parties

- Identify any undisclosed related party transactions.
- Request the management to disclose all transactions with all related parties including the real estate company.
- Inquire (e.g. from the Related Party Transactions Review Committee) why the Bank's internal controls failed to identify all the related party transcactions.
- Analyse accounting records of related party transactions with real estate co..
- Examine the terms and conditions of the purchase contract of the land including legal and regulatory requirements..
- Vouch the payment of Rs. 2.5 billion with records.
- Examine the approval to purchase the land, including:
  - Inspecting the Bank's registers for disclosing related party transactions
  - Inspecting minutes of meetings of the board/management
  - Reviewing subsequent events
  - Obtaining written representations from the management

(d) **Importance of performing audit procedures**

- Any inconsistencies between the related party disclosures in the financial statements and related party information disclosed/contained in the annual report could undermine the credibility of the financial statements and the auditor's report.

- If any material inconsistency in the related party disclosures are identified, it should be resolved by requesting the management to revise either the audited financial statements or the other information as appropriate, prior to the issue of the audior's report. If the management refuses, it would have implications on the auditor's report.

(Total: 25 marks)

Answer 07

Relevant learning outcome/s: 1.3.1, 4.7.1, 4.9.1, 4.12.1 and 5.5.1
1.3.1 Demonstrate the legal and regulatory factors affecting an audit of financial statements. 4.7.1 Explain how the auditor obtains sufficient and appropriate evidence on accounting estimates. 4.9.1 Discuss the use of written representation as audit evidence, including its limitations. 4.12.1 Outline procedures required to identify events occurring between the date of financial statements and the date of the audit report. 5.5.1 Analyse a non-complex audit engagement and propose appropriate modifications, with sufficient justification.
Study text reference: Pages 4 – 9, 323 – 326, 483 – 486, 471 – 474, 504 – 514

(a) It is the management's responsibility to ensure that the entity complies with the relevant laws and regulations. It is not the auditor's responsibility to prevent or detect non-compliance with laws and regulations.

The auditor's responsibility is to obtain reasonable assurance that the financial statements are free from material misstatement and, in this respect, the auditor must take into account the legal and regulatory framework within which the entity operates.

SLAuS 250 states the auditor's responsibilities in relation to compliance with two different categories of laws and regulations.

Laws and regulations that have a **direct effect** on the determination of material amounts and disclosures in the financial statements.	The auditor's responsibility is to obtain sufficient appropriate audit evidence about compliance with those laws and regulations.
Laws and regulations that **do not have a direct effect** on the determination of material amounts and disclosures in the financial statements but where compliance may be fundamental to the operating aspects, ability to continue in business, or to avoid material penalties.	The auditor's responsibility is to undertake specified audit procedures to help identify non-compliance with laws and regulations that may have a material effect on the financial statements.

(b)

- Enquire from the management on how the accounting estimate is made and the data on which it is based.
- Review the method of measurement used and assess the reasonableness of the assumptions made.
- Test the operating effectiveness of controls over how the management made the accounting estimate.

- Review the judgments and decisions made by the management in the making of the accounting estimate to identify whether there are indicators of possible management bias.
- Obtain sufficient appropriate audit evidence on whether the disclosures in the financial statements relate to accounting estimates and whether the estimation uncertainty is reasonable.

(c)

As the management has not provided the valuation report then there is very little evidence that was obtained by the auditor.

This representation would constitute entity-generated evidence, which is less reliable than auditor-generated evidence or evidence from an external source.

Although written representations are necessary, they cannot provide sufficient appropriate audit evidence when they stand alone.

(d)

(i) Yes, the financial statements for the year ended 30 September 2019 should be adjusted by recognising a provision of Rs. 300 million and removing the contingent liability disclosure since the settlement of the case provides further evidence that the company had a present obligation as at 30 September 2019 although the settlement took place after the year-end.

(ii)

- The auditor should communicate with the company's lawyer to confirm the settlement of the legal case by the company and the supplier.
- Review correspondence with the supplier to confirm the settlement of Rs. 300 million by them.

(e) The management has not complied with LKAS 37 Provisions, Contingent Liabilities and Contingent Assets.

The amount claimed by the supplier is Rs. 350 million but the probable payment is Rs. 300 million. This amount is material as it represents 6% of net profit.

If the management refuses to provide, then the audit report will need to be modified. If the error is material but not pervasive then a qualified opinion would be necessary.

(Total: 25 marks)

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