

CA



THE INSTITUTE OF
CHARTERED ACCOUNTANTS
OF SRI LANKA

SUGGESTED SOLUTIONS

23404 – Advanced Audit and Assurance

CA Professional (Strategic Level II) Examination
June 2014

THE INSTITUTE OF CHARTERED ACCOUNTANTS OF SRI LANKA

Answer No. 01

- (a) *The objective of the question is to test the ability of the students to suggest a suitable professional service that meets with the objectives (i) and (ii).*

Objective (i)

- FFP requires ascertaining the status of net assets. This can be achieved by providing a due diligence service. In a due diligence, the scope can be set to determine the recoverability, existence and reasonability of measurement of the stated assets and liabilities, which is the objective (i) of FFP.

OR

- An agreed upon procedure based assignment can also be carried out to report findings on agreed work done, in order to determine the status of the net assets.

OR

- a Special purpose audit scoped to assess the recoverability of net assets based on an identified financial reporting framework can also be carried out.

Objective (ii)

- As per SLSAE 3400, an Assurance engagement using the principles of Examination of Prospective Financial Information can be used as FFP is expecting “comfort” over forecast numbers

- (b) - Goodwill already recognised in VFL is related to a business not connected with a finance company. As noted in the discussion with the partner, any other business carried out by VFL may be proposed to be discontinued. Hence, it may require write off/ impairment to be accounted for in the consolidated results.

- New goodwill arising is subject to impairment annually, and proposed amortization is not in line with SLFRS

- Significant financial assets - loans and advances:

- High microfinance portfolio that is subject to collective impairment, based on past behavior
- Significant pawning advances, that are exposed to current adverse trends in gold prices / external factors

- Leases and stock out on hire are also subject to complex impairment calculations that are based on cash flow projections and past behaviors in delinquency or write offs
- Available-for-sale financial assets - require determination of fair value, that may be subjective
- Gold stock may require careful determination of realisable value, due to price changes
- PPE and investment properties both require assessment of recoverability (or fair value) as the objective is to assess the value for the acquisition
- Deposits - completeness and accuracy or fairness of recorded deposits.
- Securitisation loans – completeness, compliance with covenants or conditions
- Promissory notes - completeness and accuracy or fairness of recorded PNs
- As net assets is negative there could be tax losses remaining and any resulting deferred tax assets should be assessed.
- Contingencies in a finance business require careful assessment in terms of completeness

(c) In carrying out work related to prospective financial information, the following should be focused on:

- Management’s estimates and assumptions, in relation to allowances for impairment in loans and leases, gold stock valuation, goodwill, and investment property securitization loans and promissory notes on which the 30 September forecast is based on, should be assessed for reasonableness.
- Making sure 30 September forecast is properly prepared on the basis of the assumptions
- Making sure 30 Sep forecast is properly presented
- Making sure 30 Sep forecast’s material assumptions are adequately disclosed
- Making sure 30 Sep forecast is prepared on a consistent basis using appropriate accounting policies for gold contingencies/commitments and investment property or principles

(d)

- (i) - Threat is the self-review threat
 - Audit team may be reluctant to identify impairment
 - Team may rely unduly on audit team members who carried out the audit
- (ii) * Members of the audit team not to be involved in due diligence or related work
 - * Independent partner, or quality control reviewed by a partner not involved with the audit

(e)

- (i) Hinder continuity of operations which is critical in finance business.
- (ii) Loss of data causing severe losses
- (iii) Going concern doubt
- (iv) Difficulty for recovery of loans etc.
- (v) Delay in decision making
- (vi) Regulatory requirements/Central Bank directives not being followed

Answer No. 02

(a)

- The population has a few material items (i.e. items more than Rs. 20mn, 4 items) and a large number of small items (184 plus accounts with a total of Rs. 210mn)
- The sales force is provided with incentives on sales targets. Hence, there is a fraud risk for overstatement of sales and debtors
- Therefore a selection of samples using a sampling technique or based on professional judgment from the key material items, is appropriate.
- In addition, a selection of representative samples using a sampling technique or based on professional judgment among the smaller size accounts is also appropriate.
- Age of the debtors to be considered

(b)

- 0994 debtor is for sale of services
- 0459 debtor is for sale of goods

As alternative audit procedures, the following can be proposed for 0994:

Objective - Obtaining audit evidence that the service has been rendered as at the balance sheet date

- Examine and understand the existence of the service contract entered into with the debtor
- Examine internal records such as job cards to establish that the work has been done and costs have been incurred as at the balance sheet date
- Examine audit evidence to reasonably conclude that costs have been incurred for the service contract by examining the materials used or issued for the service
- Discuss with relevant personnel and understand the usual duration taken to carry-out a similar service job (e.g. 10 days) and cross check if the work was in progress during that period by examining relevant documents.

As alternative audit procedures the following can be proposed for 0459:

Objective - Obtaining audit evidence that goods have been delivered or risks and rewards of the good have passed on to the customer as at the balance sheet date

- Examine that the goods have been requested or ordered by the distributors as at the balance sheet date
- Examine that the goods have been issued from the stores as at the balance sheet date
- Examine that the goods have been acknowledged by customers as at the balance sheet date

- Examine if during the return period the goods have not been returned or sales have been reversed

(c)

- The prevailing dispute should be understood and concluded whether it is reasonable not to allow access to confirmations for the auditor. As the sales incentives are based on targets, there is a fraud risk to recognise fictitious debtors or non-existent sales. However, you should seek audit evidence with regard to the validity of the dispute by discussing and taking down the minutes of the discussions with personnel directly in charge. Alternatively, a special representation can also be obtained from the management regarding the dispute.
- Understand if there is audit evidence that may reveal fraud or error in connection with the debtor concerned.
- Discuss with those who are charged with governance and obtain their understanding about the existence of the dispute
- Examine the events occurring after the balance sheet date related to the debtor that establishes existence of the debtor
- Modification of the audit report

(6)

Answer No. 03

(a) As the group auditor, GCL & Co should determine the following levels of materiality:

- **Materiality for the group financial statements** as a whole.
- **The materiality level or levels to be applied to particular classes of transactions, account balances or disclosures.**
- **Component materiality for those components** where component auditors will perform an audit or a review for purposes of the group audit.
- **The threshold above which misstatements cannot be regarded as clearly trivial** to the group financial statements.

(b)

- Components operating in foreign jurisdictions that may be exposed to factors such as unusual government intervention in areas such as trade and fiscal policy, and restrictions on currency and dividend movements; and fluctuations in exchange rates.
- Components' application of accounting policies that differ from those applied to the group financial statements.
- A complex group structure

(c) SLAuS 600 Special Considerations – Audits of Group Financial Statements (Including the Work of Component Auditors) provides guidance on the factors that should be considered in relation to the work of component auditors.

B & Co audit a significant component of the group. SLAuS 600 requires that the group engagement team obtains an understanding of the component auditor when it plans to request the component auditor to perform work on the financial information of a component for the group audit.

- **Whether the component auditor understands and will comply with the ethical requirements that are relevant to the group audit and, in particular, is independent.**

When performing work on the financial information of a component for a group audit, the component auditor is subject to ethical requirements that are relevant to the group audit. Such requirements may be different or in addition to those applying to the component auditor when performing a statutory audit in the component auditor's jurisdiction.

The group engagement team therefore obtains an understanding whether the component auditor understands and will comply with the ethical requirements that

are relevant to the group audit, sufficient to fulfill the component auditor's responsibilities in the group audit.

- **The component auditor's professional competence**

The group engagement team's understanding of the component auditor's professional competence may include whether the component auditor:

- Possesses an understanding of auditing and other standards applicable to the group audit that is sufficient to fulfill the component auditor's responsibilities in the group audit;
- Possesses the special skills (for example, industry specific knowledge) necessary to perform the work on the financial information of the particular component; and
- Where relevant, possesses an understanding of the applicable financial reporting framework that is sufficient to fulfill the component auditor's responsibilities in the group audit (instructions issued by group management to components often describe the characteristics of the applicable financial reporting framework)

- **Whether the group engagement team will be able to be involved in the work of the component auditor to the extent necessary to obtain sufficient appropriate audit evidence**

- **Whether the component auditor operates in a regulatory environment that actively oversees auditors**

Where independent oversight bodies have been established to oversee the auditing profession and monitor the quality of audits, awareness of the regulatory environment may assist the group engagement team in evaluating the independence and competence of the component auditor. Information about the regulatory environment may be obtained from the component auditor or information provided by the independent oversight bodies.

(d) Communication shall include:

- (i) Whether B & Co has complied with the ethical requirements that are relevant to the group audit, including independence and professional competence;
- (ii) Whether B & Co has complied with the group engagement team's requirements;
- (iii) Identification of the financial information of the component on which B & Co is reporting;
- (iv) Information on instances of non-compliance with laws or regulations that could give rise to a material misstatement of the group financial statements;

- (v) A list of uncorrected misstatements of the financial information of the component (the list need not include misstatements that are below the threshold for clearly trivial misstatements communicated by the group engagement team)
- (vi) Indicators of possible management bias
- (vii) Description of any identified significant deficiencies in internal control at the component level
- (viii) Other significant matters B & Co communicated or expects to communicate to those charged with governance of the component, including fraud or suspected fraud involving component management, employees who have significant roles in internal control at the component level or others where the fraud resulted in a material misstatement of the financial information of the component
- (ix) Any other matters that may be relevant to the group audit, or B & Co wishes to draw to the attention of the group engagement team, including exceptions noted in the written representations that the component auditor requested from the component management;
- (x) B & Co's overall findings, conclusions or opinion.

(e) **Basis for Qualified Opinion**

Navoda PLC's investment in ABC Ltd, a foreign associate accounted for by the equity method, is carried at Rs. 200 million on the consolidated statement of financial position as at 31 March 2014, and Navoda PLC's share of ABC Ltd's net income of Rs. 50 million is included in the consolidated income statement for the year then ended. We were unable to obtain sufficient appropriate audit evidence about the carrying amount of Navoda PLC's investment in ABC Ltd as at 31 March 2014 and Navoda PLC's share of ABC Ltd's net income for the year because we were denied access to the financial information, management, and the auditors of ABC Ltd. Consequently, we were unable to determine whether any adjustments to these amounts were necessary.

Qualified Opinion

In our opinion, except for the possible effects of the matter described in the Basis for Qualified Opinion paragraph, the consolidated financial statements present fairly, in all material respects, the financial position of Navoda PLC and its subsidiaries as at 31 March 2014, and (of) their financial performance and cash flows for the year then ended in accordance with Sri Lanka Accounting Standards (LKAS/SLFRS).

Answer No. 04

- (a) **Lack of formal control for reconciling the inventory module and the general ledger in a timely manner.**

Implication	Recommendation
<ul style="list-style-type: none">• Due to the absence of a formal control in place, the differences between the inventory module and the general ledger will not be detected on a timely manner to assess the possible reasons (fraud)• As a result, the recorded purchases and creditors will not be complete as at a given date.	<ul style="list-style-type: none">• The inventory module and the general ledger should be reconciled on a weekly/monthly basis.• The member of staff responsible for performing the reconciliation should be independent of staff posting the transactions to the general ledger.• A responsible official should review the reconciliation and sign the reconciliation as evidence of review.

Lack of formal control for reconciling the suspense account in a timely manner

Implication	Recommendation
<ul style="list-style-type: none">• Due to the absence of a formal control in place, the debit balance in the suspense account could be built up without identifying the trade creditors.• The general ledger may get updated without considering the suspense account already created due to settlements made to creditors. As a result, creditors may get paid twice.	<ul style="list-style-type: none">• The suspense account should be reconciled on a weekly/monthly basis.• The member of staff responsible for performing the reconciliation should be independent of the staff posting the transactions to the suspense account.• Segregation of duties.• A responsible official should review the reconciliation and sign the reconciliation as evidence of review.

- (b)
- Call for direct confirmations from the creditors and compare the confirmed amounts with the general ledger. If there are differences, verify the reconciliations and get the management to pass the necessary entries.
 - Check settlements to creditors using the bank statements and trace the settlements to the trade creditors recorded in the general ledger as at the balance sheet date.
 - Check settlements made to creditors subsequent to the period end and trace the settlements to the creditors reported as at the balance sheet date.

Answer No. 05

Principal threats	Safeguards by firm/individual
(i) A self review threat is created after providing assistance to an audit client in preparing financial statements.	Make arrangements that the assistance in relation to journal entries and preparation of statutory accounts are not provided by a member of the assurance team. Prohibiting the individual or the teams providing such assistance from making any managerial decisions on behalf of the audit client. Obtaining approval for all the proposed journal entries or any other changes affecting the financial statements, from the audit client. Source data and the assumptions to be originated and approved by the audit client.
(ii) A contingent fee charged by a firm in respect of an assurance engagement creates a self-interest and advocacy threat.	The self-interest threat and advocacy threats cannot be reduced to an acceptable level by the application of any safeguard. Accordingly, a firm should not enter into any fee arrangement under which the amount of the fee is contingent on the result of the assurance work.
(iii) A self-interest threat is created when a member of the assurance team participates in an assurance engagement while knowing or having reasons to believe that she is or may join the client sometime in the future.	Amali must inform the firm immediately about the discussion she had with the FD. Remove Amali from the assurance engagement of Omega PLC. Perform an independent review of the significant work carried out by Amali during the assurance engagement.

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2. to assist students with their research into the subject and to further their understanding and appreciation of the subject.

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