SUGGESTED SOLUTIONS

23404 – Advanced Audit and Assurance

CA Professional (Strategic Level II) Examination
December 2012

THE INSTITUTE OF CHARTERED ACCOUNTANTS OF SRI LANKA

Answer No. 01

Answer is presented in tabular form for easy reference. Marks can be awarded for identifying, and giving reasons for the matters.

**** Candidates are not required to explain in detail the accounting requirements for the point in consideration as what is tested is the auditing knowledge rather than accounting.*
****The audit plan in respect of each item that is expected is only "Plan to pay specific attention to the application of accounting" rather than a detail audit program.*

Calculation of a suitable planning materiality- say a small percentage (4-5%) of profits as it is a PLC.

(a) Identify areas of Audit risk/factors	(b) Overall Audit Plan ***
Management bias as a result of the proposed acquisition The directors have been approached by a party to acquire their shares in QPC. The directors therefore have an incentive to overstate assets and profits and to understate liabilities and costs in order to maximise the price they achieve for their shares.	• Plan to pay specific attention to more subjective and judgemental areas of the financial statements such as provisions, inventory valuation, cut-off and revenue recognition. • Inspect board minutes for evidence of any conflict with directors' personal interests and related party disclosures.
High proportion of sales via internet QPC makes a high proportion of its sales online through its website and there is therefore a risk that sales will not be recorded correctly (completeness) in the accounting system from the website. **Significant Judgement in Revenue recognition** Significant judgement is exercised in determining the revenue recognition criteria of items subjected to defects	• Ascertain and test the control procedures around the recording of sales made online. • Plan to pay specific attention to the application of subjective and judgemental in this regard by understanding the circumstance of the defect, customer's ability to require further work or to require replacement of the goods, and how the directors are satisfied that the significant risks and rewards have been transferred recognition of an appropriate provision for the rectification costs. The analysis done by directors have let them to conclude that the revenue on the LKR 10 million transaction can be recgonised along with the related provision for rectification work. This creates a concern on whether a similar provision needs to be accounted in respect of the revenue recognised during the year.

Identify areas of Audit risk/factors	Overall Audit Plan ***
Contingent liability QPC is being sued over a possible violation of a sales contract. The outcome of case won't be known until after the audit report is signed.	• Ascertain from management how it proposes to account for or disclose the legal claim • Consider the appropriateness of the application of judgement of the case in light of other audit evidence (e.g. lawyers correspondence) .
Related party transactions The managing director and finance director own 30% and 25% of the shares in QPC respectively and are therefore related parties of the company. It appears that Related Party disclosure for remuneration of Key Management Personnel has been disclosed without the salary of the MD	• Enquire of management what transactions have occurred between themselves and QPC during the year. • Inspect board minutes for any evidence of related party transactions • Request a management representation that all related party transactions have been appropriately disclosed. • Inspect financial statements for appropriateness of disclosure.
Application of LKAS 32 and 39 It appears that the long term loan given to related party without interest has not been correctly accounted for as there is no apparent adjustment for interest free element. Redeemable cumulative preference shares are mandatorily redeemable on 31 May 2012. Hence there is an debt vs equity issue in this regard that require careful understanding of terms.	• Plan to pay specific attention to the application of accounting for financial instruments for interest free loans and resulting disclosures and deferred tax treatment. • Plan to pay specific attention to the application of accounting for financial instruments for accounting for the debt element in the preference share and resulting disclosures
Idle land/ land with undetermined use It appears that the land is shown as a PPE. However, it may have characteristics of an investment property as it is currently not owner occupied and the use is not determined yet	• Plan to pay specific attention to the application of accounting for investment property for accounting for the idle land
FV gains require special audit emphasis as it uses application of judgements and estimates and Gain/(Loss) on revaluation of properties that is included in OCI.	• Plan to pay specific attention to the application of accounting for investment property and computation of FV and use of estimates
Assets classified as held for sale- SLFRS has strict criteria for the measurement and classification of Assets held for sale	• Specific attention to the binding sale contract which is required for the classification of assets held for sale

Identify areas of Audit risk/factors	Overall Audit Plan ***
• GP ratio has changed from 40% to 38%. • Variances in Distribution expenses, Marketing expenses, Administration expenses, Finance costs and Other expenses • Profit for the year from discontinued operations. • Goodwill and other intangibles have stayed constant. Need to look at impairment testing Finance lease receivables variance. Variance in Trade and other receivables, Finance lease receivables, Available for Sale financial assets, Current tax assets, and Cash and bank balances Variance in Borrowings, Other financial liabilities, Retirement benefit obligation, Deferred tax liabilities, Trade and other payables, Other financial liabilities, Current tax liabilities, Provisions, Deferred revenue, Other liabilities, Liabilities directly associated with assets classified as held for sale. • The revenue recognition policy of recognising revenue when goods are delivered may need to be assessed during the audit. • The revenue during the year has declined despite a growing internet sales segment.	The level of explanation for the "audit plan" is a suitable summary of "plan to pay specific attention to the application of accounting" rather than a detail audit program.

(maximum 15 marks) (maximum 20 marks)

Answer No. 02

(a) Ethical and professional issues and (b) measures to be implemented to mitigate any threats to auditor independence and objectivity are tabulated as follows:

(a) Issues	**(b) Safeguards**
i.) Samanala Group PLC can be a client that generates a large audit and non audit fee income. ii.) As a result there can be fee dependence/ self interest threat iii.) Fear of losing a large fee and client may influence the auditor's judgment iv.) Familiarity threat due to acting for Samanala Group PLC for over 20 years v.) AA can be over influenced by personality of the founder chairman and senior partner in audit conclusions. vi.) Samanala Group PLC is in a specialized industry and no other Partner in AA has any expertise in such industry	a) i.) Regular review should be done to ensure that regular fees are below recommended thresholds. E.g. Fees from one client must not exceed 10% of total fee income of firm. ii.) External quality control review. iii.) Discuss the extent and nature of fess charged with audit committee or TCWG. b) Periodic rotation of key members of staff c) Partner rotation d) Another Partner to study and understand the special industry issues and take over the audit periodically
vii.) Provision of non audit services is can be non compatible with auditor independence. E.g. tax planning involvement with Samanala Group and the founder chairman and wife's personal tax planning	e) Use different teams for non audit services f) Independent Partner review of Audit and Non Audit services g) Tax planning work need to be revisited to determine threat to objectivity
vii.) Former manager becoming a finance director of the Samanala Group PLC	h) Cooling off period where staff of AA should not take up senior financial positions in Samanala Group e.g. two years

(c) Implications for audit firms if the provisions of all non audit services to audit clients is banned and mandatory rotation of audit firms is introduced.

(i) Non audit services:

a) Although a ban on the provision of non audit services is intended to remove the threat to objectivity, it may impair the audit firm's ability to recruit high calibre personnel who value the broad based training provided by firms undertaking a variety of services

b) It can also remove the audit of very relevant areas related to audit such as audit of tax and audit of IT aspects of the client.

c) As the firms <u>cannot attract and draw upon wider experienced persons</u>, it will have <u>loss of income</u> and indirectly can bring upon self interest threat for not being able to retain clients with reasonable profit return.

d) Audit fees can be affected

(ii) Mandatory Audit firm rotation:

a) Although audit firm rotation can increase the auditor independence as there is no expectation of long term relationship, there can be <u>increased risk due to the number of first time audits as the auditor may miss things due to their lack of experience</u> with a particular client.

b) Auditor can be <u>complacent or overly comfortable</u> as he may think that most of the processes that were established by the entity was done prior to him being the auditor of the entity and that the <u>previous auditor may have looked at the systems in the respective years</u> in which that auditor was present.

c) New form has to focus on any particularities of the entity's control environment thereby the new auditor's initial start up costs may be high. New assignments require a significant investment in client-specific and in some cases industry specific skills.

(Total 4 marks)

Answer No. 03

Matters to be considered
As the audit for the year ended 31 December 2011 was not carried out by your firm, the impact of this to the certificate being requested need to be considered.

The time period between the audited financial statements and the declaration of dividends is 8 months, the impact of this on the work to be done needs to be considered.

The extent of work that the firm will have to do in order to issue the certificate needs to be assessed as they have so far not done any work in relation to the new client other than client acceptance procedures.

Procedures
Sign off on the letter of engagement so that there is clear understanding of the responsibilities on all parties involved.

Request and obtain the statement of solvency signed on behalf of the Board of Directors by 2 directors.
Request and obtain the most recent financial statements prepared according to the requirements of the Companies Act.

Identify circumstances that the directors know or ought to know, which affects the value of assets and liabilities of the company. (e.g. Impairment of assets) and ensure that they are adjusted for in the Statement of Solvency.

As the period between the balance sheet date and the date of recommending the dividend is more than 3 months the auditor will need to obtain interim financial statements and perform **at least** a review engagement. But as the client is a new client and the financial statement on which the dividend is being paid has not been audited by you, you may want to extend the audit procedures to cover a scope greater than what is expected of a review engagement depending on the outcome of your dependence the other auditor to have identified matters that might affect the financial statements

As the auditor is expected to perform procedures designed to obtain sufficient and appropriate audit evidence that all events up to the date of the audit report, that may require adjustment to the financial statements' are identified: The auditor should ensure that the subsequent events review is done up to the date the dividend was authorised by the Board.

Review cash and credit lines that maybe used to pay out dividends- to ensure that the company is able to pay its debts as they become due in the normal course of business.

Ensure that the audit report is dated correctly. That is that the report clearly identifies the date up to which the subsequent events were reviewed and the sign off date (both should be the date the Board authorized the dividend)

(10 marks)

Answer No. 04

(a) As ES is a new audit client the fulfilment of the requirement of Client Acceptance needs to be ensured.

As ES operates a very complex business model and because it uses a lot of IT systems, the audit firm may not have staff with relevant expertise. It is therefore particularly important that a team with appropriate skills and experience is selected for the audit.

If the firm does not have the expertise in house the availability of expert resources for consultation need to be addressed.

As ES is a new audit client and because its business is complicated it is particularly important that the audit team is adequately directed to obtain an adequate understanding of the business.

The risks arising from the client's complex revenue structure and the lack of paper audit documents will further increase the risk of an inappropriate report being issued as the auditor does not yet know the client very well increases the importance of ensuring that the work is supervised closely and reviewed on a timely basis. (7 marks)

(b) The standard that will be appropriate to be applied in issuing the report requested by the BOI will be SLAus 805- 'Special Considerations- Audit of single financial statements and specific elements, accounts or items of a financial statement'.

This is the most appropriate as the scope of SLAus 805 covers reporting on a specific account or item of a financial statement and also provides for the account/item to be prepared in accordance with a general or special purpose framework.

The report to the BOI is in relation to a specific item/account of a financial statement (i.e Income) and requires a cash basis of accounting.

Additional Procedures to be performed

Ensure that the auditor is in compliance with the ethical requirements including those pertaining to independence prior to accepting the assignment

A statement needs to be obtained from the management of the income received during the year identified according to the currency of receipt, clearly indicating the percentage received in foreign currency. This statement needs to be signed by the management of the company accepting responsibility for its preparation. The statement should include a description of the basis of accounting.

The assignment should be planned and audit procedures performed to obtain sufficient and appropriate evidence in order to issue an opinion

Specific procedures may include,

- Testing of internal controls relevant to the preparation of the schedule,
- Assessment of risk of material misstatement of the schedule
- A total reconciliation will be obtained reconciling the opening debtors to closing debtors indicating the invoices raised and the settlement thereof.
- The invoices settled during the year will have to be cross checked with the receipts and the bank statement to ensure that the amount and currency of receipt in the schedule are accurate.(On a sample basis)
- Checking of local currency accounts to ascertain the proportion of receipts in local currency

(8 marks)

(Total 15 marks)

Answer No. 05

1. *Conclusion*-
   Unmodified opinion

   Reasons for conclusion
   The write down of inventory to its NRV would reduce profit by 4% and reduce the net assets and inventory by less than 1%. It is unlikely that the misstatement would be considered material. Since the impact on the financial statements from this accounting standard departure is limited, the auditor is unlikely to consider it material.

   Draft Modification
   Not applicable

2. *Conclusion*
   Modify the audit report by way of a adverse opinion

   Reasons for conclusion
   Not carrying the short term marketable securities at market values which are lower than the cost constitutes a departure from Sri Lanka Accounting Standards. The investment value needs to be reduced by 40% and pre tax profit would reduce by 80%. The impacts on the financial statements are both material and persuasive to require a modification by way of a Adverse Opinion.

   Draft Modification-

   We believe that the audit evidence we have obtained is sufficient and appropriate to provide the basis for our adverse audit opinion.

   Basis for Adverse Opinion
   The company's short term marketable securities are carried in the balance sheet at Rs. 200M. The management has not marked these securities to market but has instead stated them at cost, which is a departure from Sri Lanka Accounting Standards. The company's records indicate that had management marked the marketable securities to market, the company would have recognized an unrealized loss of Rs. 80M in the income statement for the year. The carrying amount of the marketable securities, net income and shareholders equity would have been reduced by the same amount.

   Adverse Opinion
   In our opinion because of the significance of the matter discussed in the Basis for Adverse Opinion paragraph, the financial statements do not give a true and fair view of the financial position of …

3. *Conclusion*-
   Qualify the audit report

   Reasons for conclusion –
   Not providing depreciation for property plant and equipment constitutes a departure from Sri Lanka Accounting Standards. The pre tax profit would reduce by 20% and the net assets by around 2%. The impacts on the financial statements are material enough to require a modification by way of a Qualified Opinion.

Draft Modification-

We believe that the audit evidence we have obtained is sufficient and appropriate to provide the basis for our qualified audit opinion.

Basis for Qualified Opinion

As described in note X to the financial statements no depreciation has been provided in the financial statement, which constitutes a departure from Sri Lanka Accounting Standards. Based on a straight line method of depreciation and annual rates of 5% for the building and 20% for the equipment, the pre tax for the year would reduce by Rs. 3M in 2012 and 2.5M in 2011. Property Plant and Equipment should be reduced by accumulated depreciation of Rs.5.5M in 2012 and Rs. 2.5M in 2011 and shareholders equity should be reduced by the same amounts.

Qualified Opinion

In our opinion except for the effects of the matter described in the Basis for Qualified Opinion paragraph, the financial statements give a true and fair view of the financial position.

Other Matter

The financial statements of the company for the year ended 31st December 2011 were audited by another who expressed a qualified report on those statements on 15th March 2012.

(Total 25 marks)

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