

**CA**



THE INSTITUTE OF  
**CHARTERED** ACCOUNTANTS  
OF SRI LANKA

# **SUGGESTED SOLUTIONS**

**KE4 – Processes, Assurance & Ethics**

**September 2019**

## SECTION 01

### Answer 01

1.1

<b>Learning Outcome/s: 1.1.2</b>
Identify the key business processes in a business organization
Study text reference: page 12-13
<b>Correct Answer: C</b>

1.2

<b>Learning Outcome/s: 1.2.4</b>
Identify the process of risk management
Study text reference: page 36
<b>Correct Answer: A</b>

1.3

<b>Learning Outcome/s: 1.6.3</b>
Identify the internal control monitoring mechanisms designed to ensure effectiveness of processes and business
Study text reference: page 64
<b>Correct Answer: D</b>

1.4

<b>Learning Outcome/s: 2.1.3</b>
Assess the business risk connected with sub activities relating to the procurement process
Study text reference: page 100
<b>Correct Answer: B</b>

1.5

<b>Learning Outcome/s: 2.3.2</b>
Identify documents relating to cash management (receipts, payment vouchers, etc.) point of origination, flow of documents and purpose
Study text reference: page 140
<b>Correct Answer: C</b>

1.6

<b>Learning Outcome/s: 2.5.1</b>
Identify activities connected with the inventory management process, such as deciding optimum order quantities, physical safeguard of inventory, receiving/issuing goods etc.
Study text reference: page 198
<b>Correct Answer: D</b>

1.7

<b>Learning Outcome/s: 2.6.1</b>
Study text reference: page 8-9, Additional study support material
<b>Correct Answer: A</b>

1.8

<b>Learning Outcome/s: 3.1.1</b> Recognise the importance of design effectiveness of control in achieving the objectives of a given business process.
Study text reference: page 227
<b>Correct Answer: D</b>

1.9

<b>Learning Outcome/s: 5.3.1</b> Discuss the general principles governing an audit of financial statements, such as professional skepticism, professional judgments etc.
Study text reference: page 297
<b>Correct Answer: B</b>

1.10

<b>Learning Outcome/s: 5.5.3</b> List different audit procedures used to gather audit evidence.
Study text reference: page 311
<b>Correct Answer: B</b>

**(2 x 10 = Total: 20 marks)**

## Answer 02

2.1

### Learning Outcome/s: 1.3.1

Identify the different types of risks that an entity is exposed to (including those arising from both the internal and external environment of an entity)

Study text reference: page 29

**External strategic risk** – Risk of changes in the financial environment, such as the risk of; a rise or fall in an important foreign exchange rate or interest rates, or; changes in conditions in the financial markets such as the stock market or bond market.

**Internal Operational risk** - Risk of failures or errors in the accounting system and financial reporting process – for example, due to errors in the bookkeeping system.

2.2

### Learning Outcome/s: 1.5.2

Identify elements of internal control.

Study text reference: page 18-21 Additional study support material

- (a) Control environment
- (b) Risk assessment
- (c) Monitoring

2.3

### 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
- As a consequence the residual risk is within the organization's risk tolerance

2.4

### Learning Outcome/s: 1.9.1

Identify who is responsible for the introduction of controls in an organisation

Study text reference: page 68

Responsibilities of the Management

- Approve the design of controls
- Ensure that controls are implemented properly
- Ensure that control information is communicated to relevant persons
- Review the effectiveness of controls and report to the audit committee or the board.

2.5

<b>Learning Outcome/s: 2.1.2</b> Identify the documents relating to the procurement cycle, point of origination, flow of documents and purpose.
Study text reference: page 85
<ul style="list-style-type: none"><li>• A new item is required which the organization has not purchased before.</li><li>• The existing supplier's costs are too high and alternative suppliers are invited to quote for the contract</li><li>• The existing supplier no longer supplies the goods, or is unable to meet the required delivery time needed</li><li>• The value of the contract is high, and the buyer is required to obtain a good price</li></ul>

2.6

<b>Learning Outcome/s: 3.2.1</b> Explain the importance of operating effectiveness of internal control
Study text reference: page 230
<ul style="list-style-type: none"><li>(a) Collusion</li><li>(b) Management override of controls</li><li>(c) Human error</li></ul>

2.7

<b>Learning Outcome/s: 1.6.1</b> Explain main control activities such as'
<ul style="list-style-type: none"><li>• Segregation of duties</li><li>• Physical controls</li><li>• Authorisation</li><li>• Business performance review</li><li>• Information processing controls</li></ul>
Study text reference: page 57
<b>Authorization and approval control</b> All fixed asset purchases above Rs. 1,000,000 require the approval of the Board of Directors.
<b>Arithmetical and accounting control</b> Reconciliation performed between the fixed assets register and the fixed assets balances recorded in the general ledger.

2.8

<b>Learning Outcome/s: 4.1.1</b>
Identify differences between law, ethics and morality.
Study text reference: page 249
Morality is the personal belief about what is right or wrong. Morality of an individual is based on the persons values. Personal values are an individuals belief about what is right and wrong, Accordingly the base of morality is "value".

2.9

<b>Learning Outcome/s: 4.2.1</b>
State the importance of ethical behaviour for a Professional Accountant.
Study text reference: page 80 Additional study support material
Public interest is considered to be the collective well-being of the community of people and institutions the professional accountants serve, including clients, lenders, governments, employers, employees, investors, the business and financial community and others who rely on the work of professional accountants.  A professional accountant has an important role in the society. Investors, creditors, employers and other sectors of the business community, as well as the government and the public at large rely on professional accountants for sound financial accounting and reporting, effective financial management and competent advice on a variety of business and taxation matters. The attitude and the behaviour of professional accountants in providing such services have an impact on the economic well-being of the community and the country.

2.10

<b>Learning Outcome/s: 5.4.1</b>
Define "audit evidence".
Study text reference: page 304
<ul style="list-style-type: none"><li>• Audit evidence is more reliable when it is obtained from independent sources outside the entity.</li><li>• Audit evidence obtained directly by the auditor is more reliable than audit evidence obtained indirectly or by inference.</li><li>• Audit evidence is more reliable when it exists in documentary form whether paper, electronic, or other medium. Audit evidence provided by the original documents is more reliable than audit evidence provided by photocopies and fax.</li></ul>

**(Total: 30 marks)**

## SECTION 2

### Answer 03

**Learning Outcome/s: 2.2.3, 2.3.1**

**2.2.3** Assess the business risks connected with sub activities relating to the payroll process.

**2.3.1** Identify activities connected with the cash management process, such as maintenance of cash book, petty cash book, bank reconciliations, investments etc.

Study text reference: page 129,142

(a) **Business risks – Payroll**

1. **Risks of incorrect payroll calculation**

There are risks of errors in the process of calculating the payroll. Gross pay or deductions may be calculated incorrectly.

In this scenario there is no indication that the payroll prepared by the payroll executive manually is checked by an officer to verify that the calculations are of free of errors.

Specially when the payroll is processed manually there is a risk of making errors in the payroll calculation. For example overtime records, attendance records are maintained manually and there is a risk of making errors in these calculations.

2. **Risks of incorrect information to the payroll executive**

For preparation of the payroll, the payroll executive relies on the information provided by different sources (e.g. new recruits, the attendance records provided by different departments etc.). There is no indication provided in the scenario that such information are verified by a relevant officer.

There is a risk that the HR department will submit incorrect information and also fail to provide timely communication to the payroll officer with regard to new recruits and/or resignations. As a result, there will be a risk of making underpayments/overpayments of salaries/ wages.

(b) Management can **invest the surplus cash** for a **short time**, usually in investments where the risk of losing money is non-existent or small. For example, it would be risky to use surplus cash to invest in **shares** on the stock market, because share prices might decrease.

Surplus cash could be invested in more secure ways, such as **deposit accounts** with a financial institution or short-term debt securities issued by the government.

Since the management does not have a good knowledge in investing in high risk investments such as shares, investing in share may not be appropriate.

As such, the Company may consider less complex investments such as fixed deposits or treasury bills.

**(Total: 10 marks)**

## Answer 04

### Learning Outcome/s: 3.4.1, 4.2.3

**3.4.1** Explain the 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: page 237-239, 262

(a)

<b>Deficiency</b> – Purchase orders are not sequentially numbered.	<b>Implication</b> – Purchase orders can be incomplete and there is no way of keeping track of unfulfilled orders.
<b>Deficiency</b> – Purchase orders are not approved by an authorised officer before the order is sent out unless the amount is greater than Rs. 500,000.	<b>Implication</b> – An order can be made for unauthorized goods up to a value of Rs. 500,000.
<b>Deficiency</b> – The supplier is selected based on the speed of the supply.	<b>Implication</b> – Goods of poor quality could be ordered or a higher price may be paid for goods from particular suppliers.

(b)

**Conflicts of interest** – A conflict of interest occurs for an accountant when there are two different loyalties or commitments which may occasionally conflicts with each other. The common conflict of interest involves self-interest. This occurs when the personal interest of an individual may differ from the interests of the company.

**Acceptance of gifts** – Gifts are inducements that can gives rise to self-interest & Intimidation threats to an accountant’s independence, objectivity and confidentiality. The parties who offer gifts may have an interest in the outcome of the accountant’s work. Gifts may be an attempt to influence the objectivity of the accountant’s decisions or make them do or not do a particular act.

**(Total: 10 marks)**



## Answer 05

### Learning Outcome/s: 2.5.2, 5.1.2

**2.5.2** Assess the business risks connected with sub activities relating to the inventory management process.

**5.1.2** Explain the key areas of the assurance framework, including elements, objectives, scope etc.

Study text reference: page 277, 209

(a)

1. Risk of issuing raw materials to unauthorized individuals who should not receive them leading to pilferage.
2. Risk of errors in inventory records that are maintained manually due to human error/ Manual systems are inefficient and not cost effective when dealing with large volumes.
3. Physical risks to inventory due to inappropriate storage of raw materials exposed to elements of weather.
4. Excessive costs delivering goods from central stores to operational units around the country.
5. Risk of running out of important inventory items and the risk of excessive inventory levels.

(b)

#### Three-party relationship

Every assurance engagement, whether a reasonable or a limited assurance engagement, involves three parties, the intended user, responsible party and the practitioner.

#### Intended users- Bank

These are the person, persons or class of persons for whom the practitioner prepares the assurance report.

#### The responsible party – Management

The person (or persons) responsible for the subject matter (in a direct reporting engagement) or subject matter information of the assurance engagement. This is usually a company that engages the assurance provider.

#### Practitioner to carry out an assurance engagement - Auditor

The practitioner is the individual providing professional services that will review the subject matter and provide the assurance.

**(Total: 10 marks)**

## Answer 06

### Learning Outcome/s: 5.5.1, 5.5.2

5.5.1 Explain the concepts and meanings of :

- \* Sufficient and appropriate audit evidence
- \* The nature, timing and extent of audit procedures.

5.5.2 Explain the meaning and the difference between test of controls and substantive procedures.

Study text reference: page 303, 304, 305-307

(a)

#### Appropriateness of audit evidence

- **Relevance** – It deals with the logical connection with the purpose of the audit procedure and the assertion under consideration.  
or
- Audit evidence is said to be relevant if it supports the achievement of audit objectives
- **Reliability** - Reliability of evidence is influenced by its source and by its nature and is dependent on individual circumstances under which it is obtained

(b) (i)

#### Quantity of audit evidence

The quantity of audit evidence is affected by the level of risk in the area being audited. It is also affected by the quality of the audit evidence obtained. If the evidence is of high quality the auditor may need less evidence than if it were of poor quality. Therefore the trainee accountant's view is not entirely correct.

(b) (ii)

#### Substantive testing

Substantive testing	Test of control
Kalana will perform a variance analysis of expenses compared to previous year and unusual variances will be investigated. (Analytical Procedure)	The payment vouchers are checked by the assistant accountant with the relevant supporting documents. (Inspection) Kalana will verify whether this control is operating effectively.
Kalana will check the supporting documents available for: <ul style="list-style-type: none"><li>○ Legal expenses</li><li>○ Fines and penalties</li><li>○ Research expenses</li></ul> (Test of detail)	The payment vouchers are sequentially generated by the system and Kalana gets the help of the IT specialist to check whether the system has been configured to maintain the sequential order.(Re-performance)

**(Total: 10 marks)**

## SECTION 3

### Answer 07

<b>Learning Outcome/s: 2.3.3, 2.6.3</b> <b>2.3.3</b> Assess the business risks connected with sub activities relating to the cash management process. <b>2.6.3</b>
Study text reference: page 148, Additional study support material

(a) Weaknesses	(b) Risks
Cash is kept in a drawer for an entire week	Risk of theft/ rolling money/misuse by the cashier within the week and stealing by unauthorized personnel.
Daily cash collections are not banked daily	
Instead of individual sales, the cash receipts are entered to the cash register as bulk receipts	Risk of theft as the cashier may combine sales to make the value over Rs. 2000 which would be entitled to a discount. Discounts on bulk sales amounts are recorded which may not be entitled for discounts if sales were recorded individually. Values of such discounts may be stolen by the cashier.
Cash, sales receipts and the banking process is handled by the cashier	Risk of theft /rolling money/misuse by the cashier.
Manual receipts are not considered in recording cash receipts and reconciled to the cash register	Risk of error and completeness of sales is not checked by agreeing the sales over Rs. 2000 to manual sales receipts. As a result there will be a difference in collected sales and recorded sales.
Only cash deposit slips are matched with the POS generated slips without tallying with manual receipts.	Risk of theft and misuse.
No authorization for discounts as the cashier grants such discounts	Cashier can manipulate discounts to his benefit.

(c) Risks	(d) Control
Supply goods to non-credit worthy customers since any corporate customer can get a credit period of 1 month without evaluating the credit worthiness.	Customers should be evaluated and pre-approved credit limits and credit periods to be introduced for each customer.
Risk of non-payment by the customers.	Evaluate the repayment capacity of the customer.
No inventory record maintained and due to sourcing inventory on shortfalls, risk of purchasing and supplying of low quality stationery.	Introducing minimum quality standards and having an approved supplier list.
Daily deliveries are not checked with the order and invoice and therefore the risk of over/ under delivery	Goods delivered should be independently checked with each other before it is dispatched.

Whole sales process is handled by one person- Sales Executive therefore there is a possibility of frauds	Segregation of duties between receiving orders, invoicing and issuing goods.
Accept orders for which the seller has no ability to deliver due to non-evaluation of order	Sales order should be evaluated in terms of quantity, delivery date and availability.
As the inventory records are not maintained there is a risk of delay in delivery if the required stationery item is out of stock	Maintain inventory records and inventory levels properly.
As the invoice is raised without any evaluation there can be under invoicing, over invoicing or duplicate invoicing	Invoices should be checked by one person and approved by another person.

(e)

1. Discounts: Giving a discount for early payments is a way to motivate people to pay off their bills early.
2. Follow up quickly: When a customer is late to make payments, follow up immediately.

**(Total: 20 marks)**

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