SUGGESTED SOLUTIONS

KB4 – Business Assurance Ethics & Audit

June 2019

SECTION 1

Answer 01

Relevant learning outcome/s: 1.1.1 and 1.3.2
1.1.1 Demonstrate the need to comply with the fundamental and ethical principles applicable to all members of the Institute of Chartered Accountants of Sri Lanka. 1.3.2 Demonstrate an auditor's responsibility and requirements in complying with laws and regulations.
Study text reference: Pages 24, 277 and 279

(a)

- Firstly, the auditor should make specific inquiries from the management. The inquiries may be about:
  - Policies and procedures established to ensure compliance with regulations in Sri Lanka
  - How management identifies non-compliance with regulations and the controls established for compliance
  - How the management has ensured compliance with regulations in the case of Sarath

- Read minutes of meetings of the management, board of directors etc. The auditor could assess whether any discussions or decisions have been made with respect to transactions with Sarath or whether there are investigations by the regulatory and enforcement authorities.

- Make inquiries from in-house legal advisors if available. If not, the auditor may consider seeking external legal advice to ascertain possible non-compliance with regulations.

- Request for and inspect correspondence with the regulatory and enforcement authorities for any indication of non-compliance.

- Inspect supporting cash records and other supporting evidence to establish whether transactions with Sarath were properly authorised and recorded, and whether the cash was banked.

- Substantively test the investment transactions on behalf of Sarath, and the legal expense account of GIP.

- Request written representations from the management. These should cover whether the management has disclosed to the auditor all known instances of actual and suspected non-compliance.

(b)

- First discuss the findings with the engagement manager and engagement partner. Then communicate with those charged with governance/board of directors.
- If the auditor suspects the board of directors is involved in violating the regulations, then consider seeking legal advice on the next step to take.

- If the auditor concludes the non-compliance has a material effect on the financial statements and it has not been adequately reflected, the auditor must consider the impact of the non-compliance on the auditor's report.

(c)

- The fundamental principle of confidentiality requires the auditor to refrain from disclosing information acquired during professional work, except where the disclosure is permitted by the client or required by the law.
- In the above scenario, the principle of confidentiality is overridden by requirements of the relevant regulations. Therefore, the auditor will not be violating any principle of confidentiality in this instance.

(Total: 10 marks)

Answer 02

Relevant learning outcome/s: 3.4.2 Discuss the factors or conditions generally present in a fraud situation.
Study text reference: Pages 266 and 267

(a)

- The CEO and CFO insisting on attending all the meetings between the audit committee and the external and internal auditors.
- Internal audit operating under very restrictive management conditions.
- Window dressing of the financial statements by way of understating expenses.

(b)

Fraud triangle	**Risk factor**
Opportunity	• Domination of the management by a single person.
Motivation/pressure/incentive	• Excessive pressure (from the group) on the management to meet financial targets. • Management performance is measured in terms of year-on-year profit growth.
Rationalisation/attitude	• The attitude that understatement of contract expenses can be justified for the betterment of the company.

(Total: 10 marks)

Answer 03

Relevant learning outcome/s: 2.2.3 and 2.2.4
2.2.3 Analyse the design, implementation and operating effectiveness of identified controls. 2.2.4 Outline both significant and minor deficiencies in control activities.
Study text reference: Pages 117 – 129 and 135

(a) **Weakness**	(b) **Improvement/recommendation**
• Order forms are not pre-printed with a serial number.	• All order forms should be sequentially pre-numbered. The sales executive should file one copy of the order form in numerical sequence and pass the other one to the warehouse.
• Orders/despatch notes are processed without authorisation or without performing a credit check on customers.	• All new customers should undergo a credit check before being accepted as new customers. • Credit limits should be set for all customers to avoid selling goods on credit to risky customers. • All orders over a certain limit should be approved by an authorised person prior to processing.
• No one matches the dispatch note to the original order prior to dispatch, and no one signs the dispatch note to confirm that the correct quantity of goods has been dispatched.	• Before orders are dispatched the warehouse officer should check the quantity of goods to the dispatch note and compare it with the original order. The supervisor should then sign the dispatch note to confirm this check has taken place.
• No one checks that all the orders have been attended to.	• The sales clerk should keep a copy of all the orders and match them to the dispatch notes. At the end of each week he should check unmatched orders and inquire why a dispatch note was not raised.
• No system or arrangement to check the completeness and accuracy of sale invoices.	• Dispatch notes should be matched to the invoice and order form, and filed together.
• No segregtion of duties.	• Duties must be segregrated in order to avoid collusion.

(Total: 10 marks)

Answer 04

Relevant learning outcome/s: 2.1.1 and 2.1.2
2.1.1 Discuss the key aspects of corporate governance, incljuding responsibilities of the Board and role of non-exeutive directors. 2.1.2 Explain the need for an audit committee, including the benefits of an audit committee to the sharehodlers ofa listed entity.
Study text reference: Pages 102 and 103

(a)

- The auditor will be invited to regularly attend meetings of the audit committee.
- The chair of the audit committee and, when relevant, the other members of the audit committee, will liaise with the auditor periodically.
- The audit committee will meet the auditor without the management present at least annually.

(b) **Weakness**	(c) **Recommendation**
• None of the directors of BP have submit themselves for re-election since the company was listed.	• All directors should be required to submit themselves for re-election at regular intervals, and at least once in every three years.
• The finance director decides on her remuneration and the remuneration of the other directors. There is no formal and transparent procedure for setting up the remuneration packages of individual directors.	• To avoid potential conflict of interest, the board of directors should set up a remuneration committee to make recommendations to the board, within agreed terms of reference, on the company's framework of remunerating executive directors.
• The audit committee comprises an executive director (i.e. the finance director).	• The audit committee should comprise of non-executive directors *only*. The finance director should resign from the committee and BP should appoint an additional non-executive director. A member of the audit committee should have recent and relevant experience in financial reporting and control.
• BP is not planning to hold an AGM considering the cost involved.	• BP should hold an AGM in accordance with the requirements of the Companies Act and the company's Articles of Association. Sending out the financial statements and any voting resolutions to the shareholders via email is not a replacement of the AGM. The board should use the AGM to effectively communicate with the shareholders.
• Decisions relating to the appointing and remunerating of the external auditor is made by the chairman.	• The responsibility of making recommendations to the board pertaining to appointment, reappointment and removal of the external auditor, and approving the remuneration and terms of engagement of the external auditor, should be delegated to the audit committee.

(Total: 10 marks)

Answer 05

Relevant learning outcome/s: 4.3.1, 4.11.1 and 5.5.1 4.3.1 Explain the use of external confirmation in gathering audit evidence. 4.11.1 Outline substantive audit procedures to be performed in relation to account balances and classes of transactions. 5.5.1 Analyse a non-complex audit engagemnte and propose appropriate modifications with sufficient justification.
Study text reference: Pages 287 – 290, 388, 389, 394, 399, 515 and 517

(a)

- For a sample of sales transactions recorded in the ledger, vouch the sales invoice back to customer orders and despatch documentation.
- Perform analytical procedures considering:
  - The level of sales over the year, compared on a month-by-month basis, with the previous year
  - The effect on the sales value resulting from changes in the quantity sold
  - The effect on the sales value resulting from changes in products or prices
  - The level of goods returned, sales allowances and discounts
  - The efficiency of labour, expressed in sales or profit per employee
  - Reasons for changes in the gross profit margin (this should be as detailed as possible, ideally broken down by product area and month or quarter)

(b)

- If management asks the auditor not to seek confirmation, the auditor shall enquire about the management's reasons for the refusal and seek audit evidence regarding the validity and reasonableness of the reasons.
- They should also evaluate the implications of the refusal on the assessment, such as the risk of material misstatement, and also on the nature, timing and extent of other audit procedures.
- The auditor should perform alternative audit procedures to obtain relevant and reliable audit evidence.
- If the auditor concludes that the refusal is unreasonable, or the auditor cannot obtain relevant and reliable audit evidence elsewhere, the auditor should communicate with those charged with governance (audit committee or the board).

(c)

- **Emphasis of matter paragraph**
  The financial and operating conditions may cast doubt about the going concern assumption. It appears that the disclosure in the financial statements is adequate. The auditor will have to decide whether the inherent uncertainty is fundamental to the users' understanding. If so, the auditor's report should include an emphasis of matter paragraph beneath the opinion paragraph with details of this matter.

- **Other matter paragraph**
  An other matter paragraph should be included in an auditor's report to draw the users' attention to the fact there is a new auditor for this year (i.e. last year's financial statements were audited by another auditor).

(Total: 10 marks)

SECTION 2

Answer 06

Relevant learning outcome/s: 1.5, 4.3, 4.13.1, 4.13.2 and 4.11.1	
1.5	Audit documentation.
4.3	External confirmation.
4.13.1	Assess events and conditions that may cast significant doubt about the going concern assumption.
4.13.2	Outline procedures required to evaluate the validity of the going concern assumption.
4.11.1	Outline substantive audit procedures to be performed in relation to account balances and classes of transactions.
Study text reference: Pages 67 – 70, 397 – 403, 426 – 433, 477, 479 and 480	

(a)

- Loss of a key customer – ZL has lost its major customer, Fuji Tel (Pvt) Ltd. This will result in a significant loss of future revenue and cash flows.
- Negative cash flows (historical or prospective) – ZL's monthly cash flows have shown a net cash outflow for the last six months of the financial year, and is forecasted to be negative for the quarter ended 30 June 2019 as well. If the company continues to have negative cash flows, then it will put further pressure on the company's sustainability.
- Inability to pay creditors on due dates – ZL's suppliers have initiated legal action to recover the debts. This will result in ZL incurring legal costs and also facing a loss of suppliers.
- Inability to comply with the terms of loan agreements – ZL has a loan which is due for repayment in full within six months from the year-end. This will put further pressure on the company's sustainability.
- Non-payment of dividends – the directors of ZL have decided that no dividend will be paid in 2019. This may result in shareholders losing confidence in the company.

(b)

- Analyse and discuss cash flow, profitability and other relevant forecasts with the management.
- Analyse and discuss the company's latest available interim financial statements (or management accounts).
- Review the terms of debentures and loan agreements and determine whether they have been defaulted.
- Read minutes of the meetings of shareholders, the board of directors and important committees to identify any cash flow and funding difficulties.
- Inquire from the company's lawyer regarding litigations and claims.
- Confirm the existence, legality and enforceability of arrangements to provide or maintain financial support related to third parties.
- Assess the financial capacity of such parties to provide additional funds.
- Consider the company's position concerning unfulfilled customer orders.

- Review events after the period-end for items affecting the company's ability to continue as a going concern.
- Obtain confirmations and details on the existence, terms and adequacy of borrowing facilities.
- Obtain and review reports of regulatory matters and diretons.
- Determine the adequacy of support of assets are dispersed.

(c)

- The working paper does not state who prepared it, so it makes it difficult for the reviewer to follow up on any queries arising during the review.
- The working paper has not been dated by the person who prepared it.
- The working paper does not indicate the period covered for the audit and therefore could potentially be filed in an incorrect audit file.
- Work done – a sample selection including basis, work done, source of information, key to any audit risks, appropriate cross referencing, has not been documented.
- The conclusion reached has not been documented.
- There is no cross-reference on the working paper so it may not be properly filed, and it will not be possible to cross-reference to it.

(d)

- The selection based on the materiality is not appropriate for accounts payable (i.e. selection of only large balances will not yield an appropriate sample as the understatement of liabilities is what is being tested for). Zero and negative balances will also need to be included in the sample.
- As the auditor observed that there is no statement available from the supplier, confirmation of the balance from the supplier should be requested or other audit procedures should be undertaken (e.g. review of previous/post year-end payments, agreement of goods received and invoices for all items).
- As the auditor observed that there is a difference of Rs. 11 million between the ledger balance and the statement balance of Ranmuthu, a reconciliation should be done as at 29 March 2019. The difference should not be regarded as immaterial as it would not serve the objective of the audit since it is to find out whether there any unrecorded liabilities.

(e)

- Examine unmatched delivery notes and supplier invoices for any unrecorded liabilities.
- Obtain confirmation of accounts payable.
- Vouch selected amounts from the trade accounts payable listing and accruals listing to supporting documentation such as delivery notes and supplier invoices.
- Perform analytical procedures comparing current year balances to the previous year to confirm reasonableness. Also calculate the payables turnover and compare it to the previous year.
- Take a sample of vouchers, compare the dates with the dates they were recorded in the ledger for application of correct cut-off.
- Test transactions around the year-end to determine whether amounts were recognised in the correct financial period.
- Perform analytical procedures on purchase returns, comparing the purchase returns as a % of sales or cost of sales to the previous year.

(f)

Where an auditor has not received any response for confirmation letters on receivables they should carry out the following procedures.

- Follow up with phone calls to get the balances confirmed directly.
- Review subsequent cash received in an effort to confirm existence of balances.
- Review past records in order to ascertain payment patterns to mitigate the risk of having bad debts.
- Verify the account balance by cross-checking invoices and related documents.
- Peruse email and other modes of confirmation to verify the existence of the customer.

(Total: 25 marks)

Answer 07

Relevant learning outcome/s: 3.6.2, 4.4.1, 4.5.1 and 5.5.1 3.6.2 Analyse financial and non-financial information of a given engagement to identify risk of material misstatements (inherent and control risk). 4.4.1 Discuss the requirements to be considered by an auditor in an initial engagement. 4.5.1 Discuss the responsibility of an auditor in the verification of physical inventory. 5.5.1 Analyse a non-complex audit engagement and propose appropriate modifications, with sufficient justification.
Study text reference: Pages 229 – 235, 320 – 323, 364 – 366 and 506 – 512

(a)

- Revenue has decreased by 0.5%, but the relative decrease in cost of sales is 10%. There could be a risk that cost of sales is understated by manipulating the closing stock.
- Gross profit margin has increased from 18% to 26%, which could indicate cost of sales are understated, sales are overstated or there is incorrect inventory valuation .
- The increase in trade receivables by 17% could suggest an overstatement of receivables due to cut-off errors or irrecoverable debts not being provided for.
- Trade payables have fallen despite the increase in trading activity. This could indicate payables are understated due to cut-off errors.
- Increase in closing inventory could suggest there are issues in valuing inventory.
- Return of a consignment stock after the balance sheet date could indicate the net relaisable value is below cost.
- There could be possible overstatement of revenue since KL recognises revenue when goods are delivered from the factory. However, the risks and rewards are passed to the buyer when the goods are delivered to the port of destination.

(b)

- Review the most recent financial statements, if any, and the prior year auditor's report, if any, for information relevant to opening balances (including disclosures).
- Determine whether the prior year closing balances were correctly brought forward to the current year.
- Determine whether the opening balances reflect the application of appropriate accounting policies.
- Consider reviewing the prior audit working papers to obtain evidence regarding opening balances.
- If this is not possible, consider whether procedures performed in the current year provide evidence over the opening balances.
- In exceptional cases the auditor may need to perform specific audit procedures to obtain evidence regarding the opening balances.

(c)

- If the auditor cannot obtain sufficient appropriate audit evidence for opening balances, the auditor should express a qualified opinion or a disclaimer of opinion.

- If the opening inventory balances contain misstatements that materially affect the current year financial statements, the auditor should express a qualified opinion or an adverse opinion.

- If the auditor concludes that the current year's accounting policies are not consistently applied in relation to opening inventory balances, or changes have not been properly accounted for and adequately presented and disclosed, the auditor should express a qualified opinion or an adverse opinion.

- If a prior-period modification remains relevant and material to the current year financial statements, the auditor should modify the auditor's opinion on the current year financial statements accordingly.

(d)

- The mere fact that the auditor is not able to attend the inventory count is not grounds for qualification. The auditor has to consider if alternative/additional procedures (e.g. observing a current physical stock take and test-checking the rollback reconciliation to the year-end inventory quantities) could be performed to ascertain the inventory balance as at the year-end.

  If the auditor is able to obtain sufficient appropriate audit evidence (as mentioned above) regarding the year-end inventory balance, the audit opinion need not be modified.

- However, if the auditor is unable to obtain sufficient appropriate audit evidence through further audit procedures regarding the year-end inventory balance, the auditor may have to modify the auditor's report, as a result of the scope limitation.

  The auditor should express a qualified or disclaimer of opinion depending on the financial impact of the scope limitation.

(e)

- Perform a physical count after 30 June 2019 and roll-back to the year-end.
- Perform analytical procedures – given the apparent disparity between sales and purchases during this period, it is necessary to carry out appropriate analytical procedures. Important ratios are gross profit margin and inventory turnover. An unexpectedly high inventory turnover ratio, or an unexpectedly low gross profit margin, may be caused by the overstatement of cost of goods sold and a corresponding understatement of inventory.
- Test movements between March and June – for selected items in the inventory count:
  - ➢ Review and inquire to ensure that the goods received notes are prepared for the goods received.
  - ➢ Confirm that the inventory accounts are debited for all the goods received.
  - ➢ Review and inquire to ensure that goods issued are properly authorised and documented on delivery documents.
  - ➢ Ensure all sales are charged to cost of sales – crediting inventory and debiting cost of sales at the appropriate cost.
- Test write-offs. For items written off:
  - ➢ Discuss with the management how they were identified
  - ➢ Carry out a physical inspection to confirm existence
  - ➢ Inquire and discuss the cost of write-offs by reference to costing records and invoices as appropriate.
  - ➢ Inquire and review possible existence of other similar items that should be written off.
- Test inventory at other locations and with third parties – when inventory is stored at other locations and with third parties, the auditor should obtain evidence regarding the existence of the inventory by direct communication with the custodian. This type of evidence will be deemed sufficient except when the amounts involved represent a significant proportion of current assets. In this case, the following addition procedures should be carried out.
  - ➢ Consider the integrity and independence of the third party.
  - ➢ Consider visiting the third party to conduct a physical inventory check and other alternative procedures.
  - ➢ Consider obtaining confirmations from the auditor of the third party.
- Test inventory valuation
  - ➢ For items at cost, examine supplier invoices.
  - ➢ For work-in-progress, verify costs by comparing with costing records.
  - ➢ All inventory items should be tested for net realisable value (NRV), and be written down to the NRV if it is below cost.
- Obtain management representations – it will be necessary for the management to include confirmation assertions relating to inventory in the letter or representation to be provided to the auditor at the end of the audit.
- Carry out cut-off procedures (i.e. note the number of the last GDN and GRN before the year-end, and the first GDN and GRN after the year-end, and check whether they have been included in the current financial year).

(Total: 25 marks)

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