PRACTICE & REVISION KIT


CA SRI LANKA CURRICULUM 2020

CL1 – Advanced Audit and Assurance

CA

THE INSTITUTE OF
CHARTERED ACCOUNTANTS OF SRI LANKA

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Contents

Question index

THE INSTITUTE OF CHARTERED ACCOUNTANTS OF SRI LANKA

Introduction

Welcome to this first edition Practice & Revision Kit for the Institute of Chartered Accountants of Sri Lanka professional examinations for curriculum 2020.

One of the key criteria for achieving exam success is question practice. There is generally a direct correlation between candidates who revise all topics and practise exam questions and those who are successful in their real exams. This Practice & Revision Kit gives you ample opportunity for such practice in the run up to your exams.

The Practice & Revision Kit is structured to follow the modules of the Study Text, and comprises banks of non-complex mini scenario and functional scenario questions as appropriate. Suggested solutions to all questions are supplied.

We welcome your feedback. If you have any comments about this Practice & Revision Kit, or would like to suggest areas for improvement, please email learningdevelopment@casrilanka.org.

Good luck in your exams!

BPP LEARNING MEDIA

How to use this Practice & Revision Kit

This Practice & Revision Kit comprises banks of practice questions, mostly in the style that you will encounter in your exam. It is the ideal tool to use during the revision phase of your studies.

Questions in your exam may test any part of the syllabus so you must revise the whole syllabus. Selective revision will limit the number of questions you can answer and hence reduce your chances of passing. It is better to go into the exam knowing a reasonable amount about most of the syllabus rather than concentrating on a few topics to the exclusion of the rest. You should at all costs avoid falling into the trap of question spotting, that is trying to predict what are likely to be popular areas for questions, and restricting your revision and question practice to those.

Practising as many exam-style questions as possible will be the key to passing this exam. You must do exam-style questions under timed conditions and ensure you write full answers to the discussion parts as well as doing the calculations.

Planning your revision

When you begin your course you should make a plan of how you will manage your studies, taking into account the volume of work that you need to do and your other commitments, both work and domestic.

In this time, you should go through your notes to ensure that you are happy with all areas of the syllabus and practise as many questions as you can. You can do this in different ways, for example:

- Revise the subject matter a module at a time and then attempt the questions relating to that module; or
- Revise all the modules and then build an exam out of the questions in this Practice & Revision Kit.

Using the practice questions

The best approach is to select a question and then allocate to it the appropriate time, based on the real exam. All the questions in this Practice & Revision Kit have mark allocations, so you can calculate the amount of time that you should spend on the question.

Using the suggested solutions

Avoid looking at the answer until you have finished a question. It can be very tempting to do so, but unless you give the question a proper attempt under exam conditions you will not know how you would have coped with it in the real exam scenario.

When you do look at the answer, compare it with your own and give some thought to why your answer was different, if it was.

If you did not reach the correct answer make sure that you work through the explanation or workings provided, to see where you went wrong. If you think that you do not understand the principle involved, go back to your own notes or your study materials and work through and revise the point again, to ensure that you will understand it if it occurs in the exam.

Our suggested solutions are comprehensive, but in some discursive questions it may be that you have made points that are not included in the suggested solution that are equally valid. In the real exams you should be given credit for such points.

Exam techniques

Using the right techniques in the real exam can make all the difference between success and failure.

Here are a few pointers:

1. During the 20-minute reading time at the start, read through the questions and decide in what order you are going to attempt the exam. You have to write your answers in the order set out in the question and answer booklet, but you can attempt the questions in any order that you like.

   Some candidates like to attempt the easiest questions first, on the basis that will enable them to gain the easiest available marks quickly, and build up their confidence.

   If you select a question on a topic area about which you feel confident, and do that first, you will build up your confidence right at the start, which will help to calm you if you are nervous and set the tone for the rest of the exam. You should decide what approach is best for you.

2. Having established the order that you are going to do the exam, allocate the time available to the questions and work out at what time you will need to stop working on one question and move on to the next. When you reach the end of the allocated time for the question that you are working on, STOP. It is much easier to gain the straightforward marks for the next question than to spend a long time working on the previous question in the hope of gaining one or two final marks.

3. Read the question. Read it carefully once, and then read it again to ensure that you have picked everything up. Make sure that you understand what the question wants you to do, rather than what you might like the question to be asking you.

4. Answer all parts of the question. Even if you cannot do all of the calculation elements, you will still be able to gain marks in the discussion parts.

5. Don't worry if you think that you have made a mistake in a computational part of a question. You will not earn the mark for that particular part, but you will still be able to gain credit for correct application in the later parts of the question, even if you are using the wrong figure.

6. When starting to read a question, especially a long case study, read the requirement first. You will then find yourself considering the requirement as you read the data in the scenario, helping you to focus on exactly what you have to do.

7. Plan your answer before you start to write your response, especially for longer case studies. This will help you to focus on the requirements of the question and to avoid irrelevance.

8. Try to make sure that your answer relates to the specifics of the question itself. If you are asked to consider the impact of the scenario on someone named in the question, make sure that you do that, so your answer is as relevant as possible.

9. If you finish the exam with time to spare, use the rest of the time to review your answers and to make sure that you answered every requirement of every question.

Action verbs checklist

Knowledge Process	Verb List	Verb Definitions
Tier - 1 Remember Recall important information	**Define**	Describe exactly the nature, scope or meaning
	Draw	Produce (a picture or diagram)
	Identify	Recognise, establish or select after consideration
	List	Write the connected items one below the other
	Relate	To establish logical or causal connections
	State	Express something definitely or clearly
Tier - 2 Comprehension Explain important information	**Calculate/Compute**	Make a mathematical computation
	Discuss	Examine in detail by argument showing different aspects, for the purpose of arriving at a conclusion
	Explain	Make a clear description in detail revealing relevant facts
	Interpret	Present in understandable terms or to translate
	Recognise	To show validity or otherwise, using knowledge or contextual experience
	Record	Enter relevant entries in detail
	Summarise	Give a brief statement of the main points (in facts or figures)
	Classify	Allocate into categories
	Describe	Communicate the key features
	Provide	Give illustrations to support or illuminate a point or assertion
Tier - 3 Application Use knowledge in a setting other than the one in which it was learned/solve close-ended problems	**Apply**	Put to practical use
	Assess	Determine the value, nature, ability or quality
	Demonstrate	Prove, especially with examples
	Graph	Represent by means of a graph
	Prepare	Make ready for a particular purpose
	Prioritise	Arrange or do in order of importance
	Reconcile	Make consistent with another
	Solve	To find a solution through calculations and/ or explanations

Knowledge Process	Verb List	Verb Definitions
	Conduct	Organize and carry out a task
	Communicate	Transmit thoughts or knowledge
	Display	Make evident or noticeable
	Perform	Do or execute, usually in the sense of a complex procedure
	Reconcile	Make or prove consistent or compatible or show differences
	Set	Fix or establish
	Select	Choose from a range of options or possibilities
	Support	Assist to make decisions by providing appropriate information about respective concepts
	Use	Apply in a practical way
	Undertake	Commit to do or perform
Tier - 4 Analysis Draw relations among ideas and to compare and contrast/solve open-ended problems	**Analyse**	Examine in detail in order to determine the solution or outcome
	Compare	Examine for the purpose of discovering similarities
	Contrast	Examine in order to show unlikeness or differences
	Construct	Build or make a diagram, model or formula
	Differentiate	Constitute a difference that distinguishes something
	Outline	Make a summary of significant features
	Write	Provide word descriptions to express an opinion or idea
Tier - 5 Evaluate Formation of judgments and decisions about the value of methods, ideas, people or products	**Advise**	Offer suggestions about the best course of action in a manner suited to the recipient
	Convince	To persuade others to believe something using evidence and/or argument
	Criticise	Form and express a judgment
	Comment	Provide written remarks expressing an opinion in both positive and negative perspectives
	Evaluate	To determine the significance by careful appraisal
	Conclude	Form a judgment about, or determine or resolve the outcome of, an issue through a process involving reasoning
	Determine	Ascertain or conclude after analysis and consideration; judge

Knowledge Process	Verb List	Verb Definitions
	Justify	Give valid reasons or evidence for
	Review	Study critically with a view to correction or improvement
	Recommend	A suggestion or proposal as to the best course of action
	Resolve	Settle or find a solution to a problem or contentious matter
	Validate	Check or prove the accuracy
Tier - 6 Synthesis Solve unfamiliar problems by combining different aspects to form a unique or novel solution	**Compile**	Produce by assembling information collected from various sources
	Design	Devise the form or structure according to a plan
	Develop	To disclose, discover, perfect or unfold a plan or idea
	Propose	To form or declare a plan or intention for consideration or adoption
	Anticipate	Foresee, or experience or realise beforehand
	Draft	Write original material for the scrutiny of others
	Formulate	Devise and put into words
	Plan	Devise the plan for an assurance engagement
	Report	Give the formal final conclusion for an assurance engagement
	Submit	Send a completed document to a particular party
	Suggest	Put forward an idea or give reasons
	Synthesize	Make or propose a new concepts or ideas by combining existing knowledge in different aspects

Learning outcomes

CA Sri Lanka's Learning outcomes for the module are set out on the following pages. Section A Questions 1 – 60 cover all sections of the syllabus. Section B 10 marks questions and Section C 20 mark questions are referenced to syllabus learning outcomes in the following table. Note. longer questions can cover multiple learning objective, so the main ones are referenced below and questions may cover additional learning outcomes.

A. Governance Internal Control Frameworks (Syllabus Weighting: 10%)				
Knowledge Component	**Learning Outcome**	**Specific Knowledge**	**Section B Questions**	**Section C Questions**
1.1 Corporate governance and audit	1.1.1 Discuss the need for an audit of financial statements using agency theory.	Ability to connect stewardship, accountability and agency conflict with a need to conduct an independent audit		8
1.2 Internal control framework	1.2.1 Evaluate components of an integrated internal control system.	COSO-2014 Internal controls five components and 17 principles		1,2,3,14
	1.2.2 Analyse design, implementation and operating effectiveness of identified controls.	SLAuS 315	1,2,3,4	
	1.2.3 Outline deficiencies in control activities to be communicated to those charged with governance.	SLAuS 265		
1.3 IT risk and controls	1.3.1 Demonstrate the importance of IT general controls and application controls in an audit of financial statements.	IT general controls and application controls		2,3

THE INSTITUTE OF CHARTERED ACCOUNTANTS OF SRI LANKA

B. Audit Planning and Risk Assessment (Syllabus Weighting: 15%)				
Knowledge Component	**Learning Outcome**	**Specific Knowledge**	**Section B Questions**	**Section C Questions**
2.1 Terms of engagement	2.1.1 Explain precondition required to perform an audit of financial statements.	SLAuS 210	31	
2.2 Overall audit strategy	2.2.1 Demonstrate the importance of overall audit strategy as part of audit planning.	Including non-complex group and SME audit scenarios covering the requirements of SLAuS 300, 315, 240 and 600	9	14,18,19,20,21
2.3 Risk of material misstatement	2.3.1 Assess risk of material misstatements including risk of frauds to be focused during the audit using risk assessment procedures.		5,6,7,8,9,10	14,18,19,20,21
2.4 Materiality	2.4.1 Apply the concept of materiality in planning and performing the audit.		5,6,10	14,18,19,20,21
2.5 Responding to risk of material misstatements	2.5.1 Outline suitable overall response and further audit procedures for identified risk at financial statement level and assertion level.	Including non-complex group and SME audit scenarios covering the requirements of SLAuS 330	6,8	17,18,29,20

B. Audit Planning and Risk Assessment (Syllabus Weighting: 15%)				
Knowledge Component	Learning Outcome	Specific Knowledge	Section B Questions	Section C Questions
2.6 Complex issues	2.6.1 Apply risk assessment procedures to identify risks relating to related party transactions, going concern and accounting estimates including fair value and measurement.	Requirements of SLAuS 540, 550 and 570 in relation to risk assessment		5,9,11,17,29,20,22
2.7 Using the work of others	2.7.1 Demonstrate the use of experts (both management and auditors experts), internal auditors and service organisation auditors in an audit of financial statements.	Requirements under SLAuS 610, SLAuS 620 & SLAuS 402	15	19,22
2.8 Laws and regulations	2.8.1 Explain auditors requirements consider compliance with laws and regulations during an audit of financial statement.	Understanding the legal and regulatory framework, procedures when non-compliance is identified or suspected and reporting of identified or suspected non-compliance	11,28	

C. Gathering Audit Evidence (Syllabus Weighting: 20%)				
Knowledge Component	Learning Outcome	Specific Knowledge	Section B Questions	Section C Questions
3.1 Test of details	3.1.1 Outline audit procedures to address assertion level risk for non-complex key account balances and classes of transactions.	This should cover audit evidence over key account balances and classes of transactions	12,13,14,15,17	3,4,8,9,10,11, 13,21
	3.1.2 Apply specific considerations in obtaining sufficient appropriate audit evidence with respect to inventory, litigation and claims involving the entity, and segment information.	SLAuS 501		14
3.2 External confirmation	3.2.1 Apply procedures to design and perform external confirmation to obtain relevant and reliable audit evidence.	SLAuS 505	14	12
3.3 Opening balances and corresponding figures	3.3.1 Discuss the requirements to be considered by an auditor in an initial engagement and in relation to corresponding figures.	SLAuS 510 and 710		10,22
3.4 Selecting items for testing and the use of audit sampling	3.4.1 Apply different methods of selecting items for audit testing including audit sampling.	SLAuS 530	12	28
3.5 Analytical procedures	3.5.1 Apply analytical procedures as substantive procedures and in the overall review of financial statements.	Recognise the importance of analytical software which has the ability to analyse 100% data to identify outliers	17	1,2,11
3.6 Complex account balances	3.6.1 Design audit procedures to address complex items including accounting estimates, fair valuation, related party transactions and going concern.	SLAuS 540, 550, 570	18	9,11
3.7 Subsequent events	3.7.1 Outline procedures required to deal with events occurring between the date of the financial statements and the date of the auditor's report and	SLAuS 560		9,11,19

C. Gathering Audit Evidence (Syllabus Weighting: 20%)				
Knowledge Component	Learning Outcome	Specific Knowledge	Section B Questions	Section C Questions
	facts that become known to the auditor after the date of the auditor's report.			

D. Auditing in a Digital Environment (Syllabus Weighting: 10%)				
Knowledge Component	Learning Outcome	Specific Knowledge	Section B Questions	Section C Questions
4.1 Digital business environment	4.1.1 Recognise trends in a digital business environments including Artificial Intelligence (AI), Robotic Process Automation (RPA), Block chain, digital currencies and their impacts on internal controls and audit.	Artificial intelligence (AI), robotic process automation (RPA), blockchain, digital currencies	19	29
	4.1.2 Recognise the use of big data and analytics as business intelligence tools and potential risk associated with big data.	Big data and analytics	19	29
4.2 Audit automation	4.2.1 Demonstrates the use of cloud based audit working papers, audit automation tools and their limitations.	Audit automation	19	
4.3 Data analytics	4.3.1 Discuss the use of data analytics software including CAATs in planning and gathering audit evidence.	Data analytics	12,16	
4.4 Cyber security	4.4.1 Outline controls required to mitigate cyber security risk.	Cyber security risk		29

E. Evaluating Audit Evidence and Audit Reporting (Syllabus Weighting: 15%)				
Knowledge Component	Learning Outcome	Specific Knowledge	Section B Questions	Section C Questions
5.1 Audit report	5.1.1 Evaluate the effects of material misstatements on audit the audit opinion.	SLAuS 450	20,21	15,24
	5.1.2 Evaluate the effect of misstatements in opening balances and corresponding figures on current year audit opinion.	SLAuS 510 and SLAuS 710	23,25	22
5.2 Key audit matters	5.2.1 Explain matters to be communicated with those charged with governance.	SLAUS 250	11,25	24, 27
	5.2.2 Apply Key Audit Matters (KAM) for a given scenario.	SLAuS 701	25	
5.3 Modified audit report	5.3.1 Apply modified audit opinions and going concern reporting requirements for a given scenario.	Reporting considerations relating to SLAuS 705, 701 and SLAuS 570	21,22,24,25	9, 15,23,24,27
5.4 Emphasis of matters and other matters (SLAuS 706)	5.4.1 Apply emphasis of matter and other matter for a given scenario of audit reporting.	SLAuS 706	23,25	6,9,23
5.5 Special purpose audit	5.5.1 Apply special purpose audits including audit of single financial statements/elements to a given scenario.	Includes both SLAuS 800 and 805	26	16
5.6 Other information	5.6.1 Explain auditor's responsibility towards other information included in documents containing audited financial statements.	Fair understanding of the auditor's responsibilities relating to other information contained in an annual report (SLAuS 720)		17

E. Evaluating Audit Evidence and Audit Reporting (Syllabus Weighting: 15%)				
Knowledge Component	Learning Outcome	Specific Knowledge	Section B Questions	Section C Questions
5.7 Review engagements	5.7.1 Explain procedures required in conducting review engagements.	Fair understanding of application of review engagement and that the procedures used in a review engagement is limited compared to an audit of financial statements (SLSRE 2400, SLSRE 2410)		16

F. Assurance and Related Services (Syllabus Weighting: 10%)				
Knowledge Component	**Learning Outcome**	**Specific Knowledge**	**Section B Questions**	**Section C Questions**
6.1 Assurance framework	6.1.1 Apply framework for assurance engagements in identifying and accepting assurance engagements.	Understanding of the definition, elements, scope of and preconditions for an assurance engagement	22,26	16, 26, 28
6.2 Assurance engagements	6.2.1 Apply Sri Lanka Standard on Assurance Engagement together with subject matter specific assurance standards to provide reasonable or limited assurance as required in the engagement circumstances.	Fair knowledge about application of SLSAE 3000 for general subject matters and subject matter specific assurance standards including prospective financial statements	22,26	
6.3 Related services	6.3.1 Apply Sri Lanka Standard on Related Services relating to agreed up on procedures and compilation as required by engagement circumstances.	Fair understanding of the SLSRE 4400 & SLSRE 4410		
6.4 Reporting	6.4.1 Outline key elements of reports used in assurance and related services.			

G. Audit Quality and Ethics (Syllabus Weighting: 15%)				
Knowledge Component	**Learning Outcome**	**Specific Knowledge**	**Section B Questions**	**Section C Questions**
7.1 Framework for audit quality	7.1.1 Demonstrate the elements of the framework for audit quality.	Understanding of the definition and elements of the quality framework		21,27,28

G. Audit Quality and Ethics (Syllabus Weighting: 15%)				
Knowledge Component	**Learning Outcome**	**Specific Knowledge**	**Section B Questions**	**Section C Questions**
7.2 System of quality controls	7.2.1 Demonstrate the elements of a system of quality controls of the firm.	Fair understanding of the importance of elements of quality controls of the firm based on SLQC 1		27,28
7.3 Audit quality	7.3.1 Explain the requirements to implement quality control procedures at the audit engagement level including the engagement quality control review.	Fair understanding of the importance of elements of quality controls of the firm based on SLAuS 220		27,28
7.4 Threats to compliance with fundamental and ethical principles	7.4.1 Analyse threats applicable to professional accountants in public practice in complying with fundamental and ethical principle.	Part B of Code of Ethics (Section200 to 270)	28,29,30,31,32, 33	5,25,26,28
7.5 Auditors independence	7.5.1 Apply conceptual framework approach to analyse threats relating to auditors independence.	Fair understanding of the importance of auditors independence including the scope of applicability and specific issues dealt in Section 290-100 to 148)	29,32	25,26
	7.5.2 Evaluate threats associated with provision of non-assurance service and methods of mitigating such threats.	Threats associated with provision of non-assurance service and methods of mitigating such threats		
	7.5.3 Apply conceptual framework approach to evaluate specific non-assurance services.	(Section 290-164- to 219)		

H. Professional Practice of Internal Audit (Syllabus Weighting: 5%)				
Knowledge Component	**Learning Outcome**	**Specific Knowledge**	**Section B Questions**	**Section C Questions**
8.1 International professional practice framework	8.1.1 Recognise the importance of professional practice in internal audit using the elements of the International Professional Practice Framework (IPPF) of the Institute of Internal Auditors.	Core principles for the professional practice of internal auditing Definition of internal auditing Code of ethics International standards for the professional practice of internal auditing		28, 29
8.2 Internal audit charter	8.2.1 Propose an internal audit charter to govern an internal audit function for a given entity considering entity specific circumstances.	Key elements and mandatory nature of the Charter based on IIA standard		
8.3 Audit universe and plan	8.3.1 Develop an audit universe and a plan aligned to organisations strategies, objectives and risks.			
8.4 Risk role of internal auditor	8.4.1 Advise the extent to which internal auditor can support risk management initiatives of an entity using assurance and advisory services.	IIA position paper-role of internal auditor in risk management (ERM FAN)		
8.5 Managing an internal audit	8.5.1 Outline key considerations in setting engagement objectives, engagement planning and conducting an internal audit engagement for a given business scenario.	Ability to apply IIA performance standards applicable to engagement objectives, planning and performance of an internal audit taking into account engagement specific issues eg fraud risk, IT controls, possibility of using data analytics etc		

H. Professional Practice of Internal Audit (Syllabus Weighting: 5%)				
Knowledge Component	**Learning Outcome**	**Specific Knowledge**	**Section B Questions**	**Section C Questions**
8.6 Governance and culture audit	8.6.1 Advise on the process of structuring a governance audit and a culture audit.	Understanding key elements of a governance and culture audit and approach to be followed in the audit		
8.7 Audit committee and internal audit	8.7.1 Advise on the oversight role to be played by the audit committee in ensuring the independence and effectiveness of internal audit function.	Application of SLAuS 610		
	8.7.2 Advice on the extent to which external auditor can rely on the work of internal audit.			

Section 1: Objective Test Questions

Questions 1 to 60 in this section cover all areas of the syllabus with each question worth 2 marks. There will be 10 of this question type on the exam paper.

1 Amerasekera & Co audits Futtalam Ltd. In accordance with CA Sri Lanka Code of Ethics, which TWO of the following circumstances would constitute a threat to objectivity?

(1) An employee of Amerasekera & Co owns shares in Futtalam Ltd but is not part of the audit team

(2) The best friend of the engagement partner owns a significant indirect financial interest in Futtalam Ltd

(3) The audit manager of Amerasekera & Co owns a small number of shares in Futtalam Ltd

(4) The husband of the audit partner owns shares in Futtalam Ltd

A (1) and (2)
B (1) and (4)
C (2) and (3)
D (3) and (4) (2 marks)

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2 Gunawardena Partners & Co is the statutory auditor of Wattala Ltd a company listed on the Colombo stock exchange.

Which of the following services is Gunawardena & Co prohibited from providing to Wattala Ltd under any circumstances?

A Provision of bookkeeping services
B Assistance in the resolution of tax disputes
C Internal audit services
D Valuation services (2 marks)

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3 What are the two elements of the risk of material misstatement at the assertion level?

A Inherent risk and detection risk
B Audit risk and detection risk
C Inherent risk and control risk
D Detection risk and control risk (2 marks)

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4 Abayakoon Ltd. is an oil and gas company mining for crude oil reserves in sub-Saharan Africa. In the external audit of Abayakoon Ltd, to which of the following might specific performance materiality levels apply?

(1) Directors' remuneration

(2) Exploration and development costs

(3) The financial statements as a whole – to reduce to an appropriately low level the probability that the aggregate of uncorrected and undetected misstatements exceeds materiality for the financial statements as a whole

(4) The financial statements as a whole – to determine whether misstatements identified during the audit should be accumulated and communicated to management

A (1), (2) and (3)
B (1), (2) and (4)
C (1) and (2)
D (2) and (4) (2 marks)

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5 The auditor of Herath Ltd. wishes to reduce audit risk. Which of the following actions could the auditor take to achieve this?

(1) Increase sample sizes
(2) Reduce control risk
(3) Assign more experienced staff to the engagement team

A (1) only
B (2) only
C (1) and (3)
D (2) and (3) (2 marks)

---

6 When gaining an understanding of the specific business operations of an audit client which of the following matters would an auditor need to consider?

A Accounting principles and industry specific practices relevant to the client's business

B Acquisitions or disposals of the client's business activities

C Leasing of property, plant or equipment for use in the client's business

D Products or services and markets of the client's business (2 marks)

---

7 The audit team of which you are a member is in the process of documenting the audit client's system of internal controls. You wish to assess what specific errors or frauds may occur, in order to identify the key controls that the team will then need to test during control testing.

Which of the following methods for recording control systems should you use?

A ICQ

B ICEQ

C Narrative notes

D Flowcharts (2 marks)

---

8 Application controls relate to procedures used to initiate, record, process and report transactions and other financial data.

Which two of the following are application controls?

(1) Records of program changes

(2) Virus checks

(3) Batch reconciliations

(4) Document counts

A (1) and (2)

B (1) and (4)

C (2) and (3)

D (3) and (4) (2 marks)

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9 One of the control objectives of the sales system of Karunaratne Ltd. is to ensure that goods and services are sold to credit-worthy customers.

Which of the following control activities would assist Karunaratne Ltd in achieving this objective?

A All sales orders are based on authorised price lists.

B Credit limits are checked before sales orders are accepted.

C Overdue debts are chased each month by the credit controller.

D The aged debt listing is reviewed by the finance director on a monthly basis. (2 marks)

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10 The auditor of Jayatilleka Ltd has identified that Jayatilleka Ltd. does not match dispatch notes to sales invoices as part of the controls in the sales system.

What is the potential consequence of this deficiency?

A Customer orders may not be fulfilled accurately.
B Sales and trade receivables may be overstated.
C Sales and trade receivables may be understated.
D Sales invoices may be posted inaccurately in the receivables control account. (2 marks)

---

11 The external auditor has identified a deficiency in the internal controls of Dahanayake Ltd.

Which of the following factors would indicate that the deficiency is a significant deficiency in accordance with SLAuS 265 Communicating Deficiencies in Internal Control to Those Charged with Governance and Management?

(1) The likelihood of the deficiency leading to material misstatement is low
(2) There is a risk of fraud
(3) The number of transactions affected by the deficiency is low
(4) The deficiency interacts with other deficiencies identified

A (1) and (2)
B (1) and (3)
C (2) and (4)
D (3) and (4) (2 marks)

---

12 The sales invoices of Pathirana Ltd. are matched to dispatch notes with any mismatched items investigated before they are recorded in the sales day book.

Which of the following control objectives does this help to achieve?

A It ensures that sales and receivables are valid and accurate.

B It ensures that all goods dispatched are recognised as sales and receivables.

C It ensures that all goods ordered by customers are dispatched.

D It ensures that customers do not exceed their credit limits. (2 marks)

---

13 To ensure that the recorded sales transactions represent goods that have actually been despatched, Jayawickrama Ltd's sales system only records sales if there is matching despatch documentation.

Which of the following would be an appropriate test of control to confirm that the control is operating effectively?

A For a sample of sales invoices, verify that there are matching goods despatched notes.

B For a sample of goods despatched notes, verify that there are matching sales invoices.

C Verify that the numerical sequence of sales invoices is complete.

D Inspect the open-order file for unfulfilled orders. (2 marks)

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14 As the external auditor of Gamage Ltd, you have performed analytical procedures which have highlighted a 40% increase in revenue compared to the previous period.

Which further audit procedures would you perform in response to this?

(1) For a sample of sales invoices around the period end, inspect the dates and compare with the dates of goods despatch and the dates recorded in the sales and receivables ledger to confirm the application of correct cut-off.

(2) Trace a sample of shipping documentation to sales invoices and into the sales and receivables ledger.

(3) For a sample of sales transactions recorded in the ledger, vouch the sales invoice back to customer orders and shipping documentation.

(4) For a sample of sales invoices, examine for proper classification into revenue accounts.

A (1) and (2)
B (1) and (3)
C (2) and (4)
D (3) and (4) (2 marks)

---

15 The draft financial statements of Silva Ltd. show the following information:

	Rs'000
Revenue	420
Cost of sales	270
Gross profit	150
Trade receivables	160
Trade payables	130

What is the receivables collection period?

A 139 days
B 175 days
C 758 days
D 958 days (2 marks)

16 The auditor of Pathirana Ltd. is planning the audit work on trade receivables.

Which of the following procedures could not be performed by using computer-assisted audit techniques?

A Selection of a sample of receivables for confirmation

B Calculation of receivables collection period

C Production of receivables confirmation letters

D Evaluation of the adequacy of the allowance for irrecoverable receivables (2 marks)

17 Wijeratne Ltd. has an internal audit function. The external auditor has concluded that the internal audit function does not apply a systematic and disciplined approach to its work.

How does this affect the extent to which the external auditor can rely on the work of the internal audit function?

A The external auditor must not use the work of the internal audit function.

B The external auditor can use the work of the internal audit function provided the individuals have been assessed as competent.

C The external auditor can use the work of the internal audit function provided the organisational status of the function supports its objectivity.

D The external auditor can use work performed by the internal audit function which relates to low risk areas of the external audit only. (2 marks)

18 The auditor of Gemunu Ltd. is performing audit procedures to confirm the company's ownership of motor vehicles.

Which of the following would provide the most persuasive evidence of this?

A Physical inspection of the motor vehicles

B Inspection of vehicle registration documents

C Checking that the motor vehicles are recorded in the non-current asset register

D Review of vehicle insurance documentation (2 marks)

---

19 The auditor of Cooray Ltd. has performed purchases cut-off procedures and has identified that in two material instances goods received prior to the inventory count have not been included on the schedule of 'goods received not invoiced'. At the period end purchase invoices have not been received. What is the auditor's conclusion based on this evidence?

A Inventory is overstated and liabilities are understated.
B Inventory is understated and liabilities are understated.
C Inventory is overstated and liabilities are overstated.
D Inventory is understated and liabilities are overstated. (2 marks)

---

20 Mendis Ltd. has a year end of 31 December 20X4. The auditor has identified that management's assessment of Mendis Ltd's ability to continue as a going concern covers the period to 30 June 20X5.

What action should the auditor take?

A Request that management extends the assessment period to 30 September 20X5

B Request that management extends the assessment period to 31 December 20X5

C Request that management extends the assessment period to 31 December 20X6

D No action is required provided the auditor is satisfied with management's assessment to 30 June 20X5 (2 marks)

---

21 SLAuS 700 (Revised) Forming an Opinion and Reporting on Financial Statements sets out the basic elements of an auditor's report.

Which of the following is not included in an unmodified auditor's report?

A Management's responsibility for the financial statements
B Auditors' responsibilities
C Audit opinion
D Deficiencies of internal controls (2 marks)

---

22 The statement of financial position of Rajapaksa Ltd. includes a material amount of Rs200,000 in respect of costs capitalised in the year as development expenditure. The auditor has concluded that these costs are research expenditure.

If the auditor is to issue an unmodified opinion which financial statements will require adjustment?

A Statement of financial position only

B Statement of profit or loss only

C Statement of financial position and statement of profit or loss

D Neither the statement of financial position nor the statement of profit or loss (2 marks)

---

23 Due to disruptions caused by the recent transition to a new accounting system, one month of Herath Ltd's inventory records have been lost. The auditors performing the statutory audit for the twelve-month period have determined that the possible effects of undetected misstatements could be material, but not pervasive.

What form of audit opinion would the auditor give?

A Unmodified opinion with an emphasis of matter paragraph

B Qualified opinion

C Adverse opinion

D Disclaimer of opinion (2 marks)

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24 Chandrasiri Ltd. has a substantial bank loan which is due to mature in 20X7, and the company plans to negotiate for a new loan in March 20X7. The auditors concluded that the company's use of the going concern assumption in the financial statements for the year ended 31 December 20X6 is appropriate. However, they believe there is a material uncertainty related to going concern, which has been appropriately disclosed in the financial statements.

What action should the auditor take with regards to going concern in the auditor's report?

A Express an unmodified opinion and describe the material uncertainty in the other matter paragraph

B Express an unmodified opinion and describe the material uncertainty in the material uncertainty related to going concern paragraph

C Express a modified opinion and describe the material uncertainty in the emphasis of matter paragraph

D Express a qualified opinion and describe the material uncertainty in the basis for qualified opinion paragraph (2 marks)

---

25 Which of the following is likely to be carried out as part of an engagement quality control review for a listed entity?

(1) Review of audit working paper files to ensure that the audit has been performed in accordance with professional standards and regulatory and legal requirements

(2) Review of selected audit documentation relating to significant audit judgements

(3) Review of the engagement team's evaluation of the firm's independence towards the audit

(4) Consideration of whether appropriate consultations have taken place on differences of opinion/contentious matters

A (1) and (3)
B (2) and (4)
C (1), (2) and (4)
D (2), (3) and (4) (2 marks)

Vimukthi Ltd.

The following scenario relates to questions 26 to 30

Vimukthi Ltd. has a year end of 31 December 20X6. The detailed audit work has been concluded and you have been asked to complete the review stage of the audit. The auditor's report is due to be signed by the audit partner on 15 March 20X7. The annual report, which includes the financial statements and other information, will be issued on 31 March 20X7. The audit file includes details of an ongoing legal claim against Vimukthi Ltd. . You are satisfied with its treatment as a contingent liability and that the details have been fully disclosed in the financial statements.

26 You have requested written representations from the directors of Vimukthi Ltd. but have not yet received them.

By which date must the written representations letter be dated and signed by the directors of Vimukthi Ltd.?

A 31 December 20X6
B 15 March 20X7
C 31 March 20X7
D Any date between 16-13 March 20X7 (2 marks)

27 The following subsequent events took place relating to Vimukthi Ltd.:

(1) On 1 February a fraud was identified which had resulted in the financial statements being materially misstated.

(2) On 20 March 20X7 inventory which was held at the year end was sold at a material amount below its carrying amount as stated in the financial statements at 31 December 20X6.

For which of these events would you be required to obtain sufficient appropriate evidence to enable you to determine whether they have been properly reflected in the financial statements at 31 December 20X6?

A 1 only

B 2 only

C 1 and 2

D Neither 1 nor 2 (2 marks)

---

28 Your review of the audit file shows that a number of misstatements have been identified during the course of the detailed audit work.

Which of the following statements correctly describes the auditor's responsibility to communicate these to Vimukthi Ltd.?

A All misstatements, both corrected and uncorrected must be communicated to those charged with governance.

B Only corrected misstatements must be communicated to those charged with governance.

C All misstatements other than those which are clearly trivial must be communicated to the appropriate level of management.

D Only material uncorrected misstatements are communicated to the appropriate level of management. (2 marks)

---

29 The annual report of Vimukthi Ltd. includes a summary of key financial results. You have reviewed this other information and have concluded that it is inconsistent with the financial statements. Your investigations have shown that it is the other information, not the financial statements, which is materially misstated. The directors of Vimukthi Ltd. have refused to correct the summary.

How should this be addressed in the auditor's report?

A An Other Matter paragraph would be included outlining the material misstatement

B The Other Information section will state that the auditors have concluded that a misstatement of the other information exists

C The auditor's opinion will be qualified on the basis of a material misstatement

D This matter would not be addressed in the auditor's report as the material misstatement is not in the financial statements (2 marks)

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30 The audit partner has concluded that the going concern basis of accounting is appropriate but a material uncertainty exists due to the ongoing legal claim against Vimukthi Ltd.

What form of audit opinion will be issued and how will the material uncertainty be disclosed in the auditor's report?

	Audit opinion	Disclosure
A	Modified	Emphasis of Matter paragraph
B	Unmodified	Material Uncertainty Related to Going Concern section
C	Modified	Material Uncertainty Related to Going Concern section
D	Unmodified	Emphasis of Matter paragraph (2 marks)

Ratwatte Ltd.

The following scenario relates to questions 31–35.

You are an audit senior of Jayakody & Co and have worked on the external audit of Ratwatte Ltd., an unlisted company, since your firm was appointed external auditor two years ago.

Ratwatte Ltd. owns a chain of nine restaurants and is a successful company. Ratwatte Ltd. has always been subject to national hygiene regulations, especially in relation to the food preparation process. Non-compliance can result in a large fine or closure of the restaurant concerned.

The board of Ratwatte Ltd. has recently notified you that the national hygiene regulations have been updated and are now much more stringent and onerous than before.

With this in mind, the board has asked your firm to conduct a review of Ratwatte Ltd's compliance with hygiene regulations, in order to allow the board to assess whether the appropriate processes have been implemented at each of the nine restaurants. The review is not expected to include the provision of accounting advice or the preparation of figures in the financial statements.

The work is likely to be very lucrative. Your firm has sufficient experience to undertake the above review engagement.

31 Despite running a successful company, the board has often needed to be reminded of some fundamental principles and you often have to explain key concepts.

Which of the following statements best defines the external audit?

- ☐ The external audit is an exercise carried out by auditors in order to give an opinion on whether the financial statements of a company are fairly presented.
- ☐ The external audit is an exercise carried out in order to give an opinion on the effectiveness of a company's internal control system.
- ☐ The purpose of the external audit is to identify areas of deficiency within a company and to make recommendations to mitigate those deficiencies.
- ☐ The external audit provides negative assurance on the truth and fairness of a company's financial statements.

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32 The board has also struggled to differentiate between its responsibilities and those of the external auditor in circumstances such as the prevention and detection of fraud and error, and compliance with regulations.

Which of the following statements best describes Jayakody & Co's responsibility regarding Ratwatte Ltd's compliance with hygiene regulations, in line with SLAuS 250 Consideration of Laws and Regulations in an Audit of Financial Statements?

- ☐ YHT & Co should actively prevent and detect non-compliance with the regulations.
- ☐ YHT & Co should perform specific audit procedures to identify possible non-compliance.
- ☐ YHT & Co should obtain sufficient appropriate audit evidence about BJM's compliance with the regulations as they have a direct effect on the financial statements.
- ☐ YHT & Co does not have any responsibility as the hygiene regulations do not have a direct effect on the financial statements.

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33 The partner responsible for the review of hygiene compliance has informed you that the engagement is an assurance engagement.

Which of the following would NOT have been relevant to the partner in forming this opinion?

- ☐ The existence of a three-party relationship
- ☐ The existence of suitable criteria
- ☐ The determination of materiality
- ☐ The subject matter

---

34 The partner responsible for the review engagement has asked you to tell him what level of assurance you believe Jayakody & Co should provide, and also what type of opinion the firm should give.

What is the level of assurance and type of opinion that can be provided on this review engagement?

	Level of assurance	Report wording
☐	Reasonable	Positive
☐	Reasonable	Negative
☐	Limited	Positive
☐	Limited	Negative

---

35 The audit engagement partner has told you that the independence threats arising from Jayakode & Co performing the review engagement should be monitored carefully.

Which of the following is likely to cause the audit engagement partner most concern?

- ☐ According to the CA Sri Lanka Code of Ethics, Jayakody & Co is prohibited from providing other assurance services to an audit client.
- ☐ The review engagement is likely to give rise to a self-review threat, as the outcomes of the review could form the basis of the financial statements which the audit team will audit.
- ☐ The lucrative nature of the review engagement may make the external audit team less inclined to require management to make adjustments or to issue a modified audit opinion, for fear of losing the review engagement.
- ☐ If the new review engagement causes Jayakody & Co's fee income from Ratwatte Ltd. to exceed 15% of the firm's total fees, the CA Sri Lanka Code of Ethics states that the new engagement must be turned down.

(Total = 10 marks)

Bridgford

The following scenario relates to questions 36–40.

You are an audit senior of Cooray & Co and your firm has recently been appointed as the auditor to Bridgford Products (Bridgford), a large company which sells televisions, DVD players and Blu-ray Disc players to electrical retailers.

You are planning the audit for the year ended 31 January 20X9 and your audit manager has asked you to produce both the audit strategy document and the detailed audit plan, including an assessment of materiality.

In order to assist you in your planning work you have visited Bridgford, where you obtained the following information.

Sales have increased during the year ended 31 January 20X9 following a move to attract new customers by offering extended credit. The new credit arrangements allow customers three months' credit, rather than the one-month credit period allowed previously. As a result of this change, you have calculated that the receivables collection period has increased from 49 days to 127 days.

Bridgford installed a new computerised inventory control system, which began operating on 1 June 20X8. Since the inventory control system records both inventory movements and current inventory quantities, Bridgford is proposing to use the inventory quantities on the computer to value the inventory at the year end rather than carrying out an inventory count.

The production director informed you that in the last month or so there have been reliability problems with the company's products which have resulted in some customers refusing to pay for the products.

As part of the planning process you also undertake a risk assessment. Based on the information you have obtained to date you have identified several audit risks which you feel your team will need to address. The first risk relates to the extended credit terms offered by Bridgford to its customers, and the recent product reliability problems resulting in customers' refusal to pay.

A second audit risk relates to the computerised inventory control system which was implemented on 1 June 20X8. You are concerned about whether data was accurately transferred into the new system, and whether it is sufficiently reliable to determine the quantity of inventory for the year-end financial statements.

36 The audit manager has requested that you cover a number of specified areas in the audit planning documentation.

For each area, indicate whether the information would be included in the audit strategy document or in the detailed audit plan.

Area		Audit strategy document	Detailed audit plan
(1)	The availability of the client's data and staff (including internal audit)	☐	☐
(2)	The allocation of responsibility for specific audit procedures to audit team members	☐	☐
(3)	The audit procedures to be undertaken for each area of the financial statements	☐	☐
(4)	The potential for using computer-assisted audit techniques (CAATs) to gather evidence	☐	☐

37 You have set the level of materiality for the financial statements as a whole, and now need to determine performance materiality.

Which of the following statements about performance materiality is NOT true?

☐ Performance materiality is used to reduce the risk that the aggregate of uncorrected and undetected misstatements exceeds materiality for the financial statements as a whole to an acceptable level.

☐ Performance materiality refers to the amounts set by the auditor at higher than the materiality level for particular classes of transactions, account balances or disclosures where the materiality level might otherwise mean that such items are not tested.

☐ Once the level of materiality for the financial statements as a whole has been set, a lower level of performance materiality is determined by the auditor using their professional judgement.

☐ The performance materiality level is affected by the auditor's understanding of the entity and the nature and extent of misstatements identified in prior audits.

38 SLAuS 520 Analytical Procedures states that where analytical procedures identify fluctuations or relationships that are inconsistent with other relevant information or that differ significantly from the expected results, the auditor shall investigate the reason for this.

Which of the following auditor responses to the increase in the receivables collection period of Bridgford is the LEAST relevant?

☐ Make enquiries of management to understand the likely reason why the receivables collection period exceeds the extended credit period

☐ Perform detailed substantive testing on the aged receivables listing, to determine whether any amounts should be written off

☐ Perform a trend analysis on current year and prior year monthly revenue, to identify whether revenue is overstated as a result of fraud or error

☐ Perform further working capital ratio analysis, to determine the effect of the extended credit on Bridgford's cash position

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39 Which of the following statements summarises your key concern regarding the risk relating to the extended credit terms and refusal of certain customers to pay?

☐ That the directors may have prepared Bridgford's financial statements on the going concern basis when this is not applicable

☐ That the financial statements include amounts due from credit customers which are not valid debts

☐ That there are balances due from credit customers which have not been included in the financial statements

☐ That the financial statements include balances due from credit customers which are not recoverable

---

40 Which TWO of the following procedures are relevant responses to the risk that inventory quantities are misstated by the new computerised inventory system?

- [ ] Review a sample of purchase requisitions to determine whether the quantity of inventory held per the inventory system was verified before the requisition was approved
- [ ] Determine how often inventory counts are performed and the level of corrections required to the inventory system
- [ ] Review sales prices of inventory sold after the year end to identify inventory where cost exceeds net realisable value
- [ ] Test the operation of the inventory system using CAATs

(Total = 10 marks)

South

The following scenario relates to questions 41–45.

You are an audit senior of De Alwis & Co, and your firm has recently been appointed as the auditor to South, a private company that runs seven supermarkets in Sri Lanka. You are currently planning your firm's audit of South and are shortly due to make a preliminary visit to South's head office.

Four months before the year end, the company installed a new till system in all supermarkets. The new till system is linked to the accounting system at head office and automatically posts transactions to the accounting system. Previously journals were made manually based on totals on till rolls. The cost of the new till system which South has capitalised as a non-current asset.

The audit engagement partner has also said that she has is concerned that the new till system may not be reliable, and that consequently not all sales have been recorded, resulting in an understatement of revenue. She is also concerned that staff may not yet be familiar with the system, leading to an increased risk of errors relating to data entry.

Finally, after a number of people living close to one of South's stores became seriously ill, the source of the illness was traced back to meat the customers had purchased from South. Legal proceedings were commenced against South by a number of customers during the financial year, demanding $1m in compensation.

41 Indicate which TWO of the following statements describe the objectives of planning the audit of South.

- ☐ To ensure appropriate attention is devoted to important areas of the audit
- ☐ To assist in the co-ordination of work done by any auditor's experts
- ☐ To ensure that the audit engagement is only accepted if this is permissible by the CA Sri Lanka Code of Ethics
- ☐ To ensure the audit is completed within budget restraints

42 You are about to begin work on the share capital section of the South audit file.

Match each of the following audit procedures to the financial statement assertion to which it is most closely related.

Procedure		Assertion
Recalculate the closing balance on the share capital account		Presentation
Review financial statement notes		Completeness
Review Memorandum and Articles of Association and compare their requirements with issued share capital		Accuracy, valuation and allocation
Read minutes of board meetings for evidence of share issues		Existence

43 In relation to the capitalised costs of the new till system, you are concerned that South may have included within the capitalised costs some items which are revenue in nature, leading to the overstatement of non-current assets.

Which of the following statements is a valid response to this audit risk?

- ☐ Obtain a copy of the training manual relating to the new till system and discuss with directors the extent of training staff have received on the new system
- ☐ Agree the capitalised costs from the trial balance back to invoices to confirm their value
- ☐ Inspect invoices capitalised within the cost of the new till system to determine whether they are directly attributable to the cost of the new till system
- ☐ Recalculate the depreciation charged on the new till system

---

44 The audit engagement partner has stated that the new till system may not be reliable. Which TWO of the following statements represent valid responses to this audit risk?

- ☐ Perform analytical procedures by comparing daily/weekly sales by store with both the prior year and with expectations, in order to determine whether any unusual patterns have occurred following the installation of the new system
- ☐ Vouch the sales revenue per the system to the till receipts to confirm the accuracy of the sales
- ☐ Obtain a copy of the training manual relating to the new till system and discuss with directors the extent of training staff have received on the new system
- ☐ Agree sales revenue from till receipts to the cashbook to determine the accuracy of till receipts

---

45 You plan to review the legal correspondence relating to the claims made by those customers to whom South sold contaminated meat.

Which TWO of the following are valid objectives of this audit procedure?

- [ ] To determine whether South's reputation will have been damaged within the local area
- [ ] To confirm whether there are deficiencies in South's internal controls relating to food hygiene
- [ ] To assess whether a provision for customer compensation is required in South's financial statements
- [ ] To determine whether disclosure of the nature and financial effect of the legal claim is required in South's financial statements

(Total = 10 marks)

Madugalle Ltd.

The following scenario relates to questions 46–50.

You are an audit senior of IBN & Co and you are planning the audit of Madugalle Air Services Ltd (Madugalle) for the year ended 31 December 20X3.

Madugalle is a company that provides specialist helicopter support to public services, such as the police force and the ambulance service. Madugalle has four of these contracts, which contain very similar terms and are equal in value. Madugalle owns and maintains the helicopter fleet which is held at cost. Each aircraft carries specialist equipment and is operated by a highly skilled specialist pilot. Under the terms of these contracts Madugalle charges the customer an annual fee to cover the maintenance, storage and testing of the aircraft and equipment. The annual fee is payable in advance each year with the first annual payment being paid on the date the contract commences.

Madugalle has not purchased any new helicopters during the year to 31 December 20X3; however, there has been a lot of refitting, replacement and adding of specialist equipment to some of the existing aircraft. This has been necessary to keep up with the latest developments in search and rescue, and to maintain the aircraft to the high standard required under the contracts in place.

The original purchase of each aircraft was funded with a secured loan carrying substantial interest charges. The loan is in the process of being renegotiated and the bank has indicated that finance costs will increase further. Furthermore, the directors have told you that Madugalle 's contract with the police force expires in March 20X4, at a time when, in the wake of government cuts, the police are trying to substantially reduce the amount they pay. It is thought that the contract will be put out to tender, and it is possible that another aircraft provider may also bid for the contract.

Madugalle also holds around $2 million of aircraft spares which are included within inventory. Madugalle sells the aircraft spares to amateur flying associations. Aircraft spares which are not sold after three years are scrapped.

Approximately one-quarter of this value is made up of specialist equipment taken out of aircraft when it was replaced by newer or more advanced equipment. Such specialist equipment is transferred from non-current assets to inventory without adjustment, and continues to be recognised at amortised cost.

46 In relation to the identical contracts, which of the following statements summarises a key audit risk?

- ☐ Madugalle's assets could be undervalued if the market value of the helicopter fleet exceeds its cost.
- ☐ Madugalle could breach the terms of its contracts with its customers and be liable to pay penalties, so provisions may be understated.
- ☐ Revenue may be overstated if it is recognised according to the contract date rather than over the relevant accounting period.
- ☐ An expert valuer is required to value the helicopters in the financial statements.

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47 Given the large amount of refitting of existing aircraft, you are concerned that property, plant and equipment may be overstated in the financial statements.

Indicate which TWO of the following statements represent valid responses to this audit risk?

- ☐ Perform a proof in total calculation of the depreciation charge for the year and investigate any significant differences
- ☐ Review minutes of training meetings to determine whether the pilots have been trained how to use the specialist equipment
- ☐ Obtain a breakdown of the capitalised costs and agree a sample of items to invoices to determine the nature of the expenditure
- ☐ Inspect management's review of whether the value of the aircraft has been impaired

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48 In relation to Madugalle 's secured loan, which is the MOST important audit risk that should be documented in the detailed audit plan?

- ☐ Disclosure relating to the secured loan may be omitted from the financial statements.
- ☐ Madugalle 's going concern status may be at risk if the contract is not renewed.
- ☐ Interest charges may be understated.
- ☐ The bank will rely on the audited financial statements when deciding whether to renew the loan.

---

49 Which TWO of the following are valid responses to the fact that Madugalle 's contract with the police force is due for renewal?

- ☐ Review Madugalle 's contracts with its other three customers to determine whether they contain a break clause, in order to determine the likelihood of losing any further contracts to other aircraft providers
- ☐ Contact the police force directly and request confirmation as to whether the contract is to be renewed
- ☐ Review the short-term and long-term funding facilities which are available to Madugalle
- ☐ Consider whether the financial statements contain appropriate disclosures in relation to the matter

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50 In relation to the aircraft spares held by Madugalle , indicate which of the following correctly describe areas of audit concern?

	Audit concern	Not audit concern
Non-current assets	☐	☐
Inventory	☐	☐
Completeness	☐	☐
Accuracy, valuation and allocation	☐	☐

(Total = 10 marks)

Weerawansa

The following scenario relates to questions 51–55.

You are an audit manager, auditing the financial statements of Weerawansa Engineering plc, a listed company, for the year ended 30 April 20X7.

Weerawansa 's management has provided you with a schedule of the realisable values of the inventories. A full inventory count was carried out at 30 April 20X7.

Audit tests have confirmed that the inventory counts are accurate and there are no purchases or sales cut-off errors.

One of the company's factories was closed on 30 April 20X7. The plant and equipment and inventories were to be sold. By the time the audit work commenced in June 20X7, most of the inventory had been sold.

You have instructed the audit junior to evaluate the valuation of the inventory related to the closing factory at the year end. The audit junior has sent you a list of planned audit procedures.

On 17 March 20X7, Weerawansa 's managing director was dismissed for gross misconduct. It was decided that the managing director's salary should stop from that date, and that no redundancy or compensation payments should be made.

The managing director has claimed unfair dismissal and is taking legal action against the company to obtain compensation for loss of his employment. The managing director says he has a service contract with the company which would entitle him to two years' salary at the date of dismissal. The directors believe that there is a 35% chance of the managing director succeeding in his claim.

The financial statements for the year ended 30 April 20X7 record the resignation of the director. However, they do not mention his dismissal and no provision for any damages has been included in the financial statements.

51 Which TWO of the following statements are true regarding the auditor's attendance at the inventory count?

- ☐ It is the auditor's responsibility to organise the inventory count.
- ☐ The auditor observes client staff to determine whether inventory count procedures are being followed.
- ☐ The auditor reviews procedures for identifying damaged, obsolete and slow-moving inventory.
- ☐ If the results of the auditors' test counts are not satisfactory, the auditor should insist that the inventory is recounted.

52 Which of the audit procedures below is NOT appropriate in auditing the valuation assertion for Weerawansa 's inventory?

- ☐ Agree the selling prices of inventory sold since the year end to sales invoices and the cash book.
- ☐ Assess the reasonableness of management's point estimates of realisable value of inventory that has not yet been sold by reviewing sales before the year end, comparing the values with inventory that has been sold since the year end and considering offers made which have not yet been finalised.
- ☐ For a sample of inventory sold just before and just after the year end, match dates of sales invoices/date posted to ledgers with date on related goods dispatched notes.
- ☐ For unsold inventory, assess reasonableness of provisions for selling expenses by comparison of selling expenses with inventory sold.

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53 Using the lists below, complete the sentence below to show the correct accounting treatment for the legal claim made by the managing director for unfair dismissal and the reason for this treatment.

The legal claim should [__________] because [__________].

Options for blanks:

First blank:

be recorded as a provision

not be recorded as a provision but disclosed as a contingent liability

Second blank:

a present obligation exists, but the outflow of economic resources is not probable

a possible obligation exists, depending on whether or not some uncertain future event occurs

54 Which of the following audit procedures is likely to provide the auditor with the MOST reliable audit evidence regarding the legal claim?

- ☐ Review the minutes of the disciplinary hearing to understand whether the company has acted in accordance with employment legislation and its internal rules
- ☐ Review correspondence between the company and its lawyers regarding the likely outcome of the case
- ☐ Request a written representation from management supporting their assertion that the claim will not be successful
- ☐ Send an enquiry letter to Weerawansa 's lawyers to obtain their view as to the probability of the claim being successful

55 The dismissal of Weerawansa 's managing director has alerted you to the possibility that the company may not have complied with employment regulations. You therefore need to determine the impact that such non-compliance may have on the audit.

SLAuS 250 Consideration of Laws and Regulations in an Audit of Financial Statements sets out the responsibilities of the auditor in relation to the entity's compliance with laws and regulations.

Which of the following responsibilities is CORRECT regarding the responsibilities of Weerawansa 's auditors in relation to compliance with employment regulations?

- ☐ To obtain sufficient appropriate evidence regarding compliance, as they have a direct effect on the financial statements
- ☐ To perform specific audit procedures to identify possible non-compliance
- ☐ The auditors do not have any responsibility, as the employment regulations do not have a direct effect on the financial statements
- ☐ To prevent and detect all non-compliance with the regulations

(Total = 10 marks)

Gemunu & Silva

The following scenario relates to questions 56–60.

You are the audit manager of Savage & Co. It is a busy time of year for you as you have several ongoing audit clients at the moment and you are in the process of dealing with a number of outstanding issues and queries from members of your audit teams.

Gemunu Ltd. (Gemunu)

Gemunu is a pharmaceutical company. The fieldwork has been completed and you are currently reviewing the audit file. The audit senior is not sure how to deal with the following issue.

Gemunu has incurred $2.1m and development expenditure of $3.2m during the year, all of which has been capitalised as an intangible asset. Profit before tax is $26.3m.

Silva Ltd. (Silva)

The fieldwork on this audit is also complete with the exception of the following issue which the audit senior has been unable to deal with.

Silva 's computerised wages program is backed up daily; however, for a period of two months the wages records and back-ups have been corrupted, and therefore cannot be accessed. Wages and salaries for these 2 months are $1.1m. Profit before tax is $10m.

56 You have just received a phone call from one particular audit senior who is unsure about the steps to take in relation to uncorrected misstatements.

Which of the following statements correctly describe the auditor's responsibility in respect of misstatements?

- ☐ SLAuS 450 Evaluation of Misstatements Identified During the Audit states that the auditor only has a responsibility to accumulate material misstatements identified during the audit.
- ☐ Where misstatements are not material the auditor should request that management correct the misstatements in the following accounting period.
- ☐ If management refuses to correct some or all of the misstatements, the auditor should consider the implications of this for their audit opinion.
- ☐ A written representation should be requested from management to confirm whether they believe that the effects of the unadjusted misstatements are immaterial, both individually and in aggregate, to the financial statements as a whole.

57 Which of the following audit procedures should be performed in order to form a conclusion on whether an amendment is required to Gemunu 's financial statements in respect of the research and development expenditure?

(1) Discuss the requirements of SLFRS 38 Intangible Assets with the directors in order to determine whether they understand the required accounting treatment of research and development expenditure

(2) Obtain a breakdown of the Rs5.3m capitalised as an intangible asset and agree to supporting documentation to determine the nature of the projects to which the expenditure relates

(3) Review minutes of board meetings to determine whether the expenditure was authorised

(4) Visit the laboratory where the current research is being undertaken and to confirm occurrence of the research expenditure

- ☐ 1 and 2
- ☐ 1 and 4
- ☐ 2 and 3
- ☐ 3 and 4

58 Which of the following options correctly summarises the impact on the auditor's report for Gemunu if the issue remains unresolved?

- ☐ Unmodified opinion with key audit matters paragraph
- ☐ Qualified opinion with key audit matters paragraph explaining the issue
- ☐ Qualified opinion
- ☐ Adverse opinion

59 Which of the following correctly summarises the effect of the issue relating to the wages balance in the financial statements of Silva ?

	Material	Financial statement impact
☐	No	Liabilities to tax authorities may be understated
☐	No	Profit may be overstated
☐	Yes	Wages may be materially misstated
☐	Yes	Proper accounting records have not been kept

60 Based on the above information, which of the following options correctly summarises the impact of the wages and salaries issue on the auditor's report for Silva?

	Audit opinion	Disclosure in the auditor's report
☐	Qualified	Basis for qualified opinion
☐	Disclaimer	Basis for disclaimer of opinion
☐	Qualified	Key audit matters section
☐	Qualified	Emphasis of matter

(Total = 10 marks)

Section 2: 10 Mark Structured Response Questions

Part A Governance and Internal Control Frameworks

Questions 1 to 4 in this section cover Governance and Internal Control Frameworks, the subject of Chapters 1 to 3 of the Study Text.

1 Jafna Flowers

Jafna Flowers sells flowers wholesale. Customers telephone the company and their orders are taken by clerks who take details of the flowers to be delivered, the address to which they are to be delivered, and account details of the customer. The clerks input these details into the company's computer system (whilst the order is being taken) which is integrated with the company's inventory control system. The company's standard credit terms are payment one month from the order (all orders are dispatched within 48 hours) and most customers pay by bank transfer. An accounts receivable ledger is maintained and statements are sent to customers once a month. Credit limits are set by the credit controller according to a standard formula and are automatically applied by the computer system, as are the prices of flowers.

Required

Explain, including their purpose, the internal controls you might expect to see in the sales system at Jafna Flowers over the:

(1) Receipt, processing and recording of orders (6 marks)
(2) Collection of cash (4 marks)

(LO 1.2.1) (Total = 10 marks)

2 Lily Window Glass Plc

Lily Window Glass Plc (Lily) is a glass manufacturer, which operates from a large production facility, where it undertakes continuous production 24 hours a day, seven days a week. Also on this site are two warehouses, where the company's raw materials and finished goods are stored. Lily's year end is 31 December.

Lily is finalising the arrangements for the year-end inventory count, which is to be undertaken on 31 December 20X2. The finished windows are stored within 20 aisles of the first warehouse. The second warehouse is for large piles of raw materials, such as sand, used in the manufacture of glass. The following arrangements have been made for the inventory count:

The warehouse manager will supervise the count as he is most familiar with the inventory. There will be ten teams of counters and each team will contain two members of staff, one from the finance and one from the manufacturing department. None of the warehouse staff, other than the manager, will be involved in the count.

Each team will count an aisle of finished goods by counting up and then down each aisle. As this process is systematic, it is not felt that the team will need to flag areas once counted. Once the team has finished counting an aisle, they will hand in their sheets and be given a set for another aisle of the warehouse. In addition to the above, to assist with the inventory counting, there will be two teams of counters from the internal audit department and they will perform inventory counts.

The count sheets are sequentially numbered, and the product codes and descriptions are printed on them but no quantities. If the counters identify any inventory which is not on their sheets, then they are to enter the item on a separate sheet, which is not numbered. Once all counting is complete, the sequence of the sheets is checked and any additional sheets are also handed in at this stage. All sheets are completed in ink.

Any damaged goods identified by the counters will be too heavy to move to a central location, hence they are to be left where they are but the counter is to make a note on the inventory sheets detailing the level of damage.

As Lily undertakes continuous production, there will continue to be movements of raw materials and finished goods in and out of the warehouse during the count. These will be kept to a minimum where possible.

The level of work-in-progress in the manufacturing plant is to be assessed by the warehouse manager. It is likely that this will be an immaterial balance. In addition, the raw materials quantities are to be approximated by measuring the height and width of the raw material piles. In the past this task has been undertaken by a specialist; however, the warehouse manager feels confident that he can perform this task.

Required

For the inventory count arrangements of Lily Window Glass Plc:

(1) Explain five deficiencies.

(2) Discuss any recommendations you would make to address each deficiency.

The total marks will be split equally between each part.

(LO 1.2.1, 1.2.2, 1.2.3) (10 marks)

3 SouthLea Plc

SouthLea Plc is a construction company (building houses, offices and hotels) employing a large number of workers on various construction sites. The internal audit department of SouthLea Plc is currently reviewing cash wages systems within the company.

The following information is available concerning the wages systems:

(i) Hours worked are recorded using a clocking in/out system. On arriving for work and at the end of each days work, each worker enters their unique employee number on a keypad.

(ii) Workers on each site are controlled by a foreman. The foreman has a record of all employee numbers and can issue temporary numbers for new employees.

(iii) Any overtime is calculated by the computerised wages system and added to the standard pay.

(iv) The two staff in the wages department make amendments to the computerised wages system in respect of employee holidays, illness, as well as setting up and maintaining all employee records.

(v) The computerised wages system calculates deductions from gross pay, such as employee taxes, and net pay. Finally, a list of net cash payments for each employee is produced.

(vi) Cash is delivered to the wages office by secure courier.

(vii) The two staff place cash into wages packets for each employee along with a handwritten note of gross pay, deductions and net pay. The packets are given to the foreman for distribution to the individual employees.

Required

(1) Explain the deficiencies in SouthLea Plc's system of internal control over the wages system that could lead to misstatements in the financial statements. (5 marks)

(2) Discuss any recommendations you would make to address each deficiency. (5 marks)

(LO 1.2.1, 1.2.2, 1.2.3) (Total = 10 marks)

4 Matalas Ltd

Matalas Ltd sells cars, car parts and petrol from 25 different locations in one country. Each branch has up to 20 staff working there, although most of the accounting systems are designed and implemented from the company's head office. All accounting systems, apart from petty cash, are computerised.

You are an audit manager in the internal audit department of Matalas. You are currently auditing the petty cash systems at the different branches. Your initial systems notes on petty cash contain the following information:

(i) The average petty cash balance at each branch is Rs. 5,000.

(ii) Average monthly expenditure is Rs. 1,538, with transaction amounts ranging from Rs. 1 to RS. 500.

(iii) Petty cash is kept in a lockable box on a bookcase in the accounts office.

(iv) Vouchers for expenditure are signed by the person incurring that expenditure to confirm they have received re-imbursement from petty cash.

(v) Vouchers are recorded in the petty cash book by the accounts clerk; each voucher records the date, reason for the expenditure, amount of expenditure and person incurring that expenditure.

(vi) Petty cash is counted every month by the accounts clerk, who is in charge of the cash. The petty cash balance is then reimbursed using the 'imprest' system and the journal entry produced to record expenditure in the general ledger.

(vii) The cheque to reimburse petty cash is signed by the accountant at the branch at the same time as the journal entry to the general ledger is reviewed.

Required

(1) Explain five internal control deficiencies in the petty cash system at Matalas (Pvt) Ltd. (5 marks)

(2) Discuss any recommendations you would make to address each deficiency. (5 marks)

(LO 1.2.1, 1.2.2, 1.2.3) (Total = 10 marks)

Part B Audit Planning Risk Assessment

Questions 5 to 11 cover Audit Planning Risk Assessment, the subject of Chapters 4 to 6 of the Study Text.

5 Favorita Plc

You are the auditor of Favorita Plc. During the audit of the financial statements for the year to 30 September 20X4, you discovered the following items:

(i) An invoice for Rs. 3,000 for repairs was incorrectly posted to the equipment account in the statement of financial position. As a result, equipment is stated at Rs. 1,230,000 rather than the correct figure of Rs. 1,227,000 and profit is stated at Rs. 240,000 instead of the correct amount of Rs. 237,000.

(ii) An invoice for Rs. 80,000 received from a supplier for services received just before the year end has not been recorded in the books and records. Trade payables in the statement of financial position are stated as Rs. 1.2 million.

(iii) An illegal payment of Rs. 2,500 was made during the year as a bribe to an overseas customer. This was recorded as 'miscellaneous expenses'.

Required

(1) Explain how the auditor should determine materiality when planning an audit. (4 marks)

(2) Assess, for each of the three items identified above, irrespective of whether they have resulted in material misstatements of the financial statements of Favorita Plc. (6 marks)

(LO 2.3.1, 2.4.1) (Total = 10 marks)

6 Paranthan Ltd

You are the auditor of Paranthan Ltd, a family-owned manufacturing company. You have obtained the following information.

(i) The company is being sued by an employee who suffered an accident at work. The case is still ongoing but if the company is found to be liable the damages are likely to be substantial.

(ii) Trading conditions have been tough over the last twelve months. In order to retain customers Paranthan has relaxed its terms on which credit is given and has extended payment terms from 60 days to 90 days.

(iii) Paranthan has experienced a number of technical difficulties with one of its production lines. This has resulted in high levels of returns of one of its key products, with customers complaining about the poor quality.

(iv) The company implemented a new IT system during the year. You have discovered that this was not fully tested before it went live.

(v) Paranthan has used a local supplier of raw materials since the business was started. However, during the current year, the supplier went out of business.. A new supplier has been found but the company is based in Europe and invoices Paranthan in Euros.

Required

(1) Explain the business risks faced by Paranthan for each of the factors listed above. (5 marks)

(2) Explain the risk of material misstatement which could result from each business risk you have identified in (1) and identify whether this is at the assertion or financial statement level. (5 marks)

(LO 2.3.1, 2.4.2, 2.5.1) (Total = 10 marks)

7 Zak Ltd

Zak (Pvt) Ltd (Zak) sells garden sheds and furniture from 15 retail outlets. Sales are made to individuals, with transactions being in the form of cash and debit cards. All items purchased are delivered to the customer using Zak's own delivery vans; most sheds are too big for individuals to transport in their own motor vehicles. The directors of Zak indicate that the company has had a difficult year, but are pleased to present some acceptable results to the members.

The statements of profit or loss for the last two financial years are shown below:

Statements of profit or loss

	31 March 20X5 Rs'000	31 March 20X4 Rs'000
Revenue	7,482	6,364
Cost of sales	(3,520)	(4,253)
Gross profit	3,962	2,111
Operating expenses		
Administration	(1,235)	(1,320)
Selling and distribution	(981)	(689)
Interest payable	(101)	105)
Investment income	145	–
Profit/(loss) before tax	1,790	(3)
Statement of financial position (extract)		
Cash and bank	253	(950)

Required

Analyse the financial statements of Zak as part of your risk assessment procedures to identify and provide a possible explanation for unusual changes in the statement of profit or loss.

(LO 2.3.1) (10 marks)

8 Sleeptight Ltd

You are an audit senior for Mills & Co and are in the process of planning the audit of Sleeptight (Pvt) Ltd (Sleeptight), which has been an audit client of Mills & Co for several years.

Sleeptight's principal activity is the manufacture and sale of expensive high-quality beds. Each bed is crafted by hand in the company's workshop, and personalised in accordance with each customer's specific requirements.

The shares in Sleeptight are owned by the two joint Managing Directors who are sisters, Anna and Anita Silva. Both have a number of other business interests. As a result, they only spend a few days a week working at the company and rely on the small accounts department to keep the finances in order and to keep them informed. There is no finance director but the financial controller is a qualified accountant.

Sleeptight requires customers who place an order to pay a deposit of 40% of the total order value at the time the order is placed. The beds will take 4 to 8 weeks to build, and the remaining 60% of the order value is due within a week of the final delivery. Risks and rewards of ownership of the beds do not pass to the customer until the beds are delivered and signed for. Beds also come with a two year guarantee and the financial controller has made a provision in respect of the expected costs to be incurred in relation to beds still under guarantee.

The company undertakes a full count of raw materials at the year end. The quantities are recorded on inventory sheets and the financial controller assigns the costs based on the cost assigned in the previous year or, if there was no cost last year, using the latest invoice. Most beds are made of oak or other durable woods and the cost of these raw materials is known to fluctuate considerably.

It is expected that work in progress will be insignificant this year, but there will be a material amount of finished goods awaiting dispatch. Anna Silva will estimate the value of these finished goods and has said she will take into account the order value when doing so.

Required

(1) Analyse the above information to identify five audit risks. (5 marks)

(2) Outline the auditor's response to each risk in planning the audit of Sleeptight. (5 marks)

(LO 2.3.1, 2.5.1) (Total = 10 marks)

9 Ja-Ela Ltd

You are an audit senior working for Sams & Co and are now commencing the planning of the annual audit of Ja-Ela (Pvt) Ltd (Ja-Ela), which owns and runs a chain of gastro pubs. The date is 4 December 20X9 and Ja-Ela's year end is 31 December 20X9.

Ja-Ela has proved to be very popular in recent years. This year, it saw its revenue from sales of food and drink increase by 15% compared to the previous year. In view of its success, the directors are considering plans to expand the business by acquiring other pubs in the region. 70% of Ja-Ela's takings are paid in cash, with the remainder being paid by credit card.

For the first time this year, Ja-Ela has outsourced its payroll function to a firm of accountants called Ricks & Co. Payroll costs form a substantial cost in Ja-Ela's statement of profit or loss. Ricks & Co prepares the payroll records and updates it for starters and leavers based on information provided by Ja-Ela.

A series of payroll reports are securely e-mailed to Ja-Ela each month and reviewed by the appropriate management. Payments are made to employees on the basis of a net pay report provided and journals are put through to reflect the wages costs and related liabilities.

Required

(1) State the purpose of three of the main sections of an audit strategy document and for each section, provide an example relevant to Ja-Ela. (6 marks)

(2) Explain the audit team's responsibilities in relation to obtaining an understanding of the services provided by Ricks & Co when planning the audit of Ja-Ela. (4 marks)

(LO 2.2.1, 2.3.1) (Total = 10 marks)

10 Matale Products

Your firm, Bandara & Co, has been appointed as the auditor of Matale Products, a large company. The company sells televisions, DVD players and Blu-ray Disc players to electrical retailers.

You are planning the audit for the year ended 31 January 20X9. The audit for the year ended 31 January 20X8 was carried out by another firm of auditors.

Information obtained from a client visit

During a recent visit to the company you obtained the following information.

(i) The company installed a new computerised inventory control system which has operated from 1 June 20X8. As the inventory control system records inventory movements and current inventory quantities, the company is proposing:

- To use the inventory quantities on the computer to value the inventory at the year-end
- Not to carry out an inventory count at the year-end

(ii) You are aware there have been reliability problems with the company's products, which have resulted in legal claims being brought against the company by customers, and customers refusing to pay for the products.

(iii) Sales have increased during the year ended 31 January 20X9 by attracting new customers and offering extended credit. The new credit arrangements allow customers three months credit before their debt becomes overdue, rather than the one month credit period allowed previously. As a result of this change, the average trade receivables age has increased from 1.6 to 4.1 months.

Required

(1) State why it is important for auditors to plan their audit work. (4 marks)

(2) Identify THREE matters you will consider in planning the audit and explain the further action you will take concerning the information you obtained during your recent visit to the company. (6marks)

(LO 2.2.1, 2.3.1) (Total = 10 marks)

11 Regulation

An audit senior has been working on the audit of properties, including storage facility warehouses. Customers rent individual self-contained storage areas of a warehouse, for which they are given keys allowing access by the customer at any time. The company's employees rarely enter the customers' storage areas.

It seems the company's policy for storage contracts which generate revenue of less than Rs10,000, is that very little documentation is required, and the nature of the items being stored is not always known.

While visiting one of the warehouses the audit senior noted what appeared to be potentially hazardous chemicals, stored in large metal drums marked with warning signs. When asked about the items being stored, the warehouse management became refused to answer any questions or allow the audit senior to ask any other employees about the large metal drums and suggested the audit senior did not mention the storage of these items to management.

Required

Discuss the implications of the audit seniors finding for the completion of the audit, commenting on the auditor's responsibilities in relation to laws and regulations, and on any ethical matters arising.

(LO 2.8, 5.2) (10 marks)

Part C Gathering Audit Evidence

Questions 12 to 18 cover Gathering Audit Evidence, the subject of Chapters 7 to 14 of the Study Text.

12 Buttala (Pvt) Ltd

Buttala (Pvt) Ltd (Buttala) is a large engineering company. The manufacturing process is capital intensive and the company holds a wide variety of plant and equipment.

The finance director prepares a detailed non-current assets budget annually. This annual budget, which is approved by the full board, is held on computer file and is the authority for the issue of a purchase order.

When the item of plant and equipment is delivered to the company, a pre-numbered goods received note (GRN) is prepared, a copy of which is sent to the accounting department, and used to update the non-current assets budget to reflect the movement. At the same time as the purchase invoice enters the purchasing system, a computerised non-current assets register is updated.

The internal audit department tests on a sample basis the operation of the system from budget preparation to entry in the non-current assets register.

As part of your work as external auditor, you are reviewing the non-current assets audit programme of the internal auditors and notice that the basis of their testing is a representative sample of purchase invoices. They use this to test entries in the non-current assets register and the updating movements on the annual budget.

Required

(1) Describe FOUR methods of selecting a sample of items to test from a population in accordance with SLAuS 530 Audit Sampling. (4 marks)

(2) Explain why the internal audit work performed is not a good test for completeness. (3 marks)

(3) State a more appropriate test to prove completeness of the non-current assets records, including the non-current assets register. (3 marks)

(LO 3.1.1, 3.4.1, 4.3.1) (Total = 10 marks)

13 Uva Toys (Pvt) Ltd

Uva Toys (Pvt) Ltd (Uva) manufactures toys. It has been an audit client of your firm for several years. As an audit senior, you are involved in the Uva audit for the first time.

The company operates a perpetual inventory counting system. While looking at the prior year audit files, you note that numerous misstatements were identified by the audit team in respect of purchases cut-off, prompting adjustments to be made in last year's financial statements.

Required

(1) Explain briefly why cut-off is an important issue in the audit of inventory. (4 marks)

(2) Describe the audit work that auditors would carry out to satisfy themselves that inventory is fairly stated, where a company uses a perpetual inventory counting system. (6 marks)

(LO 3.1.2) (Total = 10 marks)

14 Badulla Ltd.

Badulla, a limited liability company, distributes domestic electrical equipment from one warehouse. Customers are mainly installers of such equipment, but there is a 'cash and carry' counter in the warehouse for retail customers. The warehouse staff are responsible for raising invoices and credit notes relating to credit sales as well as handling cash sales.

You have carried out your interim audit in respect of the year ending 31 December 20X0 which included a circularisation of 80 trade accounts receivable as at 30 September 20X0, selected from a total credit customer list of 1,000. Replies were received from all customers circularised. The interim audit work disclosed the following.

(i) Of the 80 customers' accounts circularised, eight disagreed but could be reconciled by bringing into account payments stated by the customers concerned to have been made before 30 September 20X0 but which in each case were recorded in Badulla's books between 14 and 18 days after the dates stated by the customers as the date of payment.

(ii) Your tests suggested that some 25% of credit customers were allowed settlement discounts of 2.5% although payments were consistently received after the latest date eligible for discount.

(iii) A large number of credit notes were raised representing approximately 12% of the total number of invoices raised. A review of the copy credit notes indicated that they usually arose from arithmetical and pricing errors on invoices raised.

Required

Explain the work you would plan to carry out at the final audit on trade receivables at 31 December 20X0.

(LO 3.1.1, 3.2.1) (10 marks)

15 Rocks Forever

You are the audit manager in the firm of Cooray & Co and are planning the audit of Rocks Forever. Rocks Forever purchases diamond jewelry from three manufacturers, then sells the jewelry. The jewelry is sold from its four shops.

Inventory is the largest account on the statement of financial position, with each of the four shops holding material amounts. Due to the high value of the inventory, all shops will be visited and test counts performed.

With the permission of the directors of Rocks Forever, you have hired UJ, a firm of specialist diamond valuers who will also be in attendance. UJ will verify that the jewelry is, in fact, made from diamonds and that the jewelry is saleable with respect to current trends in fashion. UJ will also suggest, on a sample basis, the value of specific items of jewelry.

Counting will be carried out by shop staff in teams of two using pre-numbered count sheets.

Required

(1) Discuss the factors you should consider when placing reliance on the work of UJ. (5 marks)

(2) Outline the audit procedures you should perform to ensure that jewelry inventory is valued correctly. (5 marks)

(LO 2.7.1, 3.1.1) (Total = 10 marks)

16 Panadura Ltd

Panadura Ltd (Panadura) is a reseller of sports equipment, specialising in racquet sports such as tennis, squash and badminton. The company purchases equipment from a variety of different suppliers and then resells this using the Internet as the only selling media. The company has over 150 different types of racquets available in inventory, each identified via a unique product code.

Customers place their orders directly on the internet site. Most orders are for one or two racquets only. The ordering/sales software automatically verifies the order details, customer address and credit card information prior to orders being verified and goods being dispatched. The integrity of the ordering system is checked regularly by ArcherWeb, an independent internet service company.

You are the audit manager working for the external auditors of Panadura, and you have just started planning the audit of the sales system of the company. You have decided to use test data to check the input of details into the sales system. This will involve entering dummy orders into the Panadura system from an online terminal.

Required

(1) Explain four advantages of CAATs. (4 marks)

(2) Discuss the test data you will use in your audit of the financial statements of Panadura to confirm the completeness and accuracy of input into the sales system, clearly explaining the reason for each item of data. (6 marks)

(LO 4.3.1) (Total = 10 marks)

17 Jaffna Oil Plc

You are the external auditor of Jaffna Oil Plc (Jaffna Oil) for the year ended 31 March 20X1. Jaffna Oil operates 12 petrol stations in Colombo. As well as selling petrol, each petrol station also has a convenience shop and a car washing facility.

Each petrol station is responsible for its own inventory procurement and produces monthly management accounts, which are sent to the central accounts department at Jaffna Oil.

Required

(1) Define the term analytical procedures, and describe how they can be used during the various stages of an audit. (3 marks)

(2) Describe THREE analytical procedures the external auditor could perform to confirm Jaffna Oil's revenue and profit. (3 marks)

(3) Describe substantive procedures the external auditor should adopt to verify each of the following assertions:

(i) the valuation of inventory (2 marks)
(ii) the completeness of payables (2 marks)

(LO 3.5.1, 3.1.1) (Total = 10 marks)

18 Mankulam Cakes Ltd

Mankulam Cakes Ltd (Mankulam) is a manufacturer of baked goods. 85% of the equity shares in the company are owned by Albert Mankulam, with the remaining 15% being shared throughout the remainder of the Mankulam family, with no other family member owning more than 2%.

Mankulam owns 100% of the equity shares in Celebration Cakes Ltd, a company which specialises in cakes for special occasions such as birthdays and weddings.

Beautiful Biscuits (Pvt) Ltd is 100% owned by Albert Mankulam's wife, Anita. This company currently rents a factory from Mankulam.

Required

(1) Explain why related party transactions are relevant to an understanding of the financial statements. (2 marks)

(2) Explain the related party relationships of Mankulam, using the definition of a related party in SLAuS 550 Related Parties. (3 marks)

(3) State FIVE audit procedures which would be performed in order to identify related party transactions. (5 marks)

(LO 3.6.1) (Total = 10 marks)

Part D Auditing in a digital environment

Question 19 covers Auditing in a digital environment, the subject of Chapter 15 in the Study Text. Also, see Question 29 in Section C.

19 E-Spark Ltd

You are an audit manager at Appuhamy Auditors, and are responsible for the audit of E-Spark Ltd, a manufacturer and distributor of electrical components. The audit is nearing completion, but a number of issues have been encountered.

1. The client has seen exponential growth in sales over the past few years and the number of transactions occurring across all areas of the business has increased substantially. During the audit fieldwork stage, it took the engagement team almost double the time of previous years to sample and test an appropriate number of items across the audit.

2. One of the junior auditors left several files and laptop computer in their car overnight, and the car and contents were stolen. The fieldwork was nearing completion, and the bulk of the working papers were lost in the incident. The lost audit procedure had to be reperformed at a substantial cost to the firm.

Required

(1) Explain how Robotic Process Automation and data analytics might have been used to reduce the time spent on the audit of E-Spark. (4 marks)

(2) Outline the benefits of cloud-based working papers and audit software to Endeavour Auditors. (4 marks)

(3) Briefly explain the impact that the use of blockchain technology by client organisations may have on audit firms.

(LO 4.1.1, 4.2.1) (2 marks)

Part E Evaluating evidence and Audit Reporting
Questions 20 to 25 cover Evaluating evidence and Audit Reporting , the subject of Chapter 16 of the Study Text.

20 Moratuwa National Bakeries

Your firm acts as auditor of Moratuwa National Bakeries (Moratuwa). The finance director has prepared financial statements of the company for year to 31 December 20X9 which show a pre-tax profit of Rs. 450,000. You have been advised that the board of directors has approved the financial statements and decided that no amendments should be made thereto.

As partner responsible for the audit you have noted the following matters during your review of the financial statements and the audit working papers:

(i) The freehold property which was included at cost in previous years' statement of financial position, has now been restated at a professional valuation of Rs. 1,250,000 carried out during the year. You are satisfied with the valuation, the relevant figures have been correctly adjusted and the necessary information disclosed in the notes to the financial statements. (2 marks)

(ii) An amount of Rs. 45,000 due from a customer in respect of sales during the year is included in receivables but, from information made available to you, you conclude that no part of this debt will be recovered. No allowance has been made against this amount. (4 marks)

(iii) The financial statements do not disclose the fact that a director was indebted to the company for an amount of Rs. 23,000 during a period of six weeks commencing 1 February 20X9. (4 marks)

Required

Explain how each of the above will impact on the auditor's report.

(LO 5.1.1) (Total = 10 marks)

21 Mendes and Vimukithi

You are the audit manager of Wijuratne & Co and you are currently reviewing the audit files for several of your clients for which the audit fieldwork is complete. The audit seniors have raised the following issues:

Mendes (Pvt) Ltd

Mendes (Pvt) Ltd is a pharmaceutical company and has incurred research expenditure of Rs. 2.1m and development expenditure of Rs. 3.2m during the year This has all been capitalised as an intangible asset. Profit before tax is Rs. 26.3m.

Vimukithi (Pvt) Ltd

Vimukithi (Pvt) Ltd's computerised wages program is backed up daily. However for a period of two months the wages records and the back-ups have been corrupted and therefore cannot be accessed. Wages and salaries for these two months are Rs. 1.1m. Profit before tax is Rs. 10m.

Required

(1) Explain the meaning of pervasiveness in the context of a modified audit report (2 marks)

(2) For each of the clients above:

(i) Analyse the issue, including an assessment of whether it is material. (4 marks)

(ii) Explain the impact on the auditor's report if the issue remains unresolved. (4 marks)

(LO 5.1.1, 5.3.1) (Total = 10 marks)

22 Daisy & Fuchsia

You are the audit manager of Violet & Co and you are currently reviewing the audit files for several of your clients for which the audit fieldwork is complete. The audit seniors have raised the following issues:

Daisy Designs (Pvt) Ltd (Daisy)

Daisy's year end is 30 September, however, subsequent to the year end the company's sales ledger has been corrupted by a computer virus. Daisy's finance director was able to produce the financial statements prior to this occurring; however, the audit team has been unable to access the sales ledger to undertake detailed testing of revenue or year-end receivables. All other accounting records are unaffected and there are no backups available for the sales ledger. Daisy's revenue is Rs. 15.6m, its receivables are Rs. 3.4m and profit before tax is Rs. 2m.

Fuchsia Enterprises (Pvt) Ltd (Fuchsia)

Fuchsia has experienced difficult trading conditions and as a result it has lost significant market share. The cash flow forecast has been reviewed during the audit fieldwork and it shows a significant net cash outflow. Management are confident that further funding can be obtained and so have prepared the financial statements on a going concern basis with no additional disclosures; the audit senior is highly sceptical about this. The prior year financial statements showed a profit before tax of Rs. 1.2m; however, the current year loss before tax is Rs. 4.4m and the forecast net cash outflow for the next 12 months is Rs. 3.2m.

Required

For each of the two issues:

(1) Analyse the issue, including an assessment of whether it is material. (5 marks)

(2) Outline the impact on the auditor's report if the issue remains unresolved. (5 marks)

(LO 5.1.1, 5.3.1) (Total = 10 marks)

23 Builders Merchants Plc

You are the auditor of Builders Merchants Plc, a company which distributes materials to the construction industry from eight branches in the south of the country, and you are currently finalising the audit for the year ended 31 March 20X1. Your audits tests have proved satisfactory with the exception of the following three matters.

(i) The physical inventory count sheets for one of the branches were lost before they were made available to you, and you have not been able to confirm the inventory quantities and values for this branch by alternative methods. The directors have valued this part of the inventory at Rs. 75,000 and this figure is included in the overall inventory valuation of Rs. 640,000.

(ii) Included in trade receivables, which total Rs. 580,000, is a debt amounting to Rs. 45,000 from a customer which went into liquidation on 15 June 20X1. You have ascertained from the liquidator that your client is unlikely to receive a distribution. The statement of profit or loss for the year shows a pre-tax profit of Rs. 100,000 but the directors are not prepared to provide for this debt.

(iii) A substantial claim has been lodged against the company by a major customer. The matter is fully explained in the notes to the accounts, but no provision has been made for legal costs or compensation payable as it is not possible to determine with reasonable accuracy the amounts, if any, which may become payable. The directors have received legal advice which appears to be reliable in indicating that the claim can be successfully defended.

Required

(1) Explain which matters may be referred to in an emphasis of matter paragraph. (1 mark)

(2) Analyse how the above items will influence the auditor's report you will issue. (9 marks)

(LO 5.1.1, 5.4.1) (Total = 10 marks)

24 Hood Enterprises (Pvt) Ltd

You are the audit manager of Hood Enterprises (Pvt) Ltd (Hood).

Extracts from the draft auditor's report produced by an audit junior are given below:

'We have audited the accompanying financial statements of Hood which comprise... We have also evaluated the overall adequacy of the presentation of information in the company's annual report.'

Auditor's Responsibility

'...We conducted our audit in accordance with Auditing Standards. Those standards require that we comply with ethical requirements and plan and perform the audit so that we can confirm the financial statements are free from material misstatement. The directors however are wholly responsible for the accuracy of the financial statements and no liability for errors can be accepted by the auditor.

An audit involves performing procedures to obtain as much audit evidence as possible in the time available about the amounts and disclosures in the financial statements.

An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of all accounting estimates made by management as well as evaluating the presentation of the financial statements...'

Required

Explain FIVE errors in the above extract.

(LO 5.3.1, 5.6.1) (10 marks)

25 Glitch

Your firm is responsible for the audit of Glitch a listed company with a year ended 30 September 20X9. The draft financial statements recognise profit for the year of Rs30 million. The audit for the year end is nearing completion. The following matters have been discussed with management who have confirmed they will not be adjusted in the financial statements:

1. In August 20X9 a major customer went into administration with a receivable balance of Rs5 million which is still included in trade receivables at the year end.

2. A court case began in June 20X9 involving an ex-employee who is suing Glitch for unfair dismissal and damages of Rs400,000 are expected to be paid. The financial statements include a note stating the potential damages however, no adjustment has been made.

A junior staff member of the audit team has produced a draft auditor's report for your review, an extract of which is shown below:

Basis for opinion and disclaimer of opinion

We have performed our audit based on a materiality level of Rs3 million. Our audit procedures have proven conclusively that trade receivables are materially misstated. The finance director of Glitch Limited has refused to make an adjustment to provide for the outstanding trade receivable balance. In our opinion the financial statements of Glitch are materially misstated and we therefore express a disclaimer of opinion.

Key audit matters

The audit team spent considerable time working on Glitch Ltd's revenue recognition policies, which are highly complicated. We were concerned that Glitch might recognise revenue too early, but in our opinion revenue is presented fairly in accordance with LKAS 18.

Emphasis of Matter paragraph

There is an outstanding legal case where an ex-employee is claiming Rs400,000 in damages which is not included as a provision. In our opinion this amount should be adjusted for and recognised as a provision so represents as breach of LKAS 37.

Required

Comment on the auditor's report for the year ended 30 September 20X9 suggesting any required changes.

(LO 5.1, 5.2, 5.3, 5.4) (Total = 10 marks)

Part F Assurance and Related Services

Questions 26 to 27 cover Assurance and Related Services, the subject of Chapter 17 of the Study Text.

26 Batulo Ltd

You are a partner in a medium sized firm of chartered accountants. The following opportunities have arisen.

(i) A major audit client, Lilac Co, is seeking loan finance from its bank to fund an expansion into a new factory. The expansion should result in an increase in capacity of 30%. Lilac has conducted market research and is confident that they will be able to sell the added output. The financial director has recently telephoned you and mentioned that the bank are keen to obtain a reference from the audit firm, relating to Lilac's ability to repay the loan and whether the business plan is reasonable. He said 'they just need their forms filled, for their files. They know we can repay. We're one of their best clients.' Your audit team is about to commence the audit for the year ended 31 March 20X8.

Required

Comment on the matters you would consider in relation to giving such a reference to the bank. (5 marks)

(ii) The finance director of Laurel Co, another audit client, telephoned you yesterday. He recently attended a half-day course on the importance of corporate governance run by your firm. Laurel's long term plans include the possibility of flotation on a stock exchange. The finance director has told the other directors the issues discussed at the course and they feel that it might be a good idea to engage the firm to undertake an assurance engagement to assess risk management and the internal control system at Laurel Co.

Required

Comment on the matters you would consider in relation to accepting and planning such an engagement. (5 marks)

(LO 5.5, 6.1, 6.2) (Total = 10 marks)

27 Verity

Verity, a limited liability company, has a credit facility with Cranley Bank of Rs900m. The facility is due to expire on 31 December 20X1. The overdraft in the recently audited statement of financial position at 30 September 20X1 is Rs825m. The directors of Verity have started negotiations with their bankers for a renewal of the facility and to increase the amount to Rs1,350m. To support this request the bank has asked Verity to provide a business plan for the coming 12 months consisting of a cash flow forecast supported by a forecast statement of profit or loss and other comprehensive income and statement of financial position. The management of Verity has produced a cash flow forecast for the period 1 October 20X1 to 30 September 20X2 and, at the request of the bank, has asked the auditor to examine and report on it. The audit manager, who has recently completed Verity's audit, has been asked to make a preliminary examination of the cash flow forecast and supporting material and she has noted the following observations.

(i) The cash flows from sales are based on the assumption of an overall increase in sales of 24% compared to the previous financial year. Analysis shows that this is based on an increase in selling price of 5% and an increase in the volume of sales of 18%. Just over a quarter of all Verity's sales are made to foreign customers.

(ii) The cost of sales in the recently audited statement of profit or loss and other comprehensive income to 30 September 20X1 was 80% of sales revenue, giving a gross profit of 20%. In the forecast statement of profit or loss and other comprehensive income for the year to 30 September 20X2 the cost of sales has fallen to 72%, giving a gross profit of 28%. Manufacturing costs are made up of approximately one third each of materials, labour and production overheads.

(iii) The trade receivables collection period used in the cash flow forecast to 30 September 20X2 is 61 days. In the year to 30 September 20X1 this period averaged 93 days. Management has stated that it is its intention to inform all customers of a new standard 60-day credit period. In addition an early settlement discount of 1% will apply to customers who settle their account within 30 days of the statement. Conversely the credit period for trade payables has been extended from an average of 45 days in the current year to 90 days in the forecast.

(iv) The cash flow forecast showed that the maximum credit required during the period would rise to nearly Rs1,350m in August 20X2.

Required

(1) Describe the general matters an auditor should consider before accepting an engagement as a reporting accountant on forecast financial information.

(5 marks)

(2) Detail the procedures that the reporting accountant should undertake in relation to the cash flow forecast of Verity for the year to 30 September 20X2. (5 marks)

(LO 6.1.1, 6.2.1) (10 marks)

Part G Audit Quality and Ethics Questions 28 to 33 cover Audit Quality and Ethics, the subject of Chapter 17 of the Study Text.

28 Maho (Pvt) Ltd

You are a manager in the audit firm of Ali & Co; and this is the first time you have worked on one of the firm's established clients, Maho (Pvt) Ltd. The main activity of Maho (Pvt) Ltd is providing investment advice to individuals regarding saving for retirement, purchase of shares and securities and investing in tax efficient savings schemes. Maho (Pvt) Ltd is regulated by the relevant financial services authority.

You have been asked to start the audit planning for Maho (Pvt) Ltd, by Mr Son, a partner in Ali & Co. Mr Son has been the engagement partner for Maho (Pvt) Ltd, for the previous nine years and so has excellent knowledge of the client. Mr Son has informed you that he would like his daughter Zoe to be part of the audit team this year; Zoe is currently studying for her first set of business level papers for her professional qualification. Mr Son also informs you that Mr Far, the audit senior, received investment advice from Maho (Pvt) Ltd during the year and intends to receive advice next year too.

In an initial meeting with the finance director of Maho (Pvt) Ltd, you learn that the audit team will not be entertained on Maho (Pvt) Ltd's yacht this year as this could appear to be an attempt to influence the opinion of the audit. Instead, the finance director has arranged a balloon flight costing less than one-tenth of the expense of using the yacht and hopes this will be acceptable. The director also states that the fee for taxation services this year should be based on a percentage of tax saved and trusts that your firm will accept a fixed fee for representing Maho (Pvt) Ltd in a dispute regarding the amount of sales tax payable to the taxation authorities.

Required

(1) Analyse the ethical threats which may affect the auditor of Maho (Pvt) Ltd. (4 marks)

(2) Outline how the effect of each threat identified in (a) above can be mitigated. (4 marks)

(3) Assess the extent to which the auditor is responsible for Maho's compliance with financial services regulation. (2 Marks)

(LO 7.4.1, 2.8.1) (Total = 10 marks)

29 Independence

The following issues have been identified by the ethics partner in the audit firm of Shantha & Co:

(i) The audit manager in charge of the audit assignment of Gemunu (Pvt) Ltd holds 1,000 ordinary shares in the company (total shares in issue – 100,000). The audit partner holds no shares.

(ii) The recurring audit fee receivable from Devapiria (Pvt) Ltd is Rs. 100,000. The total fee income of the audit firm is Rs. 700,000.

(iii) The audit senior in charge of the audit of Margot Bank Plc has a personal loan from the bank of Rs. 2,000 on which she is currently paying 12% interest.

(iv) An audit partner is responsible for two audit assignments, Prassana (Pvt) Ltd and Sirisenna (Pvt) Ltd. Prasanna (Pvt) Ltd has recently tendered for a contract with Sirisenna (Pvt) Ltd for the supply of material quantities of goods over a number of years. Sirisenna (Pvt) Ltd has asked the audit partner to advise on the matter.

Required

(1) Explain why the ethical principle of independence is particularly relevant to auditors. (3 marks)

(2) Analyse the above situations in the context of the independence of the auditor, showing clearly the principles involved. (7 marks)

(LO 7.4.1, 7.5.1) (Total = 10 marks)

30 De Abrew Plc

You are an audit manager in Senasinge & Co, a firm of Chartered Accountants. You are preparing the engagement letter for the audit of De Abrew Plc, for the year ending 30 June 20X6.

De Abrew Plc has grown rapidly over the past few years, and is now one of your firm's most important clients. Ancients Plc has been an audit client for eight years and Senasinge & Co has provided audit, taxation and management consultancy advice during this time. The client has been satisfied with the services provided, although the taxation fee for the period to 31 December 20X5 remains unpaid.

Audit personnel available for this year's audit are most of the staff from last year, including Mr Mendis, an audit partner and Mr Pillans, an audit senior. You are aware that Allyson Mendis, the daughter of Mr Mendis, has recently been appointed as financial director at Ancients Plc.

To celebrate her new appointment, Allyson has suggested taking all of the audit staff out to an expensive restaurant prior to the start of the audit work for this year.

Required

(1) Analyse the threats to independence arising in carrying out your audit of De Abrew Plc for the year ending 30 June 20X6 (6 marks)

(2) Outline ways of mitigating each of the threats you identify. (4 marks)

(LO 7.4.1) (Total =10 marks)

31 Devapriya & Co

Devapriya & Co (Devapriya) is a firm of Chartered Accountants which has seen its revenue decline steadily over the past few years. The firm is looking to increase its revenue and client base and so has developed a new advertising strategy where it has guaranteed that its audits will minimise disruption to companies as they will not last longer than two weeks. In addition, Devapriya has offered all new audit clients a free accounts preparation service for the first year of the engagement, as it is believed that time spent on the audit will be reduced if the firm has produced the financial statements.

The firm is seeking to reduce audit costs and has therefore decided not to update the engagement letters of existing clients, on the basis that these letters do not tend to change much on a yearly basis. One of Devapriya's existing clients has proposed that this year's audit fee should be based on a percentage of their final pre-tax profit. The partners are excited about this option as they believe it will increase the overall audit fee.

Required

(1) Analyse FOUR ethical threats which arise from the above actions of Devapriya & Co. (5 marks)

(2) Outline, for each threats identified in (1) the steps which Devapriya & Co should adopt to reduce the threats arising. (5 marks)

(LO 2.1, 7.4.1) (Total = 10 marks)

32 Dharsha and Saram

You are the senior partner with Dharsha and Saram, a medium-sized accountancy and audit firm. You and your partners are keen to expand the business, and have actively been seeking new audit clients. As a result, you find yourself with three potential new clients:

Colombo (Pvt) Ltd recently removed its previous auditor, Kandy & Co, as the directors were unhappy with the level of service provided. Your firm approached Kandy & Co, but they refused to give you professional clearance or the usual handover information. The reason they gave you is that they are still owed fees from Colombo (Pvt) Ltd.

The sister of one of the firm's partners has recently set up a small company, Galle (Pvt) Ltd. Because she is keen to help her family, and knows that Dharsha and Saram are looking to expand, she has asked the firm to become Galle (Pvt) Ltd's auditor.

For several years, you have prepared the financial statements for Negombo (Pvt) Ltd. Although the company is small enough to take advantage of the small company audit exemption, the bank has now requested that Negombo (Pvt) Ltd should have their annual accounts audited. Negombo (Pvt) Ltd's directors have asked Dharsha and Saram to carry out the audit in future as well as preparing the company's financial statements.

Required

Analyse whether Dharsha and Saram should accept appointment in the case of each company identified above.

(LO 7.4.1, 7.5.3) (10 marks)

33 Estarellas Plc

You have been the auditor of manufacturing company Estarellas Plc for many years. The company is being taken to court for illegally polluting the river near one of its factories.

Although you were unaware that the company's practice of discharging pollution into the river was illegal, you were aware that it was happening. In fact, the audit files contain details about the company's production methods which would certainly prove that they are guilty.

The court has asked you to provide them with any information which you have related to this matter. The directors of Estarellas have forbidden you from handing the documents over to the court claiming that you have no right to provide the court with this information as it is confidential.

Required

(1) Outline the requirements for auditors to maintain confidentiality in respect of client information. (4 marks)

(2) Outline the circumstances where an auditor may be required or permitted to disclose confidential information about a client and what the auditor must do in respect of the audit documents for Estarellas. (6 marks)

(LO 7.4.1) (Total = 10 marks)

Section 3: Long Form Questions

Long questions

Questions 1 to 29 are 20-mark questions, each covering several different areas of the syllabus.

1 Puttalam (Pvt) Ltd

Introduction

Puttalam (Pvt) Ltd (Puttalam) assembles specialist motor vehicles such as lorries, buses and trucks. The company owns four assembly plants to which parts are delivered and assembled into the motor vehicles.

Wages system – shift workers

Shift-workers arrive for work at about 7.00 am and 'clock in' using an electronic identification card. The card is scanned by the time recording system and each production shift-worker's identification number is read from their card by the scanner. Shift-workers are paid from the time of logging in. The logging in process is not monitored as it is assumed that shift-workers would not work without first logging in on the time recording system.

At least 400 vehicles have to be manufactured each day by each work group. The workers normally work a standard eight hour day, but if necessary, overtime is worked to complete the day's quota of vehicles. The shift foreman is not required to monitor the extent of any overtime working although the foreman does ensure workers are not taking unnecessary or prolonged breaks which would automatically increase the amount of overtime worked. Shift-workers log off at the end of each shift by re-scanning their identification card.

Payment of wages

Details of hours worked each week are sent electronically to the payroll department, where hours worked are allocated by the computerised wages system to each employee's wages records. Staff in the payroll department compare hours worked from the time recording system to the computerised wages system and enter a code word to confirm the accuracy of transfer. The code word also acts as authorisation to calculate net wages. The code word is the name of a domestic cat belonging to the department head and is therefore generally known around the department.

Each week the computerised wages system calculates:

(i) Gross wages, using the standard rate and overtime rates per hour for each employee

(ii) Statutory deductions from wages

(iii) Net pay

The list of net pay for each employee is sent over Puttalam's internal network to the accounts department. In the accounts department, an accounts clerk ensures that employee bank details are on file. The clerk then authorises and makes payment to those employees using Puttalam's online banking systems. Every few weeks, the financial accountant reviews the total amount of wages made to ensure that the management accounts are accurate.

Salaries system – shift managers

All shift managers are paid an annual salary; there are no overtime payments.

Salaries were increased in July by 3% and an annual bonus of 5% of salary was paid in November.

Required

(1) Analyse the wages system of Puttalam and write a report to management which includes:

- (i) FIVE deficiencies in that system.
- (ii) The possible effect of each deficiency.
- (iii) A recommendation to alleviate each deficiency. (17 marks)

(2) Explain THREE substantive analytical procedures you should perform on the shift managers' salary system. (3 marks)

(LO 1.2, 3.5) (Total = 20 marks)

2 Mannar (Pvt) Ltd

Introduction

Mannar (Pvt) Ltd (Mannar) is a manufacturer of children's building block toys; they have been trading for over 35 years and they sell to a wide variety of customers including large and small toy retailers across the country. The company's year end is 31 March 20X1.

The company has a large manufacturing plant, four large warehouses and a head office. Upon manufacture, the toys are stored in one of the warehouses until they are dispatched to customers. The company does not have an internal audit department.

Sales ordering, goods dispatched and invoicing

Each customer has a unique customer account number and this is used to enter sales orders when they are received in writing from customers. The orders are entered by an order clerk and the system automatically checks that the goods are available and that the order will not take the customer over their credit limit. For new customers, a sales manager completes a credit application; this is checked through a credit agency and a credit limit entered into the system by the credit controller. The company has a price list, which is updated twice a year. Larger customers are entitled to a discount; this is agreed by the sales director and set up within the customer master file.

Once the order is entered an acceptance is automatically sent to the customer by mail/email confirming the goods ordered and a likely dispatch date. The order is then sorted by address of customer. The warehouse closest to the customer receives the order electronically and a dispatch list and sequentially numbered goods dispatch notes (GDNs) are automatically generated. The warehouse team pack the goods from the dispatch list and, before they are sent out, a second member of the team double checks the dispatch list to the GDN, which accompanies the goods.

Once dispatched, a copy of the GDN is sent to the accounts team at head office and a sequentially numbered sales invoice is raised and checked to the GDN. Periodically a computer sequence check is performed for any missing sales invoice numbers.

Fraud

During the year a material fraud was uncovered. It involved cash/cheque receipts from customers being diverted into employees' personal accounts. In order to cover up the fraud, receipts from subsequent unrelated customers would then be recorded against the earlier outstanding receivable balances and this cycle of fraud would continue.

The fraud occurred because two members of staff 'who were related' colluded. One processed cash receipts and prepared the weekly bank reconciliation; the other employee recorded customer receipts in the sales ledger. An unrelated sales ledger clerk was supposed to send out monthly customer statements but this was not performed. The bank reconciliations each had a small unreconciled amount but no-one reviewed the reconciliations after they were prepared. The fraud was only uncovered when the two employees went on holiday at the same time and it was discovered that cash receipts from different customers were being applied to older receivable balances to hide the earlier sums stolen.

Required

(1) Explain FIVE tests of controls the auditor would normally carry out on the sales system of Mannar, including the objective for each test. (10 marks)

(2) Outline THREE substantive procedures the auditor should perform to confirm Mannar's year-end receivables balance. (3 marks)

(3) Explain FOUR controls which Mannar should implement to reduce the risk of fraud occurring again and, for each control, outline how it would mitigate the risk. (4 marks)

(4) Outline THREE substantive procedures the auditor should perform to confirm Tinkerbell's revenue. (3 marks)

(LO 1.2, 1.3, 2.5, 3.1) (Total = 20 marks)

3 Pear Plc

Pear Plc (Pear) is a manufacturer of electrical equipment. It has factories across the country and its customer base includes retailers as well as individuals, to whom direct sales are made through their website. The company's year end is 31 March 20X2. You are an audit supervisor of Apple & Co and are currently reviewing documentation of Pear's internal control in preparation for the interim audit.

Pear's website allows individuals to order goods directly, and full payment is taken in advance. Currently the website is not integrated into the inventory system and inventory levels are not checked at the time when orders are placed.

Goods are dispatched via local couriers, however they do not always record customer signatures as proof that the customer has received the goods. Over the past 12 months there have been customer complaints about the delay between sales orders and receipt of goods. Pear has investigated these and found that, in each case, the sales order had been entered into the sales system correctly but was not forwarded to the dispatch department for fulfilling.

Pear's retail customers undergo credit checks prior to being accepted and credit limits are set accordingly by sales ledger clerks. These customers place their orders through one of the sales team, who decides on sales discount levels.

Raw materials used in the manufacturing process are purchased from a wide range of suppliers. As a result of staff changes in the purchase ledger department, supplier statement reconciliations are no longer performed. Additionally, changes to supplier details in the purchase ledger master file can be undertaken by purchase ledger clerks as well as supervisors.

In the past six months Pear has changed part of its manufacturing process and as a result some new equipment has been purchased, however, there are considerable levels of plant and equipment which are now surplus to requirement. Purchase requisitions for all new equipment have been authorised by production supervisors and little has been done to reduce the surplus of old equipment.

Required

(1) Explain the auditor's responsibilities in relation to an entity's system of internal controls. (2 marks)

(2) Outline, in respect of the internal control of Pear:

- (i) Four deficiencies.
- (ii) A control to address each of these deficiencies.
- (iii) A test of control Apple & Co would perform to assess if each of these controls is operating effectively. (12 marks)

(3) Outline substantive procedures you should perform at the year end to confirm each of the following for plant and equipment:

(i) Additions

(ii) Disposals (6 marks)

(LO 1.2.2, 1.3.1, 2.5.1, 3.1.2) (Total = 20 marks)

4 Tempest (Pvt) Ltd

You are the audit manager in charge of the audit of Tempest (Pvt) Ltd (Tempest). The company's year end is 31 March, and Tempest has been a client for seven years. The company purchases and resells fittings for ships including anchors, compasses, rudders, sails etc. Clients vary in size from small businesses making yachts to large companies maintaining large luxury cruise ships. No manufacturing takes place in Tempest.

Information on the company's financial performance is available as follows:

	20X7 Forecast	20X6 Actual
	RS. '000	RS. '000
Revenue	45,928	40,825
Cost of sales	(37,998)	(31,874)
Gross profit	7,930	8,951
Administration costs	(4,994)	(4,758)
Distribution costs	(2,500)	(2,500)
Net profit	436	1,693
Non-current assets (at carrying amount)	3,600	4,500
Current assets		
Inventory	200	1,278
Receivables	6,000	4,052
Cash and bank	500	1,590
Total assets	10,300	11,420
Capital and reserves		
Share capital	1,000	1,000
Accumulated profits	5,300	5,764
Total shareholders' funds	6,300	6,764
Non-current liabilities	1,000	2,058
Current liabilities	3,000	2,598
	10,300	11,420

Other information

The industry that Tempest trades in has seen moderate growth of 7% over the last year.

- Non-current assets mainly relate to company premises for storing inventory. Ten delivery vehicles are owned with a carrying amount of Rs. 300,000.
- One of the directors purchased a yacht during the year.
- Inventory is stored in ten different locations across the country, with your firm again having offices close to seven of those locations.
- A computerised inventory control system was introduced in January 20X7. Inventory balances are now obtainable directly from the computer system. The client does not intend to count inventory at the year-end but rely instead on the computerised inventory control system.

Required

(1) Explain why it is important to plan an audit, giving examples to illustrate your answer. (5 marks)

(2) Assess the appropriate value of materiality for the financial statements as a whole. (3 marks)

(3) Analyse the high risk areas of the audit of Tempest. (5 marks)

(4) Suggest the overall audit approach which should be taken in respect of the issues you have identified. (7 marks)

(LO 2.2.1, 2.4.1, 2.3.1, 2.5.1) (Total = 20 marks)

5 Ajantha Plc

Ajantha Plc (Ajantha) develops, manufactures and sells a range of pharmaceuticals and has a wide customer base across Europe and Asia. You are the audit manager of Nate & Co and you are planning the audit of Ajantha whose financial year end is 31 March. You attended a planning meeting with the finance director and engagement partner and are now reviewing the meeting notes in order to produce the audit strategy and plan. Revenue for the year is forecast at Rs. 25 million.

During the year the company spent Rs. 2.2 million on developing several new products. Some of these are in the early stages of development whilst others are nearing completion. The finance director has confirmed that all projects are likely to be successful and so he is intending to capitalise the full Rs. 2.2 million.

Once products have completed the development stage, Ajantha begins manufacturing them. At the year end it is anticipated that there will be significant levels of work in progress. In addition the company uses a standard costing method to value inventory; the standard costs are set when a product is first manufactured and are not usually updated. In order to fulfil customer orders promptly, Ajantha has warehouses for finished goods located across Europe and Asia; approximately one third of these are third party warehouses where Ajantha just rents space.

In September a new accounting package was introduced. This is a bespoke system developed by the information technology (IT) manager. The old and new packages were not run in parallel as it was felt that this would be too onerous for the accounting team. Two months after the system changeover the IT manager left the company; a new manager has been recruited but is not due to start work until January.

In order to fund the development of new products, Ajantha has restructured its finance and raised Rs. 1 million through issuing shares and Rs. 2.5 million through a long-term loan. There are bank covenants attached to the loan, the main one relating to a minimum level of total assets. If these covenants are breached then the loan becomes immediately repayable. The company has a policy of revaluing land and buildings, and the finance director has announced that all land and buildings will be revalued as at the year end.

The reporting timetable for audit completion of Ajantha is quite short, and the finance director would like to report results even earlier this year.

Required

(1) Outline the auditor's ethical responsibilities with regard to client confidentiality and when they have a right or responsibility to disclose client information. (4 marks)

(2) Analyse the audit risks from the information above. (6 marks)

(3) Outline the auditor's response to each identified risk in planning the audit of Ajantha. (6 marks)

(4) Outline substantive procedures you should perform to obtain sufficient appropriate evidence in relation to:

  (i) Inventory held at the third party warehouses

  (ii) Use of standard costs for inventory valuation (4 marks)

(LO 7.4.1, 2.3.1, 2.5.1, 3.1.1) (Total = 20 marks)

6 Glo-warm

Glo-Warm (Pvt) Ltd (Glo-warm), manufactures various heating products which it sells to both high street and catalogue retailers.

The statement of financial position for the years ended 20X7 and 20X6 are set out below. Last year, materiality for the financial statements as a whole was set at Rs. 10,000.

	20X7		20X6	
	Rs'000	Rs'000	Rs'000	Rs'000
Non-current assets				
Tangible non-current assets		20		21
Investments		2		2
Current assets				
Inventory	52		179	
Receivables	78		136	
Cash at bank	12		34	
Cash in hand	1		1	
	143		350	
Total assets		165		373
Current liabilities				
Trade payables	121		133	
Bank loan	5		5	
	126		138	
Long-term liabilities				
Bank loan		20		25
Provision*		20		–
Capital and reserves				
Share capital		2		2
Reserves		(3)		208
Total liabilities		165		373

*The provision of Rs. 20,000 consists entirely of a warranty provision.

Required

(1) Discuss whether the materiality level for the financial statements as a whole used in 20X6 will be appropriate for this year's audit, giving reasons for your answer. (3 marks)

(2) Analyse the statement of financial position given above and state the areas in which audit work should be concentrated, giving reasons in each case. (12 marks)

(3) Outline the impact on the auditor's report if the auditor concludes, on completion of the audit, that there is a material uncertainty regarding going concern. (5 marks)

(LO 2.2.1, 2.4.1, 2.3.1, 5.4.1) (Total = 20 marks)

7 Shantha Holidays

Shantha Holidays is an independent travel agency. It does not operate holidays itself. It takes commission on holidays sold to customers through its chain of high street shops. Staff are partly paid on a commission basis. Well-established tour operators run the holidays that Shantha Holidays sells. The networked reservations system through which holidays are booked and the computerised accounting system are both well-established systems used by many independent travel agencies.

Payments by customers, including deposits, are accepted in cash and by debit and credit card. Shantha Holidays is legally required to pay an amount of money (based on its total sales for the year) into a central fund maintained to compensate customers if the agency should cease operations.

(1) Explain how an internal audit function helps an entity deal with the risk of fraud and error. (5 marks)

(2) Discuss the responsibilities of external auditors in respect of the risk of fraud and error in an audit of financial statements. (9 marks)

(3) Analyse the nature of the risks affecting Shantha Holidays which arise from fraud and error. (6 marks)

(LO 2.3.1) (Total = 20 marks)

8 Minty Cola Plc

Minty Cola Plc (Minty) manufactures fizzy drinks such as cola and lemonade as well as other soft drinks and its year end is 31 March 20X3. You are the audit manager of Premaratne & Co and are currently planning the audit of Minty. You attended the planning meeting with the engagement partner and finance director last week and recorded the minutes from the meeting shown below. You are reviewing these as part of the process of preparing the audit strategy.

Minutes of planning meeting for Minty

Minty's trading results have been strong this year and the company is forecasting revenue of Rs. 85 million, which is an increase from the previous year. The company has invested significantly in the cola and fizzy drinks production process at the factory. This resulted in expenditure of Rs. 5 million on updating, repairing and replacing a significant amount of the machinery used in the production process.

As the level of production has increased, the company has expanded the number of warehouses it uses to store inventory. It now utilises 15 warehouses; some are owned by Minty and some are rented from third parties. There will be inventory counts taking place at all 15 of these sites at the year end.

A new accounting general ledger has been introduced at the beginning of the year, with the old and new systems being run in parallel for a period of two months.

As a result of the increase in revenue, Minty has recently recruited a new credit controller to chase outstanding receivables. The finance director thinks it is not necessary to continue to maintain an allowance for receivables and so has released the opening allowance of Rs. 1.5 million.

In addition, Minty has incurred expenditure of Rs. 4.5 million on developing a new brand of fizzy soft drinks. The company started this process in January 20X3 and is close to launching the new product into the market place. The finance director stated that there was a problem in November in the mixing of raw materials within the production process which resulted in a large batch of cola products tasting different. A number of these products were sold; however, due to complaints by customers about the flavour, no further sales of these goods have been made. No adjustment has been made to the valuation of the damaged inventory, which will still be held at cost of Rs. 1 million at the year end.

As in previous years, the management of Minty is due to be paid a significant annual bonus based on the value of year-end total assets.

Required

(1) Analyse the minutes provided, to identify SIX audit risks relevant to planning the audit of Minty Cola Plc. (6 marks)

(2) Outline the auditor's response to each risk in planning the audit of Minty Cola Plc (6 marks)

(3) Outline substantive procedures the audit team should perform to obtain sufficient and appropriate audit evidence in relation to the following three matters:

(i) The treatment of the Rs. 5 million expenditure incurred on improving the factory production process (3 marks)

(ii) The release of the Rs. 1.5 million allowance for receivables (3 marks)

(iii) The damaged inventory (2 marks)

(LO 1.1.1, 2.3.1, 3.1.1) (Total = 20 marks)

9 Vakarai (Pvt) Ltd

You are the audit senior of Vaas & Co and are planning the audit of Vakarai (Pvt) Ltd (Vakarai) for the year ended 31 March 20X4. The company produces printers and has been a client of your firm for two years. Your audit manager has already had a planning meeting with the finance director. He has provided you with the following notes of his meeting and financial statement extracts.

Vakarai's management were disappointed with the 20X3 results and so in 20X4 undertook a number of strategies to improve the trading results. This included the introduction of a generous sales-related bonus scheme for their salesmen and a high profile advertising campaign. In addition, as market conditions are difficult for their customers, they have extended the credit period given to them.

The finance director of Vakarai has reviewed the inventory valuation policy and has included additional overheads incurred this year as he considers them to be production related.

The finance director has calculated a few key ratios for Vakarai; the gross profit margin has increased from 44.4% to 52.2% and receivables days have increased from 61 days to 71 days. He is happy with the 20X4 results and feels that they are a good reflection of the improved trading levels.

Financial statement extracts for year ended 31 March

	DRAFT 20X4 Rs Mn	ACTUAL 20X3 Rs Mn
Revenue	23.0	18.0
Cost of sales	(11.0)	(10.0)
Gross profit	12.0	8.0
Operating expenses	(7.5)	(4.0)
Profit before interest and taxation	4.5	4.0
Inventory	2.1	1.6
Receivables	4.5	3.0
Cash	–	2.3
Trade payables	1.6	1.2
Overdraft	0.9	–

Required

(1) Analyse the information above to identify FIVE audit risks. Your answer should include the calculation of two additional ratios for both years. (7 marks)

(2) Outline the auditor's response to each risk in planning the audit of Vakarai. (5 marks)

(3) Outline the procedures that Vaas & Co should perform in assessing whether or not the company is a going concern. (4 marks)

(4) Explain the possible auditor's reports that can be issued where the going concern status of a company is called into question. (4 marks)

(LO 2.3.1, 2.5.1, 3.6.1, 3.7.1, 5.3.1, 5.4.1) (Total = 20 marks)

10 Fonseca Distributors (Pvt) Ltd

Fonseca Distributors (Pvt) Ltd (Fenton) is a small company which maintains its sales, purchase and general ledgers on a small PC, using a standard computerised accounting package. The company buys products from large manufacturers and sells them to shops which either sell or hire them to the general public. The products include drain clearing machines, portable generators, garden cultivators and wallpaper strippers.

You have been asked to carry out an audit of the general ledger system to verify that items are accurately recorded in the year. At the end of the year, the general ledger produces a trial balance, which is used to prepare the annual accounts.

The company employs a bookkeeper, who is responsible for posting the sales and purchase ledgers, and maintaining the general ledger. Data is posted to the general ledger as follows.

(a) At the start of the financial year, all the balances on the general ledger accounts are set to zero (using the standard year-end procedure of the computer package).

(b) The following procedures relate to purchase transactions.

  (i) When invoices are posted to the purchase ledger, the purchase analysis code (for the general ledger), the purchases value and the sales tax value are entered. The total invoice value is posted to the purchase ledger.

  (ii) At the end of the month, the computer posts the following items to the general ledger.

    – The total of each category of invoice expense and sales tax for purchase invoices and credit notes posted in the month (at the same time the computer prints details of the individual invoices making up the total of each invoice expense and sales tax for the month).

    – The total of purchase ledger cash payments, discount received and adjustments posted to the purchase ledger in the month (the computer prints details of the individual items comprising the total cash discount and adjustments for the month).

    – Where there is no account in the general ledger relating to the items being posted, the computer posts the items to a payables suspense account. Also, all adjustments are posted to the suspense account.

(c) Sales ledger data is posted to the general ledger in a similar way to purchase ledger data.

(d) Journals are posted manually to the general ledger for:

(i) The opening balances at the start of the year

(ii) Other cash book items (other than sales and purchase ledger cash)

(iii) Petty cash payments

(iv) Wages analysis (details are obtained from the computerised payroll system)

(v) Adjustments, which include:

– Correction of errors

– Dealing with items in the sale and purchase ledger suspense accounts (adjustments posted to the ledger, and items where there is no account in the general ledger)

All these journals are written manually in an accounts journal book, and they must be authorised by the managing director before posting. The opening balances are posted to the general ledger when the previous year's accounts have been approved by the auditors. Although the employee wages are calculated using another computer package, the total wages expense is posted to the general ledger manually. The wages expense is calculated from the payroll's monthly summary, using a spreadsheet package, and the wages expense is analysed into directors, sales, warehouse and office wages (or salaries).

Required

(1) Outline the audit procedures you would perform to verify the key assertions for purchases transactions which are posted to the general ledger. (5 marks)

(2) Outline the audit procedures you would perform to verify the key assertions for journals posted to the general ledger, including adjusting journals. (10 marks)

(3) Outline any other tests you would perform to verify the key assertions for the year-end balances on the general ledger. (5 marks)

(LO 3.1.1, 3.3.1) (Total = 20 marks)

11 Kelanyia Joinery (Pvt) Ltd

Kelanyia Joinery (Pvt) Ltd (Kelanyia), which is owned by its directors, manufactures wooden window frames, doors and staircases for houses. It has prepared draft accounts for the year ended 31 March 20X6 and you are concerned that they indicate serious going concern problems. The statements of profit or loss and statements of financial position for the last five years (each ended 31 March) are given below.

STATEMENT OF PROFIT OR LOSS

	20X2	20X3	20X4	20X5	20X6
	Rs'000	Rs'000	Rs'000	Rs'000	Rs'000
Sales	625	787	1,121	1,661	1,881
Cost of sales	(478)	(701)	(962)	(1,326)	(1,510)
Gross profit	147	86	159	335	371
Other expenses	(88)	(86)	(161)	(240)	(288)
Interest	(6)	(9)	(58)	(90)	(117)
Net profit/(loss)	53	(9)	(60)	5	(34)

STATEMENT OF FINANCIAL POSITION

	20X2	20X3	20X4	20X5	20X6
	Rs'000	Rs'000	Rs'000	Rs'000	Rs'000
Assets					
Current assets					
Inventory	67	133	181	307	449
Trade accounts receivable	91	240	303	313	364
	158	373	484	620	813
Net current assets	89	161	544	600	587
Total assets	247	534	1,028	1,220	1,400
Liabilities and shareholders' funds					
Current liabilities					
Trade accounts payable	90	317	355	490	641
Bank overdraft	10	65	211	269	365
Lease creditor	14	28	98	92	59
	114	410	664	851	1,065
Non-current loan	–	–	300	300	300
	114	410	964	1,151	1,365
Shareholders' funds					
Share capital	17	17	17	17	17
Reserves	116	107	47	52	18
	133	124	64	69	35
Total liabilities and shareholders' funds	247	534	1,028	1,220	1,400

The company has been in business for about 15 years. In January 20X3 it decided to build a new factory on a site leased from the local authority which would allow a major increase in sales. This new factory with new equipment was completed a year later. The factory was financed by a non-current loan of Rs. 300,000 from a merchant bank and an increase in the bank overdraft.

The loan from the merchant bank is secured by a fixed charge on the leasehold factory and the bank overdraft is secured by a second charge on the leasehold factory, a fixed charge on the other non-current assets and a floating charge on the current assets.

The company purchases its main raw material, wood, from timber wholesalers. It sells around 75% of its production to about 12 local and national builders of new houses. The remaining sales are mainly to smaller builders, with a very few sales to local builders merchants.

On 1 April 20X6, a local builder went into liquidation. The builder had a trade receivable of Rs. 15,000 owing to Kelanyia at year end. The day after the auditor's report was signed a fire destroyed one of Kelanyia's factories. The financial statements had not yet been issued.

Required

(1) Outline the responsibilities of auditors for the discovery of (i) the builder that went into liquidation after year end and (ii) the fire at Kelanyia's factory. For each event explain whether it is an adjusting or non-adjusting event. (6 marks)

(2) Assess the financial statements above so as to identify the factors which indicate that the company may not be a going concern. You should also highlight certain figures and calculate relevant ratios in the accounts.

(8 marks)

(3) Outline the procedures you would carry out to determine whether the company is a going concern. (6 marks)

(LO 2.6.1, 3.1.1, 3.5.1, 3.6.1, 3.7.1) (Total = 20 marks)

12 Turbo Plc

You are an audit senior for Purnell & Co, and Turbo Plc (Turbo) is a longstanding audit client of your firm. You have started the planning for the audit of Turbo for the year ended 31 March 20X1. You have obtained the following information from the previous year's file and from preliminary discussions with management.

Background and revenue sources

Turbo is a magazine publisher. It publishes a number of titles, all of which are weekly or monthly car and motorcycle magazines. The magazines are sold to supermarkets and newsagents who then sell them to the general public. Turbo generates its income in two ways: from the sale of the magazines themselves and from selling advertising space in the magazines to companies who want to promote their cars or motorcycles. The revenue split has typically been around 50% in total for each sale type.

The key advertisers are large household names in the car and motorcycle industry. Turbo has to negotiate contracts with these advertisers for the provision of advertising space. These contracts can vary in length and can range from between one month and six months. The contract will set out all details of the arrangement including the price of the adverts, the number or size of the adverts and how often the advertisements will appear. An invoice is raised on the date of the first advertisement and the advertisers pay within ten days of this for shorter contracts. For six month contracts the advertising fees are paid for by Turbo's customers in two instalments (half of the fee on the first date of advertising and the rest after three months). If recurring contracts have not been re-signed by the date advertising is meant to start Turbo raises an invoice based on the last contract and the paperwork is sorted out later. A few of the larger contracts run up to 31 March 20X1.

In respect of the magazine sales Turbo offers the supermarkets and newsagents up to 45 days credit but many of the newsagents are struggling financially and tend to take longer than this to pay their invoices.

Trading conditions

In the last ten years the market for the magazines has become more and more competitive resulting in Turbo needing to discount magazine prices. There is also increasing pressure from online competition and Turbo's revenue has been gradually decreasing over the last few years. This year has been a particularly bad year because difficult economic conditions have resulted in reductions in advertising revenue because many of the car and motorcycle manufacturers that advertise in the magazines have seen their marketing budgets slashed and have renegotiated their contract terms.

Other relevant information

Turbo does not employ journalists or photographers for their magazines. Instead they use the best self-employed journalists, commentators and photographers in the industry. However due to their numerous commitments, these freelancers often get behind on their paperwork and don't get round to sending in their invoices to Turbo until a month or more after they have written their article or provided the photos requested.

Turbo prints its own magazines and as a result has a significant amount of plant and equipment. Turbo has been around for a number of years now and the equipment had become quite old and inefficient compared to that used by newly formed competitors. As a result in December 20X0 extensive refurbishment of the printing equipment took place and this expenditure will be material to the financial statements. The heavy investment in refurbishment and declining revenues has seen Turbo operate close to its overdraft limit during the last six months. Although there is likely to be a small profit for the year, the management accounts for last six months show an operating loss.

The company would like to apply for a bank loan to ease cash flow concerns and has discussed this with its bank. However the initial response from the bank was not overwhelmingly positive due to the competitive market Turbo operates in. As a result Turbo needs to produce a cash flow forecast for the bank showing where the cash will be generated to pay back any loan. The bank also wants to see audited financial statements for the year to 31 March 20X1 before the end of April 20X1.

Required

(1) Explain the difference between the overall audit strategy and the audit plan and outline the key contents of the overall audit strategy document. (4 marks)

(2) Define 'performance materiality', contrasting it with materiality for the financial statements as a whole. Recommend an appropriate materiality benchmark to be used in the audit of Turbo, giving reasons. (4 marks)

(3) Analyse the information provided, so as to (i) identify SIX risks of material misstatement and (ii) outline the auditor's response to each risk in planning the audit of Turbo. (12 marks)

(LO 2.2.1, 2.4.1, 2.3.1, 2.5.1, 3.2.1) (Total = 20 marks)

13 Ratnapura Manufacturing (Pvt) Ltd

You are the audit assistant assigned to the audit of Ratnapura Manufacturing (Pvt) Ltd (Ratnapura). The audit senior has asked you to plan the audit of non-current assets. He has provisionally assessed materiality at Rs. 72,000.

Ratnapura maintains a register of non-current assets. The management accountant reconciles a sample of entries to physical assets and vice versa on a three-monthly basis. Authorisation is required for all capital purchases. Items valued less than Rs. 10,000 can be authorised by the production manager, but items costing more than Rs. 10,000 must be authorised by the Managing Director. The purchasing department will not place an order for capital goods unless it has been duly signed.

The company has invested in a large amount of new plant this year in connection with an eight year project for a government department.

The management accountant has provided you with the following schedule of non-current assets:

	Land and buildings Rs.	Plant and equipment Rs.	Computers Rs.	Motor vehicles Rs.	Total Rs.
Cost					
At 31 March 20X6	500,000*	75,034	30,207	54,723	659,964
Additions		250,729	1,154		251,883
At 31 March 20X7	500,000	325,763	31,361	54,723	911,847
Accumulated depreciation					
At 31 March 20X6	128,000	45,354	21,893	25,937	221,184
Charge for the year	8,000	28,340	2,367	13,081	51,788
At 31 March 20X7	136,000	73,694	24,260	39,018	272,972
Carrying amount					
At 31 March 20X7	364,000	252,069	7,101	15,705	638,875
At 31 March 20X6	372,000	29,680	8,314	28,786	438,780

*Of which, Rs. 100,000 relates to land.

Required

(1) Analyse the risks relating to the audit of the tangible non-current assets under the headings of inherent risk, control risk and detection risk., drawing a conclusion about the overall risk of the audit. (You are not required to perform any calculations). (4 marks)

(2) Explain the factors that influence the sufficiency and reliability of audit evidence. (4 marks)

(3) Outline the audit procedures you would undertake on non-current assets in respect of the following assertions:

(i) Existence (4 marks)
(ii) Valuation (excluding depreciation) (4 marks)
(iii) Completeness (4 marks)

(LO 2.3.1, 3.1.1) (Total = 20 marks)

14 Snu

Snu is a family-owned company which retails beds, mattresses and other bedroom furniture items. The company's year-end is 31 December 20X3. The only full inventory count takes place at the year-end. The company maintains up-to-date computerised inventory records.

Where the company delivers goods to customers, a deposit is taken from the customer and customers are invoiced for the balance after the delivery. Some goods that are in inventory at the year-end have already been paid for in full – customers who collect goods themselves pay by cash or credit card.

Staff at the company's warehouse and shop will conduct the year-end count. The shop and warehouse are open seven days a week except for two important public holidays during the year, one of which is 1 January. The company is very busy in the week prior to the inventory count but the shops will close at 15.00 hours on 31 December and staff will work until 17.00 hours to prepare the inventory for counting. The company has a high turnover of staff. The following inventory counting instructions have been provided to staff at Snu.

(i) The inventory count will take place on 1 January 20X4 commencing at 09.00 hours. No movement of inventory will take place on that day.

(ii) The count will be supervised by Mr Sneg, the inventory controller. All staff will be provided with pre-printed, pre-numbered inventory counting sheets that are produced by the computerised system. Mr Sneg will ensure that all sheets are issued, and that all are collected at the end of the count.

(iii) Counters will work on their own, because there are insufficient staff for them to work in pairs, but they will be supervised by Mr Sneg and Mrs Zapad, an experienced shop manager who will make checks on the work performed by counters. Staff will count inventory with which they are most familiar in order to ensure that the count is completed as quickly and efficiently as possible.

(iv) Any inventory that is known to be old, slow-moving or already sold will be highlighted on the sheets. Staff are required to highlight any inventory that appears to be soiled or damaged.

(v) All inventory items counted will have a piece of paper attached to them that will show that they have been counted.

(vi) All inventory that has been delivered to customers but that has not yet been paid for in full will be added back to the inventory quantities by Mr Sneg.

Required

(1) Discuss why year-end inventory counting is important to the auditors of organisations that do not have perpetual inventory systems. (4 marks)

(2) Analyse the principal risks associated with the financial statement assertions relating to inventory. (4 marks)

(3) Outline (i) the deficiencies in Snu's inventory counting instructions, (ii) the implications of those deficiencies, and (iii) why these deficiencies are difficult to overcome. (12 marks)

(LO 3.1.2, 2.3.1, 1.2.3) (Total = 20 marks)

15 Homes'r'Us

Homes'r'Us is a large listed construction company based in the north of the country, whose activities encompass house building and development. Its annual revenue is Rs550m and profit before tax is Rs70m.

You are the audit senior involved with the audit of Homes'r'Us for the year ended 31 December 20X7. The following matters have come to your attention during the review stage of the audit in April 20X8:

(i) Customer going into liquidation

One of Homes'r'Us's major commercial customers has gone into liquidation shortly after the year end. As at the year end, the customer owed the company Rs7.5m.

(ii) Claim for unfair dismissal

One of the company's construction workers, Basil Evans, was dismissed in November 20X7 after turning up to work under the influence of alcohol. In December 20X7, Mr Evans began a case against the company for unfair dismissal. Lawyers for the company have advised that it will be highly unlikely that he will be successful in his claim.

(iii) In March 20X8 a fire was started by vandals at one of the company's ten storage depots, destroying Rs1m worth of building materials.

Required

For each of the three events at Homes'r'Us mentioned above:

(1) Describe the additional audit procedures you will carry out. (7 marks)

(2) State whether the financial statements will need to be amended and explain your reasoning. (7 marks)

(3) Discuss the potential impact on the auditor's report, fully explaining your answers. (6 marks)

(LO 5.1.1, 5.3.1) (Total = 20 marks)

16 Chandan

Chandan, a private limited liability company owned by equity investors and registered in Sri Lanka. It is the parent of a major conglomerate of businesses across different market sectors including food retailing, restaurants and hotels, manufacturing and professional training, It has extended its operations throughout Asia and most recently to Africa, where it is expanding rapidly.

You are a manager in Chileshe, a firm of CA Sri Lanka accountants. You have been approached by Felix Chandan, the chief finance officer of Chandan, relating to a bid that Chandan is proposing to make for the purchase of Zafi Training Institute (ZTI) to expand its professional training division. Also, you have been asked to explain the impact of new Sri Lanka Government Regulator audit requirements for its restaurant company. You have ascertained the following from a briefing note received from Felix.

Acquisition of a training company

ZTI provides training in management, communications and marketing to a wide range of corporate clients, including multi-nationals. The 'ZTI' name is well regarded in its areas of expertise. ZTI is currently wholly-owned by Frontiers, an international publisher of textbooks, whose shares are quoted on a recognised stock exchange. ZTI has a National and an International business.

The National business comprises 11 training centres. The audited financial statements show revenue of Rs37.5m and profit before taxation of Rs3.9m for this geographic segment for the year to 30 June 20X8. Most of the National business's premises are owned or held on long leases. Trainers in the National business are mainly full-time employees. Receivables related to the national business amount to Rs21.3m.

The International business has five training centres in Africa and Asia. For these segments, revenue amounted to Rs18.9m and profit before tax Rs7.2m for the year to 30 June 20X8. Most of the International business's premises are held on operating leases. International trade receivables at 30 June 20X8 amounted to Rs11.1m. Although the International centres employ some full-time trainers, the majority of trainers provide their services as freelance consultants.

Chandan is particularly concerned about the recoverability and validity of the receivables balances in relation to both the national and international centres and has enquired about the possibility of Chileshe carrying out agreed upon procedures on receivables on its behalf.

New audit regulation for restaurant industry

There is some discussion in the news that the Sri Lanka government may extend regulation of the Food preparation industry and require a separate set of audited accounts by prepared under a fair presentation framework which will be provided and defined by the regulator to comply with new government regulations. This framework is likely to require additional disclosures of food preparation health and safety procedures and expenditure although no further details are known at this stage.

The Board of Directors would like to understand the requirement for a further audit engagement which may be required by SLAuS 800 Special Considerations—Audits of Financial Statements prepared in accordance with Special Purpose Frameworks, and request that Chileshe prepare a summary of its main requirements.

Required

(1) Describe the nature and purpose of agreed upon procedures. (3 marks)

(2) Explain the matters which the auditor should consider before accepting an engagement to conduct the agreed upon procedures. (6 marks)

(3) Illustrate what procedures may be appropriate in the agreed upon procedures engagement outlined. (4 marks)

(4) Explain the principle special purpose framework audit engagement and auditor's report disclosures that the Chileshe will needs to include in their auditor's report to the Sri Lanka Regulator in line with the requirements of SLAuS 800. (7 marks)

(LO 5.5.1, 5.7.1, 6.1.1, 6.2.1) (Total = 20 marks)

17 Axis & Co

You are the manager responsible for four audit clients of Axis & Co, a firm of Chartered Accountants. The year end in each case is 30 June 20X8.

You are currently reviewing the audit working paper files and the audit seniors' recommendations for the auditor's reports. Details are as follows.

(1) Lorenze Co has changed its accounting policy for goodwill during the year from the inventory valuation method to annual impairment testing. No disclosure of this change has been given in the financial statements. The carrying amount of goodwill in the statement of financial position as at 30 June 20X8 is the same as at 30 June 20X7 as management's impairment test shows that it is not impaired.

The audit senior has concluded that a qualification is not required but suggests that attention can be drawn to the change by way of an emphasis of matter paragraph. (4 marks)

(2) The directors' report of Abrupt Co states that investment property rental forms a major part of revenue. However, a note to the financial statements shows that property rental represents only 1.6% of total revenue for the year. The audit senior is satisfied that the revenue figures are correct.

The audit senior has noted that an unmodified opinion should be given as the audit opinion does not extend to the directors' report. (4 marks)

(3) Audit work on the after-date bank transactions of Jingle Co has identified a transfer of cash from Bell Co. The audit senior assigned to the audit of Jingle has documented that Jingle's finance director explained that Bell commenced trading on 7 July 20X8, after being set up as a wholly-owned foreign subsidiary of Jingle.

The audit senior has noted that although no other evidence has been obtained an unmodified opinion is appropriate because the matter does not impact on the current year's financial statements. (4 marks)

Required

For each situation, recommend the suitability or otherwise of the audit senior's proposals for the auditor's reports. Where you disagree, recommend what audit modification (if any) should be given instead.

Note. The mark allocation is shown against each of the three issues.

(4) You are responsible for answering technical queries from other managers and partners of your firm. An audit partner left the following note on your desk this morning.

(i) 'I am about to draft the audit report for my client, Sycamore Co. I am going on holiday tomorrow and want to have the audit report signed and dated before I leave. The only thing outstanding is the written representation from management – I have verbally confirmed the contents with the finance director who agreed to send the representations to the audit manager within the next few days. I presume this is acceptable?' (4 marks)

(ii) 'We are auditing Sycamore Co for the first time. The prior period financial statements were audited by another firm. We are aware that the auditor's report on the prior period was qualified due to a material misstatement of trade receivables. We have obtained sufficient appropriate evidence that the matter giving rise to the misstatement has been resolved and I am happy to issue an unmodified opinion. But should I refer to the prior year modification in this year's auditor's report?' (4 marks)

Required

Advise on the audit partner's comments. (Total = 20 marks)

(LO 2.5, 2.6, 5.6)

18 Colombo

You are a manager in Sambora & Co, responsible for the audit of the Colombo Group (the Group), which is listed. The Group's main activity is steel manufacturing and it comprises a parent company and five subsidiaries. Sambora & Co currently audits all components of the Group.

You are working on the audit of the Group's financial statements for the year ended 30 June 20X2.

At the planning stage, materiality was initially determined to be Rs. 900,000, and was calculated based on the assumption that the Colombo Group is a high risk client due to its listed status. During the audit, a number of issues arose which meant that it was necessary to revise the materiality level for the financial statements as a whole. The revised level of materiality is now determined to be Rs. 700,000. One of the audit juniors was unsure as to why the materiality level had been revised.

The audit senior has provided you with the draft consolidated financial statements and accompanying notes which summarise the key audit findings and some background information.

The Group's draft consolidated financial statements, with notes referenced to key audit findings, are shown below.

DRAFT CONSOLIDATED STATEMENT OF PROFIT OR LOSS AND OTHER COMPREHENSIVE INCOME

	Notes	30 June 20X2 Draft Rs'000	30 June 20X1 Actual Rs'000
Revenue	1	98,795	103,100
Cost of sales		(75,250)	(74,560)
Gross profit		23,545	28,540
Operating expenses	2	(14,900)	(17,500)
Operating profit		8,645	11,040
Share of profit of associate		1,010	900
Finance costs		(380)	(340)
Profit before tax		9,275	11,600
Taxation		(3,200)	(3,500)
Profit for the year		6,075	8,100
Other comprehensive income/expense for the year, net of tax:			
Gains on property revaluation	3	800	–
Actuarial losses on defined benefit plan	4	(1,100)	(200)
Other comprehensive income/expense		(300)	(200)
Total comprehensive income for the year		5,775	7,900

Notes. Key audit findings – Statement of profit or loss and other comprehensive income

1 Revenue has been stable for all components of the Group with the exception of one subsidiary, Galle Plc, which has recognised a 25% decrease in revenue.

2 Operating expenses for the year to June 20X2 is shown net of a profit on a property disposal of Rs. 2 million. Our evidence includes agreeing the cash receipts to bank statement and sale documentation, and we have confirmed that the property has been removed from the non-current asset register.

3 The property revaluation relates to the Group's head office. The audit team have not obtained evidence on the revaluation, as the gain was immaterial based on the initial calculation of materiality.

4 The actuarial loss is attributed to an unexpected stock market crash. The Group's pension plan is managed by Axle Plc – a firm of independent fund managers who maintain the necessary accounting records relating to the plan. Axle Plc has supplied written representation as to the value of the defined benefit plan's assets and liabilities at 30 June 20X2. No other audit work has been performed other than to agree the figure from the financial statements to supporting documentation supplied by Axle Plc.

DRAFT CONSOLIDATED STATEMENT OF FINANCIAL POSITION

	Notes	30 June 20X2 Draft Rs'000	30 June 20X1 Actual Rs'000
ASSETS			
Non-current assets			
Property, plant and equipment		81,800	76,300
Goodwill	5	5,350	5,350
Investment in associate	6	4,230	4,230
Assets classified as held for sale	7	7,800	–
		99,180	85,880
Current assets			
Inventory		8,600	8,000
Receivables		8,540	7,800
Cash and cash equivalents		2,100	2,420
		19,240	18,220
Total assets		118,420	104,100
EQUITY AND LIABILITIES			
Equity			
Share capital		12,500	12,500
Revaluation reserve		3,300	2,500
Retained earnings		33,600	29,400
Non-controlling interest	8	4,350	4,000
Total equity		53,750	48,400
Non-current liabilities			
Defined benefit pension plan		10,820	9,250
Long-term borrowings	9	43,000	35,000
Deferred tax		1,950	1,350
Total non-current liabilities		55,770	45,600
Current liabilities			
Trade and other payables		6,200	7,300
Provisions		2,700	2,800
Total current liabilities		8,900	10,100
Total liabilities		64,670	55,700
Total equity and liabilities		118,420	104,100

Notes. Key audit findings – Statement of financial position

5 The goodwill relates to each of the subsidiaries in the Group. Management has confirmed in writing that goodwill is stated correctly, and our other audit procedure was to arithmetically check the impairment review conducted by management.

6 The associate is a 30% holding in Moratuwa Plc, purchased to provide investment income. The audit team have not obtained evidence regarding

the associate as there is no movement in the amount recognised in the statement of financial position.

7 The assets held for sale relate to a trading division of one of the subsidiaries, which represents one third of that subsidiary's net assets. The sale of the division was announced in May 20X2, and is expected to be complete by 31 December 20X2. Audit evidence obtained includes a review of the sales agreement and confirmation from the buyer, obtained in July 20X2, that the sale will take place.

8 Two of the Group's subsidiaries are partly owned by shareholders external to the Group.

9 A loan of Rs. 8 million was taken out in October 20X1, carrying an interest rate of 2%, payable annually in arrears. The terms of the loan have been confirmed to documentation provided by the bank.

Required

(1) Advise the audit junior as to why there may be a need to reassess materiality as the audit progresses. (4 marks)

(2) Evaluate whether the key audit findings indicate a risk of misstatement and the adequacy of audit evidence obtained. (16 marks)

(LO 2.2, 2.3, 2.4) (Total = 20 marks)

19 Beech

You are a manager in the audit department of Beech & Co, responsible for the audits of Fir Plc (Fir), Spruce Plc (Spruce), Pine Plc (Pine) and Oak Plc (Oak). Each company has a financial year ended 31 July 20X9, and the audits of all companies are nearing completion. The following issues have arisen in relation to the audit of accounting estimates and fair values.

(1) Fir Plc

Fir is a company involved in energy production. It owns several nuclear power stations, which have a remaining estimated useful life of 20 years. Fir intends to decommission the power stations at the end of their useful life and the statement of financial position at 31 July 20X9 recognises a material provision in respect of decommissioning costs of Rs. 97 million (20X0 – Rs. 110 million). A brief note to the financial statements discloses the opening and closing value of the provision but no other information is provided.

Required

Evaluate the matters that should be considered, and the audit evidence you should expect to find in your file review in respect of the decommissioning provision. (5 marks)

(2) Spruce Plc

Spruce is also involved in energy production. It has a trading division which manages a portfolio of complex financial instruments such as derivatives. The portfolio is material to the financial statements. Due to the specialist nature of these financial instruments, an auditor's expert was engaged to assist in obtaining sufficient appropriate audit evidence relating to the fair value of the financial instruments. The objectivity, capabilities and competence of the expert were confirmed prior to their engagement.

Required

Advise of the procedures that should be performed in evaluating the adequacy of the auditor's expert's work. (5 marks)

(3) Pine Plc

Pine operates a warehousing and distribution service, and owns 120 properties. During the year ended 31 July 20X9, management changed its estimate of the useful life of all properties, extending the life on average by ten years. The financial statements contain a retrospective adjustment, which increases opening non-current assets and equity by a material amount. Information in respect of the change in estimate has not been disclosed in the notes to the financial statements.

Required

Advise of the potential implications for the auditor's report of the accounting treatment of the change in accounting estimates. (5 marks)

(4) Poppy Plc

Poppy Plc is a manufacturing company. In the last year, several investment properties have been purchased to utilise surplus funds and to provide rental income. The properties have been revalued at the year end in accordance with LKAS 40 Investment property, they are recognised on the statement of financial position at a fair value of Rs. 8 million, and the total assets of Poppy are Rs. 160 million at 31 July 20X9. An external valuer has been used to provide the fair value for each property.

Required

Propose the principal audit procedures to be performed on the valuation of the investment properties. (5 marks)

Note. Assume it is 5 December 20X9.

(LO 2.2, 2.3, 2.4, 2.6, 2.7, 3.7) (Total 20 = marks)

20 Gills Group

You are a senior audit manager in Dolphin & Co, responsible for the audit of the Gills Group, which has been an audit client for several years. The group companies all have a financial year ending 30 June 20Y0, and you are currently planning the final audit of the consolidated financial statements. The group's operations focus on the manufacture and marketing of confectionery and savoury snacks. Information about several matters relevant to the group audit is given below. These matters are all potentially material to the consolidated financial statements. None of the companies in the group are listed.

Gills Co

This is a non-trading parent company, which wholly owns three subsidiaries – Shark Co, Barracuda Co and Piranha Co, all of which are involved with the core manufacturing and marketing operations of the group. This year, the directors decided to diversify the group's activities in order to reduce risk exposure. Non-controlling interests representing long-term investments have been made in two companies – an internet-based travel agent, and a chain of pet shops. In the consolidated statement of financial position, these investments are accounted for as associates, as Gills Co is able to exert significant influence over the companies.

As part of their remuneration, the directors of Gills Co receive a bonus based on the profit before tax of the group. In April 20Y0, the group finance director resigned from office after a disagreement with the chief executive officer over changes to accounting estimates. A new group finance director is yet to be appointed.

Shark Co

This company manufactures and distributes chocolate bars and cakes. In July 20X9, production was relocated to a new, very large factory. One of the conditions of the planning permission for the new factory is that Shark Co must, at the end of the useful life of the factory, dismantle the premises and repair any environmental damage caused to the land on which it is situated.

Barracuda Co

This company's operations involve the manufacture and distribution of packaged nuts and dried fruit. The government paid a grant in November 20X9 to Barracuda Co, to assist with costs associated with installing new, environmentally friendly, packing lines in its factories. The packing lines must reduce energy use by 25% as part of the conditions of the grant, and they began operating in February 20Y0.

Piranha Co

This company is a new and significant acquisition, purchased in January 20Y0. It is located overseas, in Wetland, a developing country, and has been purchased to supply cocoa beans, a major ingredient for the goods produced by Shark Co. It is now supplying approximately half of the ingredients used in Shark Co's manufacturing. Wetland has not adopted International Financial Reporting Standards, meaning that Piranha Co's financial statements are prepared using local accounting rules. The company uses local currency to measure and present its financial statements.

Further information

Your firm audits all components of the group.

You have just received the following email from Gregory Chiluba, the audit engagement partner.

Required

Identify, explain and evaluate the principal audit risks (20 marks)

(LO 2.2, 2.3, 2.4, 2.5 2.6)

21 Dragon Group

You are a newly-qualified audit supervisor in Unicorn & Co, a global firm of Chartered Accountants, with offices in over 150 countries across the world. You work in a department within the firm which specialises in the audit of retail companies.

Unicorn & Co has been invited to tender for the Dragon Group audit (including the audit of all subsidiaries). The Dragon Group is a large group of companies operating in the furniture retail trade. The group has expanded rapidly in the last three years, by acquiring several subsidiaries each year. The management of the parent company, Dragon Plc, has decided to put the audit of the group and all subsidiaries out to tender, as the current audit firm is not seeking re-election. The financial year end of the Dragon Group is 30 September 20X9. A senior partner in your department has recently held a meeting with the group finance director, in which the current group structure, recent acquisitions and the group's plans for future expansion were discussed. The partner has produced the following notes of this meeting.

Meeting notes – Dragon Group

Group structure

The parent company owns 20 subsidiaries, all of which are wholly owned. Half of the subsidiaries are located in this country, and half overseas. Most of the foreign subsidiaries report under the same financial reporting framework as Dragon Plc, but several prepare financial statements using local accounting rules.

Acquisitions during the year

Two companies were purchased in March 20X9, both located in this country:

- Mermaid Pvt Ltd, a company which operates 20 furniture retail outlets. The audit opinion expressed by the incumbent auditor on the financial statements for the year ended 30 September 20X8 was modified by a material misstatement over the non-disclosure of a contingent liability. The contingent liability relates to a court case which is still ongoing.
- Minotaur Plc, a large company, whose operations are distribution and warehousing. This represents a diversification away from retail, and it is

hoped that the Dragon Group will benefit from significant economies of scale as a result of the acquisition.

Other matters

The acquisitive strategy of the group over the last few years has led to significant growth. Group revenue has increased by 25% in the last three years, and is predicted to increase by a further 35% in the next four years as the acquisition of more subsidiaries is planned. The Dragon Group has raised finance for the acquisitions in the past by becoming listed on the stock exchanges of three different countries. A new listing on a foreign stock exchange is planned for January 20Y0. For this reason, management would like the group audit completed by 31 December 20X9.

At the meeting the finance director of Dragon requested whether, if Unicorn & Co were appointed as auditors, a certain audit senior, Kia Nelson, could be assigned to the audit team. On further investigation it transpires that Kia Nelson is the sister of Dragon's financial controller.

Required

(1) Recommend the principal matters to be included in the firm's tender document to provide the audit service to the Dragon Group. (10 marks)

(2) Evaluate the matters that should be considered before accepting the audit engagement, in the event of Unicorn & Co being successful in the tender. (6 marks)

(3) Evaluate the ethical and other professional issues raised in respect of the finance director's request for Kia Nelson to be included in the audit team. (4 marks)

(LO 2.2, 2.3, 2.4, 3.1, 7.1-7.5) (Total = 20 marks)

22 Faster Jets

Faster Jets Co is an airline company and is a new audit client of Brown & Co. You are responsible for the audit of the financial statements for the year ended 30 November 20Y0. The draft financial statements recognise revenue of Rs1,500 million and total assets of Rs2,500 million.

(a) The purpose of SLAuS 510 Initial Audit Engagements – Opening Balances is to establish standards and provide guidance regarding opening balances when the financial statements are audited for the first time or when the financial statements for the prior period were audited by another auditor.

Required

Explain the auditor's reporting responsibilities that are specific to initial engagements.

(6 marks)

(b) During the year, Faster Jets Co purchased several large plots of land located near major airports at a cost of Rs125 million. The land is currently rented out and is classified as investment property, which is recognised in the draft financial statements at a fair value of Rs145 million. The audit partner has suggested the use of an auditor's expert to obtain evidence in respect of the fair value of the land.

Required

In respect of the land recognised as investment property:

(i) Explain the additional information which you require to plan the audit of the land; and

(ii) Explain the matters to be considered in assessing the reliance which can be placed on the work of an auditor's expert.

(14 marks)

(LO 2.6, 2.7, 3.3, 5.1) (Total = 20 marks)

23 Lychee

(1) You are the manager responsible for the audit of Lychee Co, a manufacturing company with a year ended 30 September 20X9.

The financial statements of Lychee show revenue for the year ended 30 September 20X9 of Rs. 3,500 million, net profit of Rs. 700 million, and total assets at the year-end are Rs. 18,500 million.

Additionally, Lychee has a small subsidiary called Pomelo Co which is audited by another firm of auditors. Reliance is placed on the audit report of the this firm, there are no concerns and no modification to the group audit report is required. Pomelo Co has generated revenue for the year ended 30 September 20X9 of Rs. 420 million, net profit of Rs. 65 million, and total assets at the year-end are Rs. 1,900 million.

The draft audit opinion for the group and for the parent, Lychee are both unmodified.

The finance director of Lychee Co telephoned you this morning to tell you about the announcement yesterday, of a significant restructuring of Lychee Co, which will take place over the next six months. The restructuring will involve the closure of a factory, and its relocation to another part of the country. There will be some redundancies and the estimated cost of closure is Rs. 58 million. The financial statements have not been amended in respect of this matter.

Required

In respect of the announcement of the restructuring:

(i) Comment on the financial reporting implications, and advise the further audit procedures to be performed; and (6 marks)

(ii) Recommend the actions to be taken by the auditor if the financial statements are not amended (4 marks)

(2) The finance director is aware that there is guidance for auditors relating to audit reports in SLAuS 706 Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report. The audit partner has asked you to

Required

(i) Explain the purpose of an emphasis of matter paragraph and draft a suitable emphasis of matter paragraph on the basis that the financial statements fully and adequately disclose the expected restructuring and factory closure costs. (5 marks)

(ii) Explain the purpose of an other matter paragraph and draft a suitable other matter paragraph to bring to the readers' attention that Pomelo Co is audited by another firm of auditors. (5 marks)

(LO 5.3, 5.4) (Total = 20 marks)

24 Willow

Willow Pvt Ltd (Willow) is a print supplier to businesses, printing catalogues, leaflets, training manuals and stationery to order. It specialises in using 100% recycled paper in its printing, a fact which is promoted heavily in its advertising.

You are a senior audit manager in Bark & Co, and you have just been placed in charge of the audit of Willow Co. The audit for the year ended 31 August 20X1 is nearing completion, and you are reviewing a summary of outstanding issues:

Summary of issues for manager's attention, prepared by audit senior

Materiality has been determined as follows.

- Rs. 800,000 for assets and liabilities
- Rs. 250,000 for income and expenses

Issues related to audit work performed:

(i) Audit work on inventory

Audit procedures performed at the inventory count indicated that printed inventory items with a value of Rs. 130,000 were potentially obsolete. These items were mainly out of date training manuals. The finance director, Cherry Laurel, has not written off this inventory as she argues that the paper on which the items are printed can be recycled and used again in future printing orders. However, the items appear not to be recyclable as they are coated in plastic. The junior who performed the audit work on inventory has requested a written representation from management to confirm that the items can be recycled and no further procedures relevant to these items have been performed.

(ii) Audit work on provisions

Willow is involved in a court case with a competitor, Aspen Pvt Ltd (Aspen), which alleges that a design used in Willow's printed material copies one of Aspen's designs which are protected under copyright. Our evidence obtained is a verbal confirmation from Willow's lawyers that a claim of Rs. 125,000 has been made against Willow, which is probable to be paid. Cherry Laurel has not made a provision, arguing that it is immaterial. Cherry refused our request to ask the lawyers to confirm their opinion on the matter in writing, saying it is not worth bothering the lawyers again on such a trivial matter.

(iii) Audit work on current assets

Willow made a loan of Rs. 6,000 to Cherry Laurel, the finance director, on 30 June 20X1. The amount is recognised as a current asset. The loan carries an interest rate of 4% which we have confirmed to be the market rate for short-term loans and we have concluded that the loan is an arm's length transaction. Cherry has provided written confirmation that she intends to repay the loan by 31 March 20X2. The only other audit work performed was to agree the cash payment to the cash book. Details of the loan made to Cherry have not been separately disclosed in the financial statements.

Other issues for your attention:

Property revaluations

Willow currently adopts an accounting policy of recognising properties at cost. During the audit of non-current assets Willow's property manager said that the company is considering a change of accounting policy so that properties would be recognised at fair value from 1 January 20X2.

Non-current asset register

The audit of non-current assets was delayed by a week. We had asked for the non-current asset register reconciliation to be completed by the client prior to commencement of our audit procedures on non-current assets, but it seems that the person responsible for the reconciliation went on holiday having forgotten to prepare the reconciliation. This happened on last year's audit as well, and the issue was discussed with the audit committee at that time.

Procurement procedures

We found during our testing of trade payables that an approved supplier list is not maintained, and invoices received are not always matched back to goods received notes. This was mentioned to the procurement manager, who said that suppliers are switched fairly often, depending on which supplier is the cheapest, so it would be difficult to maintain an up-to-date approved supplier list.

Financial controller

Mia Fern, Willow's financial controller, owns a holiday home overseas. It appears that she offered the audit team free use of the holiday home for three weeks after the audit, as a reward for the team's hard work. She also bought lunch for the audit team on most days.

Required

(1) Evaluate the audit implications of the three issues related to the audit work raised by the audit senior. You should consider the sufficiency of evidence obtained, any necessary adjustments to the financial statements and the impact on the audit report if any necessary adjustments are not made. (15 marks)

(2) Advise on the matters, other than the three issues related to the audit work raised by the audit senior, which should be brought to the attention of Willow's audit committee. (5 marks)

(LO 5.1, 5.2, 5.3) (Total = 20 marks)

25 Lapwing

You are a manager in Lapwing & Co. One of your audit clients is Hawk Plc (Hawk) which operates commercial real estate properties typically comprising several floors of retail units and leisure facilities such as cinemas and health clubs, which are rented out to provide rental income.

Your firm has just been approached to provide an additional engagement for Hawk, to review and provide a report on the company's business plan, including forecast financial statements for the 12-month period to 31 May 20X3. Hawk is in the process of negotiating a new bank loan of Rs. 30 million and the report on the business plan is at the request of the bank. It is anticipated that the loan would be advanced in August 20X2 and would carry an interest rate of 4%. The report would be provided by your firm's business advisory department.

Extracts from the forecast financial statements included in the business plan are given below.

STATEMENT OF PROFIT OR LOSS (EXTRACT)

	Notes	FORECAST 12 months to 31 May 20X3	UNAUDITED 12 months to 31 May 20X2
		Rs'000	Rs'000
Revenue		25,000	20,600
Operating expenses		(16,550)	(14,420)
Operating profit		8,450	6,180
Profit on disposal of Beak Retail	1	4,720	–
Finance costs		(2,650)	(1,690)
Profit before tax		10,520	4,490

STATEMENT OF FINANCIAL POSITION

	Notes	FORECAST 31 May 20X3	UNAUDITED 31 May 20X2
Assets		Rs'000	Rs'000
Non-current assets			
Property, plant and equipment	2	330,150	293,000
Current assets			
Inventory		500	450
Receivables		3,600	3,300
Cash and cash equivalents		2,250	3,750
		6,350	7,500
Total assets		336,500	300,500
Equity and liabilities			
Equity			
Share capital		105,000	100,000
Retained earnings		93,400	92,600
Total equity		198,400	192,600
Non-current liabilities			
Long-term borrowings	2	82,500	52,500
Deferred tax		50,000	50,000
Current liabilities			
Trade payables		5,600	5,400
Total liabilities		138,100	107,900
Total equity and liabilities		336,500	300,500

Notes

1 Beak Retail is a retail park which is underperforming. Its sale is currently being negotiated, and is expected to take place in September 20X2.

2 Hawk Plc is planning to invest the cash raised from the bank loan in a new retail and leisure park which is being developed jointly with another company, Kestrel Plc.

Required

(1) Evaluate the matters that should be considered in agreeing the terms of the engagement to provide a report on Hawk's business plan. (6 marks)

(2) Recommend the procedures that should be performed in order to examine and report on the forecast financial statements of Hawk for the year to 31 May 20X3. (10 marks)

(3) Advise on the ethical issues which are relevant when providing other services to an audit client. (4 marks)

(LO 6.1-6.4. 7.4, 7.5) (Total 20 = marks)

26 Baltimore

You are a manager in the business advisory department of Goleen & Co. Baltimore owns auditors cannot perform other assurance services to ensure independence of the statutory audit. Therefore, Baltimore have approached Goleen & Co. to provide agreed upon procedures assurance to Baltimore Plc (Baltimore) relating the to the potential acquisition is Mizzen Pvt Ltd.

Baltimore is a book publisher specialising in publishing textbooks and academic journals. In the last few years the market has changed significantly, with the majority of customers purchasing books from online sellers. This has led to a reduction in profits, and the company has recognised that it needs to diversify its product range in order to survive. As a result of this, Baltimore has decided to offer a subscription-based website to customers, which would provide the customer with unlimited access to its full range of textbooks and journals online in exchange for an annual subscription fee for each year for subscription.

On investigating how to set up this website, Baltimore found that it lacked sufficient knowledge and resources to develop this themselves and began to look for another company which had the necessary skills, with a view to acquiring the company. It has identified Mizzen Pvt Ltd (Mizzen), which provides an online publishing platform for readers of digital books, as a potential acquisition. Baltimore has approached the bank for a loan which will be used to finance the acquisition if it goes ahead.

Baltimore is seeking agreed upon procedures assurance Goleen & Co to support its finance application to the bank, should it decided to proceed with the acquisition.

Potential acquisition of Mizzen by Baltimore

Mizzen was established four years ago by two university graduates, Vic Sandhu and Lou Lien, who secured funds from a venture capitalist company, BizGrow, to set up the company. Vic and Lou created a new type of website interface which has proven extremely popular, and which led to the company growing rapidly and building a good reputation. They continue to innovate and have won awards for website design. Vic and Lou have a minority shareholding in Mizzen.

Mizzen employs 50 people and operates from premises owned by BizGrow, for which a nominal rent of Rs. 1,000 is paid annually. The company uses few assets other than computer equipment and fixtures and fittings. The biggest expense is wages and salaries and due to increased demand for website development, freelance specialists have been used in the last six months. According to the most recent audited financial statements, Mizzen has a bank balance of Rs. 500,000.

The company has three revenue streams:

(i) Developing and maintaining websites for corporate customers. Mizzen charges a one-off fee to its customers for the initial development of a website and for maintaining the website for two years. The amount of this fee depends on the size and complexity of the website and averages at Rs. 10,000 per website. The customer can then choose to pay another one-off fee, averaging Rs. 2,000, for Mizzen to provide maintenance for a further five years.

(ii) Mizzen has also developed a subscription-based website on which it provides access to technical material for computer specialists. Customers pay an annual fee of Rs. 250 which gives them unlimited access to the website. This accounts for approximately 30% of Mizzen's total revenue.

(iii) The company has built up several customer databases which are made available, for a fee, to other companies for marketing purposes. This is the smallest revenue stream, accounting for approximately 20% of Mizzen's total revenue.

Extracts from audited financial statements of Mizzen Pvt Ltd

STATEMENT OF PROFIT OR LOSS AND OTHER COMPREHENSIVE INCOME

	Year ended 30 September 20X3	Year ended 30 September 20X2	Year ended 30 September 20X1	Year ended 30 September 20X0
	Rs'000	Rs'000	Rs'000	Rs'000
Revenue	4,268	3,450	2,150	500
Operating expenses	(2,118)	(2,010)	(1,290)	(1,000)
Operating profit/(loss)	2,150	1,440	860	(500)
Finance costs	(250)	(250)	(250)	–
Profit/(loss) before tax	1,900	1,190	610	(500)
Tax expense	(475)	(300)	(140)	–
Profit/(loss) for the year	1,425	890	470	(500)

There were no items of other comprehensive income recognised in any year.

Required

(1) Advise on the matters which you would focus on in your agreed upon procedures audit of Mizzen Pvt Ltd for your client, Baltimore, and recommend the additional information which you will need to perform this assurance engagement. (15 marks)

(2) Advise on the type of conclusion which would be issued for an agreed upon procedures report in comparison to an audit report. (2 marks)

Expansion of Goleen & Co services

On a completely separate matter, Goleen & Co is considering expanding the range of services offered by its business advisory department. Ingrid Sharapova, a senior manager, has suggested that the firm could offer a recruitment advisory service to its current audit clients, specialising in the recruitment of finance professionals. Goleen & Co would charge a fee for this service based on the salary of the employee recruited. Ingrid Sharapova worked as a recruitment consultant for a year before deciding to train as an accountant.

(3) Evaluate the ethical and practice management implications of the proposal by Goleen & Co to offer recruitment advisory services to its existing audit clients. (3 marks)

(LO 6.1, 6.3, 6.4, 7.4, 7.5) (Total = 20 marks)

27 Banana

You are a manager in Grape & Co. You have been temporarily assigned as audit manager to the audit of Banana Pvt Ltd (Banana), because the engagement manager has been taken ill. The final audit of Banana for the year ended 30 September 20X9 is nearing completion, and you are now reviewing the audit files and discussing the audit with the junior members of the audit team. Banana designs and manufactures equipment such as cranes and scaffolding, which are used in the construction industry. The equipment usually follows a standard design, but sometimes Banana designs specific items for customers according to contractually agreed specifications. The draft financial statements show revenue of Rs. 12.5 million, net profit of Rs. 400,000, and total assets of Rs. 78 million.

The following information has come to your attention during your review of the audit files.

During the year, a new range of manufacturing plant was introduced to the factories operated by Banana. All factory employees received training from an external training firm on how to safely operate the machinery, at a total cost of Rs. 500,000. The training costs have been capitalised into the cost of the new machinery, as the finance director argues that the training is necessary in order for the machinery to generate an economic benefit. After the year end, Cherry Pvt Ltd (Cherry), a major customer with whom Banana has several significant contracts, announced its insolvency, and that procedures to shut down the company had commenced. The administrators of Cherry have suggested that the company may be able to pay approximately 25% of the amounts owed to its trade payables (creditors). A trade receivable of Rs. 300,000 is recognised on Banana's statement of financial position in respect of this customer.

In addition, one of the junior members of the audit team voiced concerns over how the audit had been managed. The junior said the following:

'I have only worked on two audits prior to being assigned the audit team of Banana. I was expecting to attend a meeting at the start of the audit, where the partner and other senior members of the audit team discussed the audit, but no meeting was held. In addition, the audit manager has been away on holiday for three weeks, and left a senior in charge. However, the senior was busy with other assignments, so was not always available.

'I was given the task of auditing the goodwill which arose on an acquisition made during the year. I also worked on the audit of inventory, and attended the inventory count, which was quite complicated, as Banana has a lot of work-in-progress. I tried to be as useful as possible during the count, and helped the client's staff count some of the raw materials. As I had been to the inventory count, I was asked by the audit senior to challenge the finance director regarding the adequacy of the provision against inventory, which the senior felt was significantly understated.

'Lastly, we found that we were running out of time to complete our audit procedures. The audit senior advised that we should reduce the sample sizes used in our tests as a way of saving time. He also suggested that if we picked an item as part of our sample for which it would be time consuming to find the relevant evidence, then we should pick a different item which would be quicker to audit.'

Required

(1) Evaluate the matters to be considered and the audit evidence you should expect to find during your file review in respect of:

(i) The training costs that have been capitalised into the cost of the new machinery

(ii) The trade receivable recognised in relation to Cherry (12 marks)

(2) Evaluate the junior’s concerns regarding the management of the audit of Banana. (8 marks)

(LO 5.2, 5.3, 7.1, 7.2, 7.3) (Total = 20 marks)

28 Retriever

Kennel & Co is the external audit provider for the Retriever Group (the Group), a manufacturer of mobile phones and laptop computers. The Group obtained a stock exchange listing in July 20X9. The audit of the consolidated financial statements for the year ended 28 February 20Y0 is nearing completion.

You are a manager in the audit department of Kennel & Co, responsible for conducting engagement quality control reviews on listed audit clients. You have discussed the Group audit with some of the junior members of the audit team, one of whom made the following comments about how it was planned and carried out:

"The audit has been quite time-pressured. The audit manager told the juniors not to perform some of the planned audit procedures on items such as directors' emoluments and share capital as they are considered to be low risk. He also instructed us not to use the firm's statistical sampling methods in selecting trade receivables balances for testing, as it would be quicker to pick the sample based on our own judgement.

Two of the juniors were given the tasks of auditing trade payables and going concern. The audit manager asked us to review each other's work as it would be good training for us, and he didn't have time to review everything.

I was discussing the Group's tax position with the financial controller, when she said that she was struggling to calculate the deferred tax asset that should be recognised. The deferred tax asset has arisen because several of the Group's subsidiaries have been loss-making this year, creating unutilised tax losses. As I had just studied deferred tax at college I did the calculation of the Group's deferred tax position for her. The audit manager said this saved time as we now would not have to audit the deferred tax figure.

The financial controller also asked for my advice as to how the tax losses could be utilised by the Group in the future. I provided her with some tax planning recommendations, for which she was very grateful."

In addition, the audit committee of the Group has contacted Kennel & Co to discuss an incident that took place on 1 June 20YO. On that date, there was a burglary at the Group's warehouse where inventory is stored prior to despatch to customers. CCTV filmed the thieves loading a lorry belonging to the Group with boxes containing finished goods. The last inventory count took place on 30 April 20Y0.

The Group has insurance cover in place and Kennel & Co's internal audit service has been asked to undertake a special investigation in order to determine the amount to be claimed in respect of the burglary. The insurance covers the cost of assets lost as a result of thefts.

It is thought that the amount of the claim will be immaterial to the Group's financial statements, and there is no ethical threat in Kennel & Co's internal audit services providing the services requested.

Additionally, Retriever Group would like to extend its overdraft facility and its banker, Golden Bank, has asked for confirmation that account payables liabilities as at 28 February 20YO of Rs. 15 million are fairly stated. Retriever Group would like an auditor to undergo further agreed-upon procedures to confirm the accounts payable balance with individual suppliers to Golden Bank in a separate report.

Required

(1) Evaluate the quality control, ethical and other professional matters arising in respect of the planning and performance of the group audit. (10 marks)

(2) Advise on the matters to be considered and the steps to be taken in planning the internal audit special investigation. (4 marks)

(3) Recommend the audit procedures to be performed in determining the amount of the claim. (4 marks)

(4) Explain the main reporting requirements of an agreed upon procedures engagement and provide a draft report format for the required accounts payable report to Retriever Group and Golden Bank which will need to be agreed as part of engagement acceptance. (7 marks)

(LO 3.4, 6.3, 7.1-7.5, 8.1-8.7) (Total = 25 marks)

29 Megabon Plc

Viastrom & Co has just been appointed as the auditor of Megabon Plc, a large insurance company, for the year ending 31 January 20X0. During the year, Megabon has made a substantial investment in a new internal audit software system. This system enables the internal audit team to run real time internal auditing procedures on any area of the transaction processing and accounting system. The software is designed to identify any anomalous transactions and thereby reduce the risk of fraud and error. For the year to date, 50% more errors have been detected than the finance staff discovered in the previous year.

In a separate project, Megabon has purchased an automated investment decision making programme that has enabled Megabon to reduce its team of 160 analysts to 20. The analysts had previously been responsible for instigating the company's investments, managing the overall liquidity position of the company, and recording the company's performance. This software uses machine learning based artificial intelligence on an initial set of parameters around risk levels and liquidity requirements to attempt to maximise investment returns.

The investments that are chosen by the system are enacted and settled using a blockchain ledger. The blockchain was set up by a group of global securities exchanges with the aim of providing a single system to invest in shares, bonds, commodities and other stocks traded on various exchanges around the world. The blockchain ledger also records investment transactions and provides real time investment data.

The blockchain ledger uses 'blocks' of information with a unique encrypted code for each, to store and record information on a digital 'chain' once the transaction is completed. The blockchain transaction is recorded and distributed across a large network of computers but cannot be edited by the exchange or investment companies providing a control around the validity and completeness of transactions.

The blockchain is accessed by many global investment companies who have successfully a rigorous application process which includes minimum liquidity and IT security requirements..

The benefit of accessing the blockchain is that it allows for almost real-time settlement that had previously taken several days and thus frees up liquidity for the company and allows much greater agility to quicker alter its investment strategy. In addition, information produced is fully encrypted and cannot be altered before it feeds directly into the company's financial reporting system to track gains and losses on investments, and to automatically value investments and provide automated liquidity analysis and other investment trading data in real time.

Megabon holds a large amount of its customers' data, including banking details, and is concerned at recent news reports of data breaches at similar companies.

Required

(1) Discuss the potential impact of the following new systems on the external auditor of Megabon PLC.

(i) New internal audit software system.

(ii) Automated investment decision making software; and

(iii) Blockchain ledger

(15 marks)

(2) Explain TWO cyber-security risks that a Megabon Plc faces and suggest how they could mitigate against those risks.

(5 marks)

(LO 4.1.1, 4.4.1) (Total = 20 marks)

Answers

THE INSTITUTE OF
CHARTERED ACCOUNTANTS OF SRI LANKA

Part 1 Objective Test Questions

Questions 1 to 60 are short form objective test questions covering all areas of the syllabus. You will see this type of question in Section A of the exam.

1 D The CA Sri Lanka Code of Ethics (s. 290) does not allow the following to have a direct or indirect material financial interest in a client: the audit firm, a member of the audit team and an immediate family member of a member of the audit team.

2 A Valuation for an immaterial matter can be undertaken for a public interest entity provided safeguards exist, such as second partner review and the use of separate personnel for the valuation and the audit. Assistance can be given in tax disputes provided the firm is not acting as an advocate of the client and the effect of the matter is material to the financial statements. Internal audit services can be provided except where this would result in the audit firm's personnel assuming management responsibility.

3 C The risk of material misstatement at the assertion level is made up of inherent risk and control risk. Detection risk is the risk that the auditor's procedures will not detect a misstatement that exists in an assertion that could be material. Audit risk is the risk that the auditor gives an inappropriate audit opinion when the financial statements are materially misstated. Audit risk is made up of inherent risk, control risk and detection risk ($AR = IR \times CR \times DR$)

4 A Performance materiality may be set for particular classes of transactions, account balances or disclosures. Directors' remuneration is an account where law and regulation affect users' expectations regarding disclosure. A lower level of performance materiality therefore should be applied. Exploration and development costs are material due to the industry in which the company operates, and therefore merits a lower performance materiality level.

SLAuS 320, Materiality in Planning and Performing an Audit requires performance materiality to be set to reduce to an appropriately low level the probability that the aggregate of uncorrected and undetected misstatements exceeds materiality for the financial statements as a whole. All uncorrected misstatements should be cumulated and communicated to management, unless they are clearly trivial.

5 C The auditor cannot affect control risk or inherent risk. The auditor can reduce audit risk by manipulating detection risk. Increasing sample sizes and assigning more experienced staff to the audit will both reduce detection risk and therefore audit risk.

6 D The matters mentioned in option D relate specifically to business operations. The matters mentioned in the other options relate specifically to financial reporting A, investments B and financing C.

7 B ICEQs would be best suited to help auditors identify the key controls for controls testing. ICQs focus on whether the desirable controls are present, and so would not identify the areas at risk of specific errors or frauds. Narrative notes describe and explain the system, but their detailed nature makes it difficult to identify control exceptions at a glance. Flowcharts also describe the system but do not highlight exceptions.

8 D Records of program changes and virus checks are general IT controls.

9 B This means that customers are not able to exceed their credit limits and are therefore more likely to be able to pay. A helps to ensure that goods are sold at the right price. C & D are effective controls regarding the recovery of debts but do not prevent sales being made to customers who are unlikely to pay as the sale has already been made by this stage.

10 C The matching of dispatch notes to an invoice ensures that for all goods dispatched an invoice has been raised. If this is not the case sales and trade receivables may be understated. For answer B an appropriate control would be to match dispatch notes to invoices. Matching dispatch notes and invoices would not prevent orders being dispatched incorrectly (A) or prevent invoices being input incorrectly (D).

11 C This is in accordance with guidance given in SLAuS 265, Communicating Deficiencies in Internal Control to Those Charged with Governance and Management. If the likelihood of material misstatement and the number of transactions affected by the deficiency is low, the deficiency is unlikely to be judged to be significant.

12 A The control helps to ensure sales are valid as sales are only recognised for goods which have been dispatched.

13 A The direction of the test is important here. The sample is taken from sales invoices, as this tests whether each sales order has been fulfilled (the assertion of occurrence). If the sample is taken from goods despatched notes, this would instead confirm whether the goods sold had been correctly invoiced (the assertion of completeness). C and D both test for completeness.

14 B The risk here is the overstatement of sales revenue. Audit procedure 1 tests for cut-off, where potential errors may cause revenue to be overstated. Audit procedure 3 is a test of occurrence, also focusing on the overstatement of revenue. Audit procedure 2 tests for completeness, so therefore identifies the understatement of revenue

instead. Audit procedure 4 relates to classification – this assertion has no impact on the overall revenue balance.

15 A $(160/420) \times 365$

16 D Computer-assisted audit techniques cannot replace the skill of judgement used by the auditor.

17 A In accordance with SLAuS 610 Using the Work of Internal Auditors the external auditor is prohibited from using the work of internal audit in this situation as the risks to the quality of the evidence provided are too great.

18 B The vehicle registration document records the details of the legal registered owner of the vehicle.

19 B As the goods have been received, the goods must be recognised as an asset and the liability for the goods must be recognised at the period end. As a purchase invoice has not been received and the invoice amount has not been accrued for, liabilities are understated. This implies that the corresponding asset (inventory) is also understated.

20 B Where the period used by management to determine whether the entity is a going concern is less than 12 months from the period end, the auditor should request that management extends the assessment period to at least 12 months from the period end (SLAuS 570 Going concern: para. 13).

21 D The basic elements of the auditor's report are title, addressee, introductory paragraph, management's responsibility for financial statements, auditor's responsibility, opinion paragraph, other reporting responsibilities, auditor's signature, date of the report and auditor's address.

22 C Both statements are materially misstated as the asset must be written off reducing the profit for the year. An unmodified opinion can only be issued if both statements are adjusted.

23 B A qualified opinion is appropriate, because the matter is considered to be material, but not pervasive. An unmodified opinion with an emphasis of matter paragraph is not relevant: it serves to draw the attention of users to a matter appropriately presented or disclosed in the financial statements, which is fundamental to the users' understanding of the financial statements.

24 B The matter should be described in a material uncertainty related to going concern paragraph, in accordance with SLAuS 570 (: para. 19) Going concern. The other matter paragraph is used to refer to a matter that is not presented or disclosed in the financial statements: the material uncertainty is disclosed in this case, so that would not be

appropriate. The emphasis of matter paragraph does not modify the audit opinion. As the going concern assumption is appropriate and there is adequate disclosure, the audit opinion should not be modified.

25 D The review of audit working paper files to ensure that the audit has been performed in accordance with professional standards and regulatory and legal requirements is carried out by the audit engagement partner.

Vimukthi Ltd.

26 B In accordance with SLAuS 580, Written Representations, written representations must be dated as near as is practicable, but not after, the date of the auditor's report.

C and D are after the date of the auditor's report therefore would not be relevant audit evidence in forming the audit opinion.

A is possible as it is before 15 March but does not answer the question which is asking for the latest date on which they can be signed.

27 A SLAuS 560, Subsequent Events requires auditors to obtain sufficient appropriate evidence of events occurring between the date of the financial statements (31 December 20X6) and the date of the auditor's report (15 March 20X7).

Event 2 takes place after 15 March 20X7 therefore B and C are incorrect. The auditor does have a responsibility in respect of Event 1 therefore D is incorrect.

28 C All misstatements accumulated during the audit must be communicated to the appropriate level of management SLAuS 450, Evaluation of Misstatements Identified during the Audit, Accumulated misstatements are all misstatements except those which are clearly trivial.

D is incorrect as it only refers to material uncorrected misstatements being communicated.

Uncorrected misstatements only are communicated to those charged with governance, therefore A and B are incorrect.

29 B SLAuS 720, The Auditors Responsibilities Relating to Other Information in Documents Containing Audited Financial Statements requires the inclusion of an Other Information section in the auditor's report.

A and D are incorrect as the matter is addressed in the auditor's report but not in an Emphasis of Matter paragraph.

C is incorrect as the audit opinion is on the financial statements, not the other information.

30 B The audit opinion is not modified as the auditor agrees with the treatment of the claim and the disclosure is adequate. There is a material uncertainty re going concern and in accordance with SLAuS 570, Going Concern this is addressed in the Material Uncertainty Related to Going Concern section of the auditor's report.

A and C are incorrect as the audit opinion would not be modified as the financial statements are not mis-stated and sufficient audit evidence has been obtained.

D is incorrect as an Emphasis of Matter paragraph is not used to disclose a material uncertainty related to going concern.

Ratwatte Ltd.

31 The correct answer is: The external audit is an exercise carried out by auditors in order to give an opinion on whether the financial statements of a company are fairly presented.

The external audit is carried out by external auditors, who are independent of the company so that they can provide an independent opinion on whether the company's financial statements are prepared, in all material respects, in accordance with an applicable financial reporting framework. The principal aim of the audit is not in relation to the control system in place or to identify other areas of deficiency, although deficiencies and recommendations may be suggested by the external auditors as a by-product of the external audit in a report to management at the conclusion of the audit.

32 The correct answer is: Jayakody & Co should perform specific audit procedures to identify possible non-compliance.

SLAuS 250, Consideration of Laws and Regulations in an Audit of Financial Statements distinguishes between regulations which have a direct effect on the financial statements (in the sense of directly affecting the determination of balances) and those which do not have a direct effect but can still have a material effect (such as an operating licence).

The hygiene regulations do not have a direct effect but they may have a material effect. The external auditor must therefore perform audit procedures to help identify any non-compliance which might have a material effect on the financial statements, ie any breaches of the hygiene regulations that could result in material fines or restaurant closures.

33 The correct answer is: The determination of materiality

This review engagement is an example of an assurance engagement. There are five elements to an assurance engagement: criteria, report, evidence, subject matter and three-party relationship (CREST) (IFAC, 2016).

34 The correct answer is: Limited; Negative.

A review engagement, such as a review of compliance with hygiene regulations, is an assurance engagement where the practitioner carries out limited procedures on Ratwatte's internal controls relating to hygiene compliance.

As the procedures are limited, the practitioner will gain only enough evidence to provide a negative expression of opinion. This means the practitioner gives assurance that nothing has come to their attention which indicates that Ratwatte's internal controls relating to hygiene compliance are not, in all material respects, compliant with national regulation.

35 The correct answer is: The lucrative nature of the review engagement may make the external audit team less inclined to require management to make adjustments or to issue a modified audit opinion, for fear of losing the review engagement.

The fees from the review engagement are likely to be very lucrative, so there is a risk that Jayakody & Co will not seek adjustments during the external audit process for fear of upsetting the board of Ratwatte and losing the review engagement work.

The provision of non-audit services to unlisted audit clients is not specifically prohibited. While Jayakody & Co should be alert to self-review threats, in this case it seems unlikely: the scenario states that the review engagement does not include the provision of accounting advice or the preparation of figures in the financial statements. A firm is not required to turn down work when a 15% limit is exceeded. Where fee income from a listed audit client is expected to exceed 15% of the audit firm's total fee revenue, this fact should be disclosed to those charged with governance and a separate review may be required (The Institute of Chartered Accountants of Sri Lanka Code of Ethics para. 290.217). However, the 15% fee cap is not a major concern to YHT & Co in this instance because Ratwatte is unlisted.

Bridgford

36 The correct answer is:

Area	Audit strategy document	Detailed audit plan
(1) The availability of the client's data and staff (including internal audit)	X	
(2) The allocation of responsibility for specific audit procedures to audit team members		X
(3) The audit procedures to be undertaken for each area of the financial statements		X
(4) The potential for using computer-assisted audit techniques (CAATs) to gather evidence	X	

The audit strategy includes areas such as identifying the characteristics of the engagement, the reporting objectives, timing and nature of communications, knowledge gained from previous audits and during the preliminary risk assessments and the nature, timing and extent of resources in terms of using appropriate personnel.

The availability of the client's data and staff (including internal audit) and the potential for using CAATs are included in the characteristics of the engagement.

The auditor will take the overall audit strategy and convert it into a more detailed audit plan. This will include the allocation of work to audit team members and the audit procedures to be undertaken for each area of the financial statements.

37 The correct answer is:

Performance materiality refers to the amounts set by the auditor at higher than the materiality level for particular classes of transactions, account balances or disclosures where the materiality level might otherwise mean that such items are not tested.

The auditor sets performance materiality at an amount which is lower than the materiality level for the financial statements as a whole. This is so that the impact of misstatements for particular classes of transactions, account balances or disclosures will be considered even if they are not material to the financial statements as a whole SLAuS 320, Materiality in Planning and Performing an Audit.

38 The correct answer is:

Perform a trend analysis on current year and prior year monthly revenue, to identify whether revenue is overstated as a result of fraud or error

An overstatement of revenue would result in a reduction, not an increase in the receivables collection period.

39 The correct answer is:

That the financial statements include balances due from credit customers which are not recoverable

The audit risk relates to the concern about receivables taking 127 days to settle their invoices rather than the permitted 90 days (3-month credit terms), and that some customers are refusing to pay for products due to the reliability issues encountered. This means that the financial statements may include balances from receivables that are not recoverable. This would result in an overstatement of assets, and gives rise to concerns about the valuation of receivables.

Despite the worsening working capital position indicated by the increase in the receivables collection period, on its own it is unlikely to give rise to doubts over Bridgford's going concern status.

40 The correct answers are:

Determine how often inventory counts are performed and the level of corrections required to the inventory system

Test the operation of the inventory system using CAATs

The risk which has been identified relates to inventory quantities. Testing the operation of the inventory system using CAATs and reviewing the level of corrections required to the system would provide evidence regarding the operation of the system used to record the number of units of inventory held.

Reviewing purchase requisitions is a test to determine whether authorisation controls are in place to prevent orders of unnecessary items. The comparison of cost and net realisable value is a valid audit test, however it provides evidence regarding the valuation of inventory rather than quantity.

South

41 The correct answers are: To ensure appropriate attention is devoted to important areas of the audit; To assist in the co-ordination of work done by any auditor's experts.

The main aim of planning is not to ensure the audit is completed within budget restraints, but to ensure that it is carried out in an effective manner as described by the other statements (SLAuS 300, Planning an Audit of Financial Statements).

The determination of whether the audit engagement is ethically acceptable should have been done before the planning stage, and is not therefore an objective of planning.

42 The correct answer is:

Procedure		Assertion
	Review financial statement notes	Presentation
	Read minutes of board meetings for evidence of share issues	Completeness
	Recalculate the closing balance on the share capital account	Accuracy, valuation and allocation
	Review Memorandum and Articles of Association and compare their requirements with issued share capital	Existence

Comparing issued share capital with the Memorandum and Articles of Association relates to existence because 'equity' that is not issued pursuant to those documents does not legally exist.

43 The correct answer is: Inspect invoices capitalised within the cost of the new till system to determine whether they are directly attributable to the cost of the new till system

The audit risk relates to the concern that South may have capitalised costs which are revenue in nature. As such the appropriate response is to review the invoices which have been capitalised not just for their amount but also to determine the nature of the expense to which the invoice relates.

44 The correct answers are: Perform analytical procedures by comparing daily/weekly sales by store with both the prior year and with expectations, in order to determine whether any unusual patterns have occurred following the installation of the new system; Obtain a copy of the training manual relating to the new till system and discuss with directors the extent of training staff have received on the new system.

The audit risk relates to the concern that the system may not be reliable, that not all invoices have been recorded and that staff may not be familiar with the system.

Vouching the revenue per the system back to till receipts is not a valid response to the audit risk. Given that one concern is that revenue is understated, testing should be from the till receipts to the system to ensure that all sales have been recorded. Similarly, agreeing revenue from till receipts to the cashbook is also the wrong way around – this test should begin with the cashbook in order to test for completeness.

45 The correct answers are: To assess whether a provision for customer compensation is required in South's financial statements; To determine whether disclosure of the nature and financial effect of the legal claim is required in South's financial statements.

The concern over deficiencies in South's internal controls is a valid concern, but the review of legal correspondence is unlikely to be an appropriate response to this as the auditor would need to review internal controls. The impact on the reputation of South is also a valid concern as it could have implications for the viability of the company but again it is unlikely that information specifically relating to this would be available in the legal correspondence reviewed.

Madugalle Ltd.

46 The correct answer is: Revenue may be overstated if it is recognised according to the contract date rather than over the relevant accounting period.

There is a risk that the revenue for the annual fees is not properly recognised in the period to which it relates, leading to revenue (and deferred income) being materially misstated in the financial statements. Revenue should be recognised according to the accounting period in which the related performance obligations of the contract are met.

47 The correct answers are: Obtain a breakdown of the capitalised costs and agree a sample of items to invoices to determine the nature of the expenditure; Inspect management's review of whether the value of the aircraft has been impaired.

The auditor should obtain a breakdown of the capitalised costs and vouch them back to invoices to determine whether they relate to a capital or revenue expense. They can then determine whether they have been recognised appropriately in accordance with SLFRS 16 Property, Plant and Equipment.

The large amount of refitting work could also indicate that something is wrong with the aircraft and that their value has become impaired.

48 The correct answer is: Madugalle's going concern status may be at risk if the contract is not renewed.

The key risk here is going concern. It is possible that the company will lose one of only four customers. In addition, a bank loan is being renegotiated and it is expected that costs will increase. This may threaten Madugalle's ability to continue as a going concern.

49 The correct answers are: Review Madugalle's contracts with its other three customers to determine whether they contain a break clause, in order to determine the likelihood of losing any further contracts to other aircraft providers; Review the short-term and long-term funding facilities which are available to Madugalle.

The main risk here is to the going concern assumption, if Madugalle loses other key sources of revenue. The auditor would therefore want to consider whether this is likely, by reviewing the other contracts. If, as appears likely, they do, then Madugalle would need a source of funding to survive.

It would not be appropriate to contact an audit client's customer directly in relation to a matter such as this.

The issue of disclosure would only need to be considered once the going concern status of Madugalle had been determined.

50 The correct answer is:

	Audit concern	Not audit concern
Non-current assets	☐	☑
Inventory	☑	☐
Completeness	☐	☑
Accuracy, valuation and allocation	☑	☐

Specialist equipment has been removed from the aircraft and is now included in inventory. Inventory should be valued at the lower of cost and net realisable value, not at amortised cost. The fact that the equipment has been replaced suggests that its net realisable value is lower than its cost. This may mean that inventory is overstated in the financial statements.

Weerawansa

51 The correct answers are:

The auditor observes client staff to determine whether inventory count procedures are being followed.

The auditor reviews procedures for identifying damaged, obsolete and slow-moving inventory.

Management is responsible for organising the inventory count, not the auditor. If the results of the auditor's test counts are not satisfactory, the auditor can request that inventory is recounted, but the auditor cannot insist on a recount. However, if management refuses the auditor's request then the auditor will need to consider the implications of this on the auditor's report.

52 The correct answer is:

For a sample of inventory sold just before and just after the year end, match dates of sales invoices/date posted to ledgers with date on related goods dispatched notes.

All of the suggested audit procedures test the valuation assumption, except for matching the dates of sales invoices with the dates on the related goods dispatched notes, which is an audit procedure around cut-off.

53 The correct answer is:

The legal claim should not be recorded as a provision but disclosed as a contingent liability because a present obligation exists, but the outflow of economic resources is not probable.

Management believe that there is a 35% chance of the claim succeeding. For an event to be 'probable', it should be more likely than not to occur (ie a 50% probability) (SLFRS 37). In this case, the outflow of economic resources is therefore not probable, so a provision should not be recognised. A present obligation (not a possible obligation) exists, since the former managing director has sued Weerawansa for unfair dismissal. It is because the likelihood of him succeeding in his claim is not probable that the claim should be treated as a contingent liability instead of a provision.

54 The correct answer is:

Send an enquiry letter to Weerawansa's lawyers to obtain their view as to the probability of the claim being successful

Independent third-party audit evidence is generally considered to be more reliable than client generated or auditor-generated audit evidence. Although all the procedures are valid, only the written confirmation from Weerawansa's lawyers provides an expert, third-party confirmation on the likelihood of the claim being successful. It is also sent directly to the auditor rather than to the client.

55 To perform specific procedures to identify possible non-compliance

SLAuS 250, Consideration of Laws and Regulations in an Audit of Financial Statements distinguishes between those laws and regulations which have a direct effect on the financial statements, and those which have an indirect effect. For those which do not have a direct effect on the financial statements the auditor must undertake specified audit procedures to help identify non-compliance with laws and regulations that may have a material effect on the financial statements (SLAuS 250, Consideration of Laws and Regulations in an Audit of Financial Statements).

Gemunu & Silva

56 The correct answer is: A written representation should be requested from management to confirm whether they believe that the effects of the unadjusted misstatements are immaterial, both individually and in aggregate, to the financial statements as a whole

SLAuS 450 Evaluation of Misstatements Identified During the Audit states that the auditor has a responsibility to accumulate misstatements identified during the audit, other than those that are clearly trivial (SLAuS 450).

All the accumulated misstatements should be communicated to the appropriate level of management on a timely basis (SLAuS 450). The auditor must request that management correct the misstatements.

If management refuses to correct some or all of the misstatements, the auditor must obtain an understanding of the reasons for not making the corrections, and take these into account when determining whether the financial statements are free from material misstatement (SLAuS 450). This may affect the auditor's opinion if this results in the financial statements being materially misstated, but the refusal to correct the misstatements does not affect the opinion.

The auditor should determine whether uncorrected misstatements are material, both individually and in aggregate (SLAuS 450).

57 The correct answer is: 1 and 2

Audit procedures should focus on determining the extent of research expenditure which has been incorrectly capitalised.

Whilst it is generally important to authorise expenditure, the issue is not authorisation or occurrence but its classification.

58 The correct answer is: Qualified opinion

Research expenditure of Rs2.1m has been capitalised within intangible assets. This accounting treatment is incorrect, as SLFRS 38 Intangible Assets requires research expenditure to be expensed to profit or loss (SLFRS 38).

The error is material as it represents 8% of profit before tax (Rs2.1m/Rs26.3m).

Management should adjust the financial statements by removing the Rs2.1m research expenditure from intangibles and debiting the amount to profit or loss.

If management refuse to make the adjustment, the auditor's opinion will need to be modified. As the error is material but not pervasive, a qualified opinion would seem appropriate.

The basis of opinion section would need to include a paragraph explaining the misstatement and its effect on the financial statements. The opinion paragraph would be qualified 'except for'.

59 The correct answer is:

Material	Financial statement impact
Yes	Wages may be materially misstated

Two months' worth of wages records have been lost and so audit evidence has not been gained in relation to this expense. Wages and salaries for the 2-month period represent 11% of profit before tax (Rs1.1m/Rs10m) and so wages and salaries may be materially misstated.

60 The correct answer is:

Audit opinion	Disclosure in the auditor's report
Qualified	Basis for qualified opinion

The auditors should seek alternative audit procedures to audit the wages and salaries account. If no alternative audit procedures are possible, the loss of data would constitute a lack of sufficient appropriate audit evidence.

The auditors will need to modify the auditor's opinion on the basis that they are unable to obtain sufficient appropriate evidence in relation to a material amount in the financial statements. As the two months' salary and wages are not pervasive, a qualified opinion would seem appropriate.

The basis of opinion section would require an explanation of the insufficient audit evidence in relation to wages and salaries. The opinion paragraph would be qualified on the grounds of an inability to obtain sufficient appropriate audit evidence.

Section 2: 10 Mark Structured Response Questions

Part A Governance and Internal Control Frameworks

Questions 1 to 4 in this section cover Governance and Internal Control Frameworks, the subject of Chapters 1 to 3 of the Study Text.

1 Jafna Flowers

Internal control activities

(1) Receipts, processing and recording of orders

All orders should be recorded on pre-printed sequentially numbered documentation. This could be a four part document, one copy being the order, one copy being the dispatch note, one copy being sent to the customer as evidence of the order and the last copy retained by the accounts receivable clerk.

To ensure completeness of orders a sequence check should be performed on the documents either manually or by computer. Any missing documents should be traced.

As the clerk inputs the order the system should automatically check whether the customer remains within its credit limit. Any orders which exceed the credit limit should be rejected.

In exceptional circumstances where credit limits are to be exceeded this should be authorised by the department manager. Orders should also be rejected if the customer has a significantly overdue balance.

As the order is being input the system should check whether the item required is in inventory. This is possible as the ordering and inventories systems are integrated. If items are unavailable the order should be rejected. This will enable the clerk to inform the customer which will enhance customer service.

Periodically an independent review should be performed of the standing data on the system. A sample of credit limits should be checked to ensure that they have been calculated in accordance with the standard formula. Any breaches should be investigated. Similarly the price of flowers should be matched against an up to date price list.

Sales invoices should be posted automatically to the sales daybook and accounts receivable ledger. An accounts receivable control account reconciliation should be performed on a monthly basis and any discrepancies should be investigated and dealt with.

Customer statements should be generated by the system automatically. Any queries raised by the customer on receipt of these should be investigated promptly. Any resulting credit notes should be authorised.

(2) Collection of cash

Details of all bank transfers received should be input into the cash book/bank control account and the accounts receivable ledger and accounts receivable control account.

Entries in the accounts receivable ledger should be matched against specific invoices. Any unallocated cash should be investigated via an exception report.

On a monthly basis a bank reconciliation should be performed. Together with the accounts receivable control account reconciliation and the following up of queries on customer statements this will help to ensure that the cash is correctly recorded and allocated.

On a monthly basis an aged receivables listing should be generated. The company should have procedures in place for the chasing of debts which the credit controller would follow ranging from a telephone reminder to the threat of legal action.

2 Lily Window Glass Plc

(Note: Only five deficiencies and five related recommendations are needed to gain 10 marks.)

(1) Deficiency	(2) Recommendation
The warehouse manager will supervise the inventory count and is not independent as he has overall responsibility for the inventory. He therefore has an incentive to conceal or fail to report any issues that could reflect badly upon him.	An independent supervisor should be assigned, such as a manager from the internal audit department.
Aisles or areas counted will not be flagged. This could result in items being double counted or not counted at all.	Once areas have been counted they should be flagged. At the end of the count the supervisor should check all areas have been flagged and therefore counted.
There is no-one who is independent reviewing controls over the count or test counting to assess the accuracy of the counts.	Instead of the internal auditors being involved in the count itself, they should perform secondary test counts and review controls over the count.

(1) Deficiency	(2) Recommendation
Damaged goods are being left in their location rather than being stored separately. This makes it more difficult for finance to assess the level of damage to the goods and establish the level of write down needed. Also, if not moved, damaged goods could be sold by mistake.	Damaged goods should be clearly marked as such during the count and at the end of the count they should be moved to a central location. A manager from the finance team should then inspect these damaged goods to assess the level of allowance or write down needed.
Due to the continuous production process, there will be movement of goods in and out of the warehouse during the count, increasing the risk of double counting or failing to count inventory. This could mean inventory in the financial statements is under or overstated.	Although it is not practicable to disrupt the continuous production process, raw materials (RM) required for 31 December should be estimated and separated from the remainder of inventory. These materials should be included as part of work-in-progress (WIP). Goods manufactured on 31 December should be stored separately, and at the end of the count should be counted once and included as finished goods. Goods received from suppliers should also be stored separately, counted once at the end and included in RM. Goods dispatched to customers should be kept to a minimum during the count.
The warehouse manager is going to estimate WIP levels. The warehouse manager is unlikely to have the necessary experience to estimate the WIP levels which is something the factory manager would be more familiar with. Alternatively a specialist may be needed to make the estimate. This could ultimately result in an inaccurate WIP balance in the financial statements.	A specialist should be used assess the work-in-progress.

(1) Deficiency	(2) Recommendation
The warehouse manager is going to approximate RM quantities. Although he is familiar with the RM, and on the basis that a specialist has been required in the past, the warehouse manager may not have the necessary skill and experience to carry out these measurements. This could result in an inaccurate RM balance in the financial statements.	As in previous years, a specialist should assess the quantities of raw materials, or at least check the warehouse manager's estimate to give comfort that the manager's estimates will be reasonable going forward.
There is no indication that inventory sheets are signed or initialled by the counting team, nor a record kept of which team counted which area. This means it will be difficult to follow up on any anomalies noted, as the identity of the counters may not be known.	Inventory sheets should be signed by both team members once an aisle is completed. The supervisor should check the sheets are signed when handed in.
Inventory not listed on the sheets is to be entered onto separate sheets. These sheets are not sequentially numbered and the supervisor will be unable to ensure the completeness of all inventory sheets.	Every team should be given a blank sheet on which they can enter any inventory counted which is not on their sheets. The blank sheets should be sequentially numbered with any unused sheets returned at the end of the count. The supervisor should then check the sequence of all sheets.
The responsibilities of each of the two staff members within a counting team is unclear. It does not appear that one has been told to count and the other to check. Therefore errors in counting may not be picked up.	For each area one team member should be asked to count and the second member asked to check that the inventory has been counted correctly. The roles of each can then be reversed for the next area.

3 SouthLea Plc

Wages system – deficiencies and recommended controls

(Note: only 5 weaknesses and recommendations are required.)

(1) Deficiency	(2) Internal control recommendation
The foreman is in a position to set up fictitious employees on the wages system as he has authority to issue temporary employee numbers. This would allow him to collect cash wages for such bogus employees.	The issue of new employee numbers should be authorised by a manager and supported by employee contract letters etc.
Employees could clock in a long time before starting work or clock out too late in order to obtain wages for hours they have not worked.	The foreman or another manager should supervise clocking in and out at the start of a shift. Before wages are paid, management should compare hours logged in the system to budget and previous months and investigate any unexpected increases.
The two wages clerks are responsible for the set up and maintenance of all employee records. They could therefore, in collusion, set up bogus employees and collect cash wages from them.	The list of personnel should be matched with the payroll by a manager and all new employee records should be authorised before being set up on the system.
The wages clerks are responsible for making amendments to holidays and illness etc. They could make unauthorised amendments which affect individual staff members' pay.	Any amendments to standing data on the wages system should be done by an authorised manager so that unauthorised amendments are not made. A log of amendments should be regularly reviewed.
The computer system calculates gross pay and any deductions but these are hand-written by the wages clerks for the staff pay packets, so errors could be made and incorrect wages issued.	A payslip should be generated by the computer system and included in the wage packet to reduce the chance of errors in deductions and gross pay being made.

(1) Deficiency	(2) Internal control recommendation
The computer automatically calculates gross pay and deductions, however there is no check to ensure the calculations are accurate.	One of the wages clerks should check the gross pay and deductions for a sample of employees to gain assurance that the computer is calculating amounts correctly. Management should compare gross pay and deductions to budget and prior months and any unexpected differences should be investigated.
The foreman distributes cash wages to the employees. He could therefore misappropriate any wages not claimed.	The distribution of wages should be overseen by another manager. Unclaimed wages should be noted on a form and returned to the wages department.

4 Matalas (Pvt) Ltd

(Note: Only 5 deficiencies and controls are required.)

(1) Deficiency	(2) Control
The amount of cash held in the petty cash box is high (Rs. 5,000) in comparison to the average monthly expenditure of (Rs. 1,538). This increases the risk that the cash will be stolen or that errors will be made in counting.	The amount of the petty cash balance at each branch should be reviewed. Based on an average monthly expense of Rs. 1,538, a balance of Rs. 2,000 would seem reasonable.
The petty cash box is not physically secure as it is kept on a bookcase in the accounts office. This increases the risk of theft.	The petty cash box should be kept in the branch safe or in a locked drawer in the accountant's desk.
Reimbursement for petty cash expenditure takes place without evidence of the expenditure being incurred eg receipt. This may result in false claims being made.	All petty cash claims should be supported by a receipt.
The petty cash vouchers are not authorised – they are only signed by the individual claiming reimbursement.	All petty cash vouchers should be authorised by the accounts clerk.

(1) Deficiency	(2) Control
In some instances significant items are purchased through petty cash (up to Rs. 500). These are not authorised prior to the purchase being made. This could result in unnecessary expense being incurred.	Expenditure over a certain limit (eg Rs. 50) should be authorised in advance.
There is no indication that the vouchers are pre-numbered, meaning that the branch cannot confirm completeness of the vouchers. Unauthorised claims could be made and then blamed on missing vouchers.	Petty cash vouchers should be pre-numbered. On entry into the petty cash book the sequential numbering should be checked to ensure that all expenditure has been completely recorded.
There is a lack of segregation of duties. The petty cash is counted by the accounts clerk who is also responsible for the cash balance. There is no additional independent check on the petty cash balance.	The accountant should check the petty cash count to confirm the accuracy of the balance and ensure that the asset is safeguarded.
Whilst the accountant confirms that the cheque to reimburse petty cash agrees to the journal entry to the general ledger, the petty cash vouchers are not reviewed to support the amounts involved.	The petty cash vouchers should be reviewed by the accountant to confirm that the monthly petty cash expenditure agrees to the reimbursement cheque and journal entries.

Part B Audit Planning and Risk Assessment

Questions 5 to 10 cover Audit Planning Risk Assessment, the subject of Chapters 4 to 6 of the Study Text.

5 Favorita Plc

(1) During planning, the auditor must establish materiality for the financial statements as a whole. However, if there are classes of transactions, account balances or disclosures for which misstatements less than materiality for the financial statements as a whole could reasonably be expected to influence the economic decisions of users taken on the basis of the financial statements, the auditor must also determine materiality levels to be applied to these.

The auditor must also determine performance materiality in order to assess the risks of material misstatement and to determine the nature, timing and extent of further audit procedures. Determining materiality for the financial statements as a whole involves the exercise of professional judgement. Generally, a percentage is applied to a chosen benchmark as a starting point for determining materiality for the financial statements as a whole. The following factors may affect the identification of an appropriate benchmark:

- Elements of the financial statements (eg assets, liabilities, equity, revenue, expenses)
- Whether there are items on which users tend to focus
- Nature of the entity, industry and economic environment
- Entity's ownership structure and financing
- Relative volatility of the benchmark

Materiality also has qualitative aspects. Some misstatements may fall under the quantified materiality level, but are still considered material overall due to their qualitative effects.

(2) (i) In this case, the financial statements are presented fairly and are not materially misstated. This is because the Rs. 3,000 difference in assets and net income will not make a difference to the financial statement users (being an error of only 0.2% of equipment and 1.25% of profit). The difference is therefore not material.

(ii) In this case, the financial statements are materially misstated. This is mainly because profit is overstated by Rs.80,000 – a factor which would make a difference to the users of the financial statements being 33.5% of profit. Trade payables are also understated by a significant amount (6.7%), although the amount is not material.

(iii) Here, even though the amount involved is relatively small, the item is likely to be material, as illegal payments, if they are found out, could harm the company's reputations, its operations and its share price. The matter could therefore be considered qualitatively material, even though it is not quantitatively so.

6 Paranthan Ltd

(1) Business risks

Factor (i)

Depending on the outcome of the court case the legal proceedings could result in a significant cash outflow to the business. This may result in cash flow problems making it difficult for the business to settle its liabilities. The reputation of the company as an employer may also be damaged making it difficult for the company to employ staff of the highest calibre.

Factor (ii)

The tough trading conditions indicate that the company may be struggling to maintain its market share. Revenue and profitability may be affected as a result. The business may suffer losses if sales are made to customers who are not creditworthy and fail to pay for the goods they have purchased. Extending the credit terms will have an adverse cash flow effect increasing the risk of cash flow problems.

Factor (iii)

The high levels of returns will reduce revenue and profitability. The company may have to incur costs to rectify the problems or may have to write off the costs if the items are to be scrapped. The loss of customer goodwill is also an issue which may affect levels of sales and profits in the short to medium term. The company will need to incur costs in order to rectify the issues with the faulty production line.

Factor (iv)

There is a risk that the new system is not operating effectively. Information may be of poor quality and management may make incorrect decisions if the information on which they are basing them is either incomplete or incorrect. These decisions could affect any aspect of the business.

Factor (v)

The new supplier may not be reliable which may result in raw material not being available when required, exacerbated by the longer delivery times from Europe. This may cause disruption to the manufacturing process and may mean that the company is not able to fulfil orders on time. The company is also exposed to the risk of exchange rate fluctuations as the supplier invoices in Euros.

(2) Risks of material misstatement

Factor (i)

The ongoing litigation increases the risk that liabilities may be understated if the financial statements fail to include a liability for damages where there is an obligation to pay these. Disclosures may be inadequate if there is a contingent liability in respect of the damages which is not properly disclosed.

This is a risk of material misstatement at the assertion level since only one balance is affected.

Factor (ii)

There is an increased risk that receivables may be overstated as the relaxing of credit checks increases the likelihood that credit is given to customers who cannot pay. Extending the credit terms may also affect recoverability of receivables as this may attract customers who have cash flow difficulties, and therefore need to take advantage of the extended terms. This is a risk of material misstatement at the assertion level since only one balance is affected.

Factor (iii)

The increased levels of returns increases the risk of overstatement of inventories. In accordance with LKAS 2 Inventories inventory must be valued at the lower of cost and net realisable value. Inventory which has been returned may need to be scrapped or may need to be repaired. In either case net realisable value will need to be considered. The value of other inventory produced on this production line also needs to be considered. There is also a risk that inventory provisions are understated if no allowance has been made for items sold which are likely to be returned due to the same fault.

This is a risk of material misstatement at the assertion level since only one balance is affected.

Factor (iv)

The lack of testing of the new system increases the risk of material misstatement throughout the financial statements. It increases the risk that the information produced by the system is unreliable. It may contain errors and/or it may be incomplete.

This is a risk of material misstatement at the financial statement level since all balances in the financial statements are affected.

Factor (v)

The added complexity of exchange rate translation calculations increases the risk of misstatement in the financial statements. The transactions should be accounted for in accordance with LKAS 21 The Effects of Changes in Foreign Exchange Rates. Balances potentially affected include purchases, inventory and trade payables.

This is a risk of material misstatement at the financial statement level since many balances in the financial statements are affected.

7 Zak Ltd

Revenue

Although the directors have indicated that the company has had a difficult year, revenue has increased from the previous year by 18%. The auditors need to establish the reason for this increase as it does not correlate with the directors' comments.

Cost of sales

Cost of sales has fallen by 17% in comparison to the previous year – this is strange given that revenue has increased, as one would expect cost of sales to similarly increase. The reason for this decrease needs to be ascertained. It could be as a result of closing inventory being undervalued.

Gross profit

Gross profit has increased dramatically by 88% in comparison to the previous year. The reason for this needs to be established, given that revenue has increased but cost of sales has decreased.

Administration costs

Administration costs have fallen slightly by 6%. This appears unusual given that revenue has increased from the previous year, as one would expect the increased revenue to lead to increased administration costs. Expenditure in this area may be understated perhaps as a result of incorrect cut-off being applied.

Selling and distribution costs

Selling and distribution costs have increased significantly by 42%. An increase is expected given that revenue has also increased, however the increase is not comparable. There may have been a misallocation between administration and selling and distribution costs – again this will need to be investigated thoroughly.

Interest payable

It is surprising that Zak has a reasonable cash surplus this year but still continues to pay a similar level of interest. The interest payable may be overstated and the reasons for interest payments not decreasing despite the absence of the large overdrawn balance seen last year must be established. One explanation for this might be a cash injection immediately prior to the year end.

8 Sleeptight Ltd

(1) Audit risk	(2) Auditor's response
The directors only work part-time at Sleeptight and there is no finance director. This may promote a weak control environment, resulting in undetected errors or frauds.	The controls will need to be documented and evaluated. If these are weak the level of substantive testing will need to be increased accordingly.
SLFRS 15 requires the revenue to be recognised when control of the good passes to the customer. The requirement for customers to pay 40% on ordering and the remainder following delivery could result in revenue recorded before it should be, if the deposit is recorded as a sale and not deferred until delivery. The deposit should be treated as a liability until control passes on delivery per SLFRS 15 and then recognised as revenue on delivery. Recognising the deposit as revenue before delivery of the bed would result in revenue being overstated. Alternatively, revenue could be understated if the revenue is only recognised when the final payment is received, rather than on delivery of the bed.	Enquire of management the point at which revenue is actually recognised, and review the system of accounting for deposits to ensure they are not included in revenue until goods delivered and signed for. For a sample of transactions within 8 weeks of the year end, ensure the revenue recorded is only in respect of beds delivered to customers in the same period and ensure they have been signed for.
LKAS 37 requires that if there is a legal obligation that is probable to result in an outflow of economic benefit of a reliably measured amount then a provision should be made. The two year guarantee on the beds therefore gives rise to a provision, the measurement of which involves a high degree judgement, and therefore carries a risk of misstatement.	Establish the basis of the amount provided for and assumptions made by the financial controller. Re-perform any calculations and establish the level of warranty costs in the year, and compare with the previous provision. Review the level of repair costs incurred post year-end and use these to assess the reasonableness of the provision.
The current year raw materials costs for materials also in inventory last year are based on prices at least a year old. They should be based on the actual cost or reasonable average cost. Given that prices	For a sample of materials to include the cost of wood, compare material costs to actual prices on invoices. Investigate and resolve any significant differences and evaluate the potential impact on the

(1) Audit risk	(2) Auditor's response
fluctuate the value of year end raw materials may be over or undervalued due to price rises/decreases occurring during the year.	inventory value in the financial statements.
The finished goods value is to be estimated by Anna Silva, who appears to be basing her estimate on order value rather that applying the LKAS 2 rule that goods should be valued at the lower of cost and NRV. This could result in inventory being overstated in the financial statements.	For beds awaiting dispatch, establish the lower of cost and NRV and compare with the figures provided by Anna Silva. Investigate any differences evaluate the potential impact on the inventory value in the financial statements.
(1) Audit risk	(2) Auditor's response
The directors only work part-time at Sleeptight and there is no finance director. This may promote a weak control environment, resulting in undetected errors or frauds.	The controls will need to be documented and evaluated. If these are weak the level of substantive testing will need to be increased accordingly.
The requirement for customers to pay 40% on ordering and the remainder following delivery could result in revenue recorded before it should be, if the deposit is recorded as a sale and not deferred until delivery. This would result in revenue being overstated. Alternatively, revenue could be understated if the revenue is only recognised when the final payment is received, rather than on delivery of the bed.	Enquire of management the point at which revenue is actually recognised, and review the system of accounting for deposits to ensure they are not included in revenue until goods delivered and signed for. For a sample of transactions within 8 weeks of the year end, ensure the revenue recorded is only in respect of beds delivered to customers in the same period and ensure they have been signed for.
The two year guarantee on the beds gives rise to a provision, the measurement of which involves a high degree judgement, and therefore carries a risk of misstatement.	Establish the basis of the amount provided for and assumptions made by the financial controller. Re-perform any calculations and establish the level of warranty costs in the year, and compare with the previous provision. Review the level of repair costs incurred post year-end and use these to assess the reasonableness of the provision.
The current year raw materials costs for	For a sample of materials to include the

(1) Audit risk	(2) Auditor's response
materials also in inventory last year are based on prices at least a year old. They should be based on the actual cost or reasonable average cost. Given that prices fluctuate the value of year end raw materials may be over or undervalued due to price rises/decreases occurring during the year.	cost of wood, compare material costs to actual prices on invoices. Investigate and resolve any significant differences and evaluate the potential impact on the inventory value in the financial statements.
The finished goods value is to be estimated by Anna Silva, who appears to be basing her estimate on order value rather that applying the LKAS 2 rule that goods should be valued at the lower of cost and NRV. This could result in inventory being overstated in the financial statements.	For beds awaiting dispatch, establish the lower of cost and NRV and compare with the figures provided by Anna Silva. Investigate any differences evaluate the potential impact on the inventory value in the financial statements.

9 Ja-Ela Ltd

(1) Audit strategy document

Section	Purpose	Example relevant to Ja-Ela
Characteristics of the engagement	Provides details of the industry and regulatory environment the client operates in. Describes the entity's activities.	Ja-Ela runs a chain of gastro pubs. As a result, it will need to comply with significant food hygiene and health and safety regulations. The payroll function has been outsourced this year and evidence might not be readily available. The auditors may need to arrange this in advance. Ja-Ela is growing and it will need to be determined whether the appropriate financial reporting framework is SLFRS or SLFRS for SME. If the planned acquisition takes place before year-end, sufficient time and suitably qualified resources will be needed to audit it and ensure the correct disclosures

Section	Purpose	Example relevant to Ja-Ela
		are made in the financial statements. Materiality will be greater if Ja-Ela expands and this will have an impact of the extent of audit testing. The pubs being acquired are all local, so the audit team are unlikely to have difficulty travelling to them for the purposes of the audit.
Reporting objectives, timing of the audit engagement and nature of communications	Provides details of the client's reporting dates, the proposed timetable and dates for proposed meetings with management.	The audit is being planned less than a month before the end of the period to be audited. It may be necessary to schedule an initial meeting with management before the year end, to ensure any necessary year-end testing can be carried out (eg non-current asset verification, food and beverages inventory count.)
Significant factors, preliminary engagement activities, and knowledge gained on other engagements	Identifies areas where there is a greater risk of material misstatement and a greater susceptibility to fraud. Details management's commitment to design, implementation and maintenance of a sound internal control environment. Details the basis for setting materiality.	Ja-Ela makes cash sales. This increases the susceptibility to fraud. An approach which can appropriately test the completeness of income is needed.

(2) Audit team's responsibilities to obtain an understanding of the services provided

Ricks & Co is a service organisation because it is an external organisation that provides a service to Ja-Ela that could be done internally (it is managing the payroll function for Ja-Ela). Under SLAuS 402 Audit considerations relating to an entity using a service organisation, Ja-Ela is the user entity and Sams & Co is the user auditor.

As the user auditor, Sams & Co must obtain an understanding of the services provided by the service organisation (Ricks & Co) including:

(i) The nature of the services provided and the significance of these to the Ja-Ela, including the effect on Ja-Ela's internal control

(ii) The nature and materiality of transactions processed or financial reporting processes affected

(iii) The degree of interaction between Ricks & Co and Ja-Ela

(iv) The nature of the relationship including the contractual terms in place between Ricks & Co and Ja-Ela

When obtaining an understanding of the internal control relevant to the audit, Sams & Co must evaluate the design and implementation of relevant controls at Ja-Ela that relate to the services provided by Ricks & Co.

10 Matale Products

(1) Auditors should plan their work so that:

(i) Attention is devoted towards the key audit areas. These will be areas which are large in materiality terms, where there is significant risk of material misstatement, or which have had significant problems in previous years.

(ii) Staff are briefed. The audit strategy should provide enough detail about the client to enable staff to carry out the detailed work effectively. Budgets should ensure that appropriate time is spent on each audit area.

(iii) The efficiency of the audit process should be enhanced. Good planning should ensure that the right staff are selected, that information technology is used appropriately, and that maximum use is made of schedules prepared by the client and of the work of internal audit if applicable.

(iv) The timing of the audit is appropriate. Staff will need to be available to carry out an inventory count and circularisation of receivables at the year-end. If use is to be made of work done by the client or internal audit, then this work will need to have been completed in time for the final audit. The timing should also allow sufficient time for the audit to be completed so that the financial statements can be signed on the date desired by the client.

(v) Review is facilitated. Setting out an audit plan and budgets at the planning stage means that the reviewer has measures against which the work can be examined at the end of the assignment.

(2)

Matters to consider	Further action
Whether data was accurately transferred in to the new system on 1 June 20X8 and whether the computerised inventory system is reliable for determining the quantity of inventory at the year end.	The auditor will need to determine the process by which information was input in to the new system and the level of testing which was done by the client to ascertain the accuracy of the transfer. The auditor will also need to document the new system. If they are to rely on to gather audit evidence they will also need to test the system using computer assisted audit techniques.
Whether there are provisions required in the financial statements which have not been provided for, as a result of the production problems. These could relate to provisions for legal claims by customers, allowances against receivables (if customers refuse to pay for defective goods) and provisions to reduce the carrying amount of inventory to the lower of cost and net realisable value.	The auditor should consider the outcome of any legal action in the post year end period in order to determine whether any write downs need to be made to the carrying amounts of both receivables and inventory and whether provision for legal claims is necessary.
Whether the extended credit offered to new customers may lead Matale to experience cash flow difficulties and ultimately raise concern over the entity's ability to continue as a going concern.	The auditor should examine Matale's cash flow position at the year end and its cash flow forecasts for the future (at least 12 months) in order to assess whether it is likely to struggle to meet its obligations as they fall due. They should also consider whether there is a risk that the extended credit terms may mean that there is an increase risk that receivables may not be recoverable.

11 Regulation

The storage of the potentially hazardous chemicals raises concerns that the company being audited may not be complying with regulations such as health and safety legislation. The auditor needs to consider the requirements of SLAUS 250 Consideration of Laws and Regulations in an Audit of Financial Statements and the Sri Lanka Code of Ethics. It is management's responsibility to ensure that the entity's operations are conducted in accordance with the provisions of laws and regulation. However, the auditor does have some responsibility, especially where Non-Compliance with Laws and Regulations ('NOCLAR') has an effect on the financial statements.

The auditor is required by SLAUS 315 Understanding the entity and its environment and assessing the risks of material misstatement to obtain an understanding of the legal and regulatory framework in which the audited entity operates. This will help the auditor to identify NOCLAR and to assess its implications. Therefore, the auditor should obtain a full knowledge and understanding of the laws and regulations relevant to the storage of items in the company's warehouses, focusing on health and safety issues and the implications of NOCLAR.

SLAUS 250 requires that when NOCLAR is identified or suspected, the auditor shall obtain an understanding of the nature of the act and of the circumstances in which it has occurred, and further information to evaluate the possible effect on the financial statements. Therefore, procedures should be performed to obtain evidence about the suspected non-compliance, and to identify any further instances of NOCLAR in the company's other warehouses.

Management may not be aware that the warehouse manager is allowing the storage of these potentially hazardous items. SLAUS 250 requires the matter to be discussed with management, and, where appropriate, with those charged with governance. The Sri Lanka Code of Ethics requires the NOCLAR to be communicated with the most appropriate level of management, ie at least one level above the person involved. The auditor must therefore ignore the warehouse manager's threats and communicate the suspected NOCLAR. Given the potential severity of the situation, and that the chemicals may not be safe, there is the risk of injury to the company's employees or the general public, so the matter should be communicated as soon as possible.

The auditor needs to consider the potential implications for the financial statements. The NOCLAR could lead to regulatory authorities imposing fines or penalties on the company, which may need to be provided for directly in the financial statements. Audit procedures should be performed to determine the amount, materiality and probability of payment of any such fine or penalty imposed.

In terms of reporting NOCLAR to the relevant regulatory authorities, SLAUS 250 requires the auditor to determine whether they have a responsibility to report the identified or suspected NOCLAR to parties outside the entity. In the event that management or those charged with governance of the company fail to make the necessary disclosures to the regulatory authorities, the auditor should consider whether they should make the disclosure. This will depend on matters including whether there is a legal duty to disclose or whether it is considered to be in the public interest to do so. Confidentiality is also an issue, and if disclosure were to be made by the auditor, it would be advisable to seek legal advice on the matter. This is very much a worst case scenario, however, as the company's management is likely to make the necessary disclosures, and should be encouraged by the auditor to do so.

There is also an ethical issue arising from the warehouse manager's aggressive attitude and threatening behaviour. It would seem that the manager has something to hide, and that he was the only person who knew about the storage of the chemicals. He may have been bribed to allow the storage of the dangerous chemicals. His behaviour amounts to intimidation of the auditor, which is not acceptable behaviour, and those charged with governance should be alerted to the situation which arose. SLAUS 260 Communication of audit matters with those charged with governance requires the auditor to communicate significant difficulties encountered during the audit, which may include examples of lack of co-operation with the auditor, and imposed limitations on auditors performing their work.

The final issue is that the company should review its policy of requiring limited documentation for contracts less than Rs10,000. This would seem to be inappropriate because it may lead to other instances of unknown items being stored in the company's warehouses. This would seem to be a significant control deficiency, and should be reported to those charged with governance in accordance with both SLAUS 260. The auditor could recommend improvements to the controls over the storage of items which should prevent any further non-compliance with laws and regulations from occurring.

Part C Gathering Audit Evidence

Questions 12 to 18 cover Gathering Audit Evidence, the subject of Chapters 7 to 14 of the Study Text.

12 Buttala (Pvt) Ltd

(1) Sampling methods

Methods of selecting a sample acceptable according to SLAuS 530 Audit Sampling:

Random selection ensures that all items in the population have an equal chance of selection, eg by use of random number tables or random number generators.

Systematic selection involves selecting items using a constant interval between selections, the first interval having a random start.

Haphazard selection is selection of a sample without following any particular structured technique. It may be an alternative to random selection provided auditors are satisfied that the sample is representative of the entire population.

Block selection may be used to check whether certain items have particular characteristics. For example an auditor may use a sample of 50 consecutive cheques to test whether cheques are signed by authorised signatories rather than picking 50 single cheques throughout the year.

(2) Purchase invoice based testing

Comparing a representative sample of purchase invoices to non-current assets register and the annual budget proves only that those particular invoices are accurately recorded and gives little evidence over completeness.

Purchase invoices form the basis of the entries on the asset register (they are updated simultaneously) and testing one to the other will not detect missing purchase invoices.

Similarly testing from the invoices to the budget will only aid in highlighting an asset not recorded on the budget if that asset was delivered and the invoice was received. However it will not identify missing asset entries for items that have been delivered but no purchase invoice has received.

(3) Appropriate completeness test

The audit team could use a CAAT to compare the non-current asset register to purchase orders, goods received notes and invoices. This will test for completeness by identifying any assets not included in the non-current asset register for which purchase orders, good received notes or invoices exist.

Additionally, in order to test completeness of non-current asset records effectively, a sample should be selected from assets which physically exist. This sample should be agreed to the non-current asset register to ensure assets in the factory are included in the financial records.

The auditors should also perform a review of the repair and maintenance account to assess whether any items have been expensed when they should have been capitalised. A sample of items should be agreed to invoice to ensure they have been expensed appropriately.

13 Uva Toys (Pvt) Ltd

(1) Importance of cut-off in the audit of inventory

All purchases, transfers and sales of inventory must be recorded in the correct accounting period as inventory can be a material figure for many companies, particularly those engaged in manufacturing.

The points of purchase and receipt of goods and services are particularly important in order to ensure that cut-off has been correctly applied. The transfer of completed work-in-progress to finished goods is also important as is the sale and dispatch of such goods.

Incorrect cut-off can result in misstatements in the financial statements at the year-end and this can be of particular concern where inventory is material.

Auditors therefore need to consider whether the management of the entity being audited have implemented adequate cut-off procedures to ensure that movements into and out of inventory are properly identified and reflected in the accounting records and ultimately in the financial statements.

(2) Perpetual inventory counting systems

Where a perpetual inventory system is in place, the auditors should carry out the following work:

- Talk to management to establish whether all inventory lines are counted at least once a year.
- Inspect inventory records to confirm that adequate inventory records are kept up-to-date.
- Review procedures and instructions for inventory counting and test counts to ensure they are as rigorous as those for a year-end inventory count.
- Observe inventory counts being carried out during the year to ensure they are carried out properly and that instructions are followed.

- Where differences are found between inventory records and physical inventory, review procedures for investigating them to ensure all discrepancies are followed-up and resolved and that corrections are authorised by a manager not taking part in the count.
- Review the year's inventory counts to confirm the extent of counting, the treatment of differences and the overall accuracy of records, and to decide whether a full year-end count will be necessary.
- Perform cut-off testing and analytical review to gain further comfort over the accuracy of the year-end figure for inventory in the financial statements.

(Note: Only 6 points are required.)

14 Badulla Ltd

Audit work on trade accounts receivable at the final audit

(i) Second circularisation

(1) Consider circularising all trade receivables accounts, or at least a larger sample than before of accounts not circularised at 30 September.

(2) Circularise and investigate disagreeing replies. Discover if reasons are similar to those given at 30 September circularisation.

(ii) To gain further evidence about the rights and obligations and existence of receivables

(1) Check the sales invoices which make up the balances with backing documentation, for example purchase orders and despatch notes (if the latter exist).

(2) Ascertain extent of cash received from customers after the year-end; reconcile the individual invoices to ensure that no discrepancies exist.

(3) Obtain explanations for invoices remaining unpaid after subsequent invoices have been paid.

To gain evidence about the valuation of receivables, I would review the cash received after-date and would also carry out the following tests.

(1) Check calculation of outstanding invoices.

(2) Carry out further tests on settlement discounts and ascertain whether the position has improved or deteriorated since the time of the interim audit.

(3) Confirm necessity/adequacy of provision against write-off of specific debts by review of correspondence, solicitors' debt collection, agencies' letters, liquidation statements.

(4) Consider whether amounts owed may be not recovered where there have been round sum payments on account or invoices unpaid after subsequent invoices paid.

(5) Review customer files/correspondence from solicitors and circularisation results for evidence of potential bad debts.

(6) Confirm the accuracy of allowances for irrecoverable receivables made in the past.

I would check the completeness of receivables by carrying out cut-off tests at 31 December to ensure that all goods leaving the premises by that date (and only those) have been included in sales. I would also check that all returns of goods after the year-end relating to 20X0 sales have been correctly recorded.

Other general tests include:

(1) Agree the opening balance on the sales ledger control account with the previous year's working papers to ensure all the necessary adjustments were put through last year.

(2) Scrutinise sales ledger control for unusual entries.

(3) Check list of trade account receivables balances to and from sales ledger, and reconcile with sales ledger control account.

(4) Carry out analytical procedures, particularly reviewing changes in the receivables turnover period, and changes in the age profile of receivables.

(5) Check that trade receivables have been separately disclosed in the notes to the accounts.

15 Rocks Forever

(1) Factors to consider

- The need for an auditor's expert

  The auditor must consider the risk of material misstatement and whether there is the required expertise within the audit firm. In this case, as inventory is material and this is the only client in the diamond industry which the firm has, it would seem appropriate to use an expert. This need is increased by the specialised nature of the client's business.

- The competence of the expert

  The expert should be a member of a relevant professional body. The auditor should also consider the individual's experience and reputation in his field.

- The objectivity of the expert

  The opinion of UJ could be clouded if, for example, they were related in some manner to Rocks Forever. This could be a personal relationship or one of financial dependence.

- The scope of the expert's work

  If the auditor is to rely on this evidence it must be relevant to the audit of inventory. In this case UJ is considering issues which will impact on the valuation of inventory. This is of great importance to the auditor and is therefore relevant.

- Evaluation of the work performed

  The auditor will need to assess the quality of the work performed by the expert. The auditor will consider the following:

  – Source data used

  – Assumptions and methods used and their consistency with previous years

  – The consistency of the results of UJ's work with other audit evidence taking into account UJ's overall knowledge of the business.

  In spite of the fact that the auditor's expertise is limited in this field UJ may test the data used by UJ. For example comparative price information may be available from other shops or industry sources.

(2) Inventory valuation: audit procedures

The key principle is that inventory should be valued at the lower of cost and net realisable value.

Cost

For a sample of items agree the cost price to the original purchase invoice. Care should be taken to ensure that the invoice relates specifically to the item in question.

Net realisable value

Review the report produced by UJ for any indication that items are fake. (This is unlikely to be the case but should be confirmed.)

For a sample of items sold after the year end verify that the sales price exceeds cost. Where this is not the case the item should be written down to its net realisable value.

Confirm that items valued by the valuer have been included in the inventory total at this valuation. If there are discrepancies the inventory balance should be revised to include UJ's valuation.

Obtain a schedule of the ageing of inventory. For items identified as slow moving discuss with management the need to make an allowance.

16 Panadura (Pvt) Ltd

(1) Advantages of Computer-Assisted Audit Techniques (CAATs)

Time savings

Potentially time-consuming procedures, such as checking casts of ledgers, can be carried out much more quickly using CAATs.

Reduction in risk

Larger samples can be tested, giving greater confidence that material errors have not been missed.

Testing programmed controls

Without CAATs many controls within computerised systems cannot be tested, as they may not produce any documentary evidence. This gives greater flexibility of approach.

Cost effective

Many CAATs have low set-up costs, such as where information is downloaded from the client's system onto the auditor's copy of the same system. Even where CAATs have had to be written specially for a particular audit, the on-going costs will be minimal as they can be reused until the client changes its systems.

(2)

Test data	Reason
Order for unusually high quantities, eg 20 racquets	This would identify whether any reject controls requiring special authorisation for large orders are effective. This control would also prompt the customer to recheck the quantity if they had accidentally keyed in the wrong quantity.
Orders with fields left blank	This would give evidence as to whether orders could be accepted that prove impossible to deliver because, for example, the name of the town has been omitted from the delivery address.
Orders with invalid credit card details	This will identify whether the controls over the ordering system will protect the company from losses arising from credit card frauds.

Test data	Reason
Orders with details of customers on retailers' 'blacklists' or of cards that have been reported as stolen	This will identify whether the company has effective procedures to ensure that their system is regularly updated for security. This should reduce the risk of bad debts.
Order with invalid inventory code	This will show whether the system will alert the customer to the code error and prompt them to check it. This should ensure that the correct goods are dispatched.
Order with complete and valid details	This order should be accepted by the system so will allow the auditor to inspect the order confirmation to determine whether the order details are transferred accurately into the dispatch system.

17 Jaffna Oil Plc

(1) Analytical procedures

- Analytical procedures involve the evaluation of financial information by comparing it with financial and non-financial data and investigating fluctuations/relationships which are inconsistent with other information.
- They are used at the planning stage of an audit to identify unusual trends/ variances which may indicate audit risks.
- They can be used as a substantive audit procedure to gain audit evidence. For example, reviewing the receivables collection period in the current period compared to the prior year may highlight that customers are taking longer to pay their balances, which in turn suggests there may be balances that need an allowance made against them.
- Finally they are used at the final review stage, where the audit senior/ manager must ensure they have sufficient appropriate evidence for the trends shown in the completed financial statements.

(2) Three examples of analytical procedures

- Obtain a breakdown of monthly sales per petrol station analysed according to income from fuel sales, shop sales and the car wash and compare to other petrol stations in the company. Investigate significant variances.

- Compare the profit margins for fuel sales across each of the petrol stations and investigate significant differences.
- Determine the average mark up charged on petrol and diesel from management. Apply this mark up to the costs recorded and estimate expected revenue. Compare estimated revenue with recorded revenue and investigate significant differences.

(3) (i) Valuation of inventory (note only 2 procedures were required)

- For a sample of invoices received from oil suppliers/ other suppliers vouch the cost of goods to invoices.
- If cost approximation is used, discuss method of cost approximation with management (for example average cost) and compare to current oil prices to ensure that the use of a cost approximation is appropriate.
- For a sample of shop sales made post year end, agree sales price to invoices to confirm the net realisable value of inventory is greater than cost.

(ii) Completeness of payables

- Analytically review the level of payables this year compared to prior year and discuss any balances that seem artificially low with management.
- Request that Jaffna Oil Plc send a circularisation letter/ confirmation to the oil/ petrol supply company asking them to send a reply to the auditor stating the balance owed by Jaffna Oil to them at the year end.
- Review the cash book post year end for significant payments to suppliers, trace large payments to the year end payables listing to ensure they relate to balances for payments made to suppliers post year end. Discuss any large payments not on the year end listing to determine why these amounts were paid.
- For shop suppliers, calculate the payables payment period, compare to prior year and investigate significant differences.

18 Mankulam Cakes Ltd

(1) Users of financial statements assume that the financial information they are reading reflects transactions which have been carried out on an arms length basis, ie on normal commercial terms, and between entities that are not connected. If this is not the case then the way that the users may interpret the information could be altered.

In order for the financial statements to reflect the transactions fairly and for them to give a true and fair view, the users must be given all the information they need to understand the nature of the transactions. This is why disclosure of certain related party relationships and transactions is required.

(2) In accordance with the definition of a related party in SLAuS 550, Related Parties, Albert Mankulam is a related party of Mankulam as he controls the entity through his ownership of the majority of the ordinary share capital. The other members of his family would not be seen as related parties as they do not have sufficient shares to exercise control.

Celebration Cakes would be a related party of Mankulam as it is controlled by Mankulam. This control is achieved through the ownership of 100% of the equity shares.

Beautiful Biscuits would also be seen as a related party of Mankulam, even though Mankulam does not own any shares directly. This is on the basis that both Mankulam and Beautiful Biscuits are under common control through having owners who are close family members. This because Mankulam is controlled by Albert Mankulam and Beautiful Biscuits is controlled by his wife, Anita.

(3) Audit procedures would include the following:

- Obtaining an understanding of Mankulam's system for identifying related parties and related party transactions
- Reviewing prior year working papers for names of known related parties
- Enquiring of management about any changes since the prior period
- Reviewing minutes of meeting of shareholders and directors
- Reviewing the register of directors' interests and other statutory records
- Enquiring of management as to whether transactions have taken place
- Reviewing invoices and correspondence from lawyers

(Note: Only five procedures required for full marks)

Part D Auditing in a digital environment

Question 19 covers Auditing in a digital environment, the subject of Chapter 15 in the Study Text.

19 E-Spark Ltd

(1) Robotic Process Automation (RPA) is the use of software to complete rules-based tasks more efficiently than is possible using manual processes. Data analytics is the examination of data to try to identify patterns, trends or correlations. As the quantity of data created by businesses has increased, it has become more and more necessary to evolve ways of processing and making sense of it. The combination of these can enable the auditor to use an automated system to carry out data analytics on client information.

The automated, digital nature of RPA and data analytics means that the auditor is able to test many more transactions and make a more accurate assessment of controls. In some cases it is possible to test 100% of transactions and look for fraud or error across the entire population rather than undertaking a risk assessment and selecting a sample to test.

In the case of the audit of E-Spark it would appear that Endeavour Auditing had difficulty completing the required testing due to the number of transactions having increased. The use of RPA and data analytics would have automated that process, reducing the time taken to carry out testing, improving the accuracy of the results and potentially enabling the auditor to test more items than would have previously been tested.

This does require the auditor to have sufficient technical knowledge to implement RPA software, together with an investment in the software itself. It also requires the integration of the client data into the automation software to enable the testing to take place. However, if these issues can be overcome, then the speed and quality of the audit are likely to increase.

(2) Cloud-based audit working papers are generated through the use of cloud based software that both facilitates collaboration between the audit team, and enables more efficient management of working papers.

The cloud-based nature of the system means that problems such as loss of physical working papers would no longer exist, as the working papers would be stored on the cloud and would always therefore be backed up. The loss of the physical device when the audit junior's car was stolen is also no longer such a problem (so long as the device is encrypted), since the working papers are not stored on the device itself.

Other benefits include the following.

The availability of real-time dashboards that enable audit managers to quickly assess the status of the audit at a glance, and to take corrective action where problems arise.

The integration of up-to-date auditing standards and requirements means that compliance is made easier for the audit firm

The application of state of the art security and encryption standards, which reduces the risk of storing data in comparison with storage on local hard drives.

The working papers are accessible and can be collaborated on by all members of the audit team in real-time.

(3) Block Chain uses 'blocks' of information with a unique code for each, to store and record information on a digital 'chain' once verified. The blockchain is recorded and distributed across a large network of computers and cannot be edited.

The fact that the information is verified and then cannot be edited has been claimed by some to have the potential to reduce the need for external audit, as the block chain can be guaranteed to be 'correct' as it is immutable.

Whilst the blockchain can provide evidence both of a transaction having occurred and of details about it, there will still be a need for judgement about whether the transaction was authorised, whether it was with a related party or was even fraudulent, and whether it has been accounted for appropriately in accordance with Sri Lanka accounting standards. The auditor will therefore need to assess the reliability of the information on the blockchain together with its suitability for accounting purposes.

Part E Evaluating Evidence and Audit Reporting

Questions 20 to 25 covers Evaluating Evidence and Audit Reporting, the subject of Chapter 16 of the Study Text.

20 Moratuwa National Bakeries

Impact on audit report

(i) Freehold property

In past years this property has been shown in the statement at its original cost, whereas it is now restated at Rs. 1,250,000 as professionally valued during the year. The auditor is satisfied as to the basis of the revaluation, adjustment to and disclosure made in the financial statements. As a result of the audit evidence obtained no further reference to the property revaluation will be required in the auditor's report.

(ii) Allowance for doubtful debts

No part of the debt of Rs. 45,000 outstanding is expected to be recovered by the company. The financial statements which the directors have approved include no allowance for this debt and contain a misstatement. This misstatement is 10% of pre-tax profit so is material to the financial statements. Since it only impacts upon one area of the financial statements, it is not pervasive. The auditor's opinion will therefore need to be qualified due to a material misstatement in the financial statements.

The opinion section of the auditor's report will be headed 'Qualified Opinion' and will state that 'In our opinion, except for the failure to make such allowance, the financial statements present fairly, in all material respects, (or give a true and fair view of) the state of the company's affairs and its results.'

The opinion will be followed by a 'Basis for Qualified Opinion' paragraph which will explain that no allowance has been made against an amount of Rs. 45,000 owing by the customer which audit work has found to be irrecoverable.

(iii) Loan to a director

The director's indebtedness of Rs. 23,000 which existed during a six week period has not been disclosed in the financial statements in accordance with LKAS 24 Related Party Transactions. This amount is material at 5.1% of profit before tax. If the directors refuse to amend the financial statements the auditor's report must be modified with a qualified opinion. The issue is not pervasive to the financial statements since it only impacts one area and thus an adverse opinion is not appropriate.

The opinion section of the auditor's report will be headed 'Qualified Opinion' and will state that 'In our opinion, the financial statements, except for the information specified above, are presented fairly in all material respects (or give a true and fair view) in accordance with the applicable financial reporting framework.'

The opinion paragraph will be followed by a 'Basis for Qualified Opinion' paragraph which will explain the reason for the qualification and also quantify the amount of the loan, any interest and the zero outstanding balance at the year-end.

21 Mendes and Vimukithi

(1) Pervasiveness

The impact of a material misstatement or omission is pervasive if the material misstatements or omissions:

- Are not confined to specific elements, accounts or items: or
- Only impact on one element, account or item but this represents a substantial proportion of the financial statements; or
- Relate to disclosures which are fundamental to the users' understanding of the financial statements.

(2) Auditor's reports

Mendes (Pvt) Ltd

Research expenditure of Rs. 2.1m has been capitalised within intangible assets. This is incorrect, as LKAS 38 Intangible Assets requires research expenditure to be expensed to profit or loss.

The error is material as it represents 8% of profit before tax (Rs. 2.1m/Rs. 26.3m). Management should adjust the financial statements by removing the research expenditure from intangibles and debiting the amount to profit or loss.

If management refuse to make the adjustment, the auditor's report will need to be modified. As the error is material but not pervasive, a qualified opinion would seem appropriate on the grounds that the financial statements are materially misstated.

The opinion paragraph would be qualified 'except for'. The basis of opinion section would need to include a paragraph explaining the misstatement and its effect on the financial statements.

Vimukithi (Pvt) Ltd

Two months' worth of wages records have been lost. The auditor should seek alternative audit procedures to audit the wages and salaries account. If no alternative audit procedures are possible, the loss of data would constitute an inability to obtain sufficient appropriate audit evidence.

Wages and salaries for the two month period represents 11% of profit before tax (Rs. 1.1m/Rs. 10m). Therefore, if alternative audit procedures are not possible, the inability to obtain evidence would be material.

The auditors will need to modify the auditor's report on the basis that they are unable to obtain sufficient appropriate evidence in relation to a material amount in the financial statements. As the two months' salary and wages are not pervasive, a qualified opinion would seem appropriate.

The opinion paragraph would be qualified 'except for'. The basis of opinion section would require an explanation of the lack of sufficient appropriate evidence in relation to wages and salaries.

22 Daisy & Fuchsia

Daisy

(1) The company's sales ledger was corrupted by a computer virus so it has not been possible to carry out detailed procedures on receivables and the related revenue. Unless there is an alternative way of confirming revenue and receivables the auditor will have been unable to obtain sufficient appropriate evidence over two very material areas of the financial statements. Receivables of Rs. 3.4m are in excess of profit before tax (PBT) of Rs. 2m. Revenue, at Rs. 15.6m is nearly eight times PBT.

(2) The auditor is unable to obtain sufficient appropriate evidence over the two highly material areas of receivables and revenue. More than one area is affected and this, together with the magnitude of the areas unable to be tested, means the possible effects of any misstatement could be pervasive. Therefore a disclaimer of opinion is necessary.

A basis for disclaimer of opinion paragraph explaining the inability to obtain evidence over revenue and receivables will be included before the opinion paragraph. The disclaimer of opinion in the opinion paragraph will state Violet & Co were unable to form an opinion on the financial statements.

Fuchsia

(1) The financial statements have been prepared on a going concern basis, even though there are indications that the company is not a going concern. Fuchsia has experienced difficult trading conditions, has lost market share and its cash flow forecast for the coming year shows a significant cash

outflow of Rs. 3.2m. This anticipated outflow of Rs. 3.2m is 73% of the current year loss (Rs. 3.2/Rs. 4.4m) and is therefore a material issue. In any case, the basis of preparation of the accounts is a material issue and pervasive, as it impacts on many financial statement areas.

(2) If Violet & Co conclude the going concern basis is inappropriate then the financial statements have been prepared on the wrong basis and are misleading. The effects of this would be pervasive and an adverse opinion would be issued.

The adverse opinion in the opinion paragraph will be an adverse opinion and will state that the financial statements are not presented fairly in all material respects (or do not give a true and fair view). A basis for adverse opinion paragraph will be included after the opinion paragraph to explain that the going concern assumption has been applied when it should not have been.

If management can demonstrate that the going concern basis is appropriate, they should still provide disclosures in light of the uncertainty over going concern. As there are no disclosures the financial statements will be materially misstated even if the going concern basis is appropriate and the audit opinion should be modified. This lack of disclosure would probably be considered material but not pervasive and so a qualified opinion would be issued. If the lack of disclosure were considered pervasive, then an adverse opinion would be given.

23 Builders Merchants Plc

(1) A matter referred to in an emphasis of matter paragraph is one which is appropriately presented or disclosed in the financial statements that in the auditor's judgement is of such importance that it is fundamental to users' understanding of the financial statements. The emphasis of matter paragraph is used to draw attention to the disclosure of this issue in the financial statements.

(2) Impact on audit report

(i) This represents a potential material inability to obtain sufficient appropriate audit evidence because the 'missing' inventory represents 12% of the total. The auditor would expect all inventory counting sheets to be available. The auditor's opinion would therefore be modified.

The qualified opinion paragraph would state that except for the material misstatement in relation to this inventory, the financial statements are fairly presented in all material respects (or give a true and fair view). The auditor's report would include a basis of qualified opinion paragraph after the opinion paragraph which would refer to the fact that the inventory counting sheets for this depot were lost.

The auditor's report would also state that in relation to inventory quantities:

- All information and explanations considered necessary were not obtained; and
- The auditor was unable to determine whether proper accounting records were kept.

(ii) This represents a material misstatement. The debt represents 8% of the total receivables balance and 45% of the profit for the year.

The auditor's opinion would therefore be modified. A qualified opinion would be issued on the grounds of a material misstatement

The qualified opinion paragraph would state that except for the material misstatement in respect of this allowance the financial statements are presented fairly, in all material respects (or give a true and fair view), in accordance with the applicable financial reporting framework.

The basis of qualified opinion paragraph would refer to the fact that the customer is in liquidation and there is little prospect of payment. It would also state that net assets and profits are overstated by Rs. 45,000.

(iii) The auditors need to determine whether the legal claim is a material matter and even whether it is pervasive to the financial statements as a whole. For example, if the customer involved is a major customer, it could be that an adverse outcome could affect the going concern basis of the company.

It appears that the disclosure in the financial statements is adequate and there appears to be no basis on which to make a provision in the financial statements. However, the auditor's report will be affected by the fact that there is an uncertainty affecting the business. The auditor will have to decide whether the inherent uncertainty is fundamental to users' understanding. If so, the auditor's report should include a going concern section beneath the basis for opinion section with details of this matter and a reference to the disclosure in the financial statements. It should also state that the auditor's opinion on the financial statements is not modified in relation to this matter.

24 Hood Enterprises (Pvt) Ltd

Errors in the report extract

(i) 'Presentation of information in the company's annual report'

The auditor's legal responsibilities relate to the financial statements, which comprise the primary statements plus the supporting notes. They do not extend to any other information, for example a chairman's statement, or 5-year summary. To make this clear, this section should refer only to the financial statements.

(ii) 'The auditor's responsibilities relating to other information in documents containing audited financial statements'

Under SLAuS 720, The Auditors Responsibilities Relating to Other Information in Documents Containing Audited Financial Statements, the auditor has a responsibility to read the other information to identify whether there are any inconsistencies with the financial statements or anything that is misleading, but the primary opinion is given on the financial statements only.

(iii) 'In accordance with Auditing Standards'

The report should specify exactly which auditing standards have been used so that there is no risk that readers misunderstand how the audit has been done. It should specify that the audit has been performed in accordance with Sri Lanka Auditing Standards.

(iv) 'Evaluating ....the reasonableness of all accounting estimates'

It is inappropriate to imply that the auditor has considered every estimate made by management. This is unlikely to be true because auditors do not look at every single transaction and item in the financial statements; it is the duty of the auditor to give assurance only on whether the financial statements are free from material misstatement.

(v) *'As much audit evidence as possible in the time available'

This phrase is inappropriate because it implies that the auditor has not had time to obtain all the evidence that is needed. The auditor is expected to obtain sufficient appropriate audit evidence on which to base conclusions. The auditor should have planned the audit so as to obtain sufficient appropriate audit evidence. The time available is not a relevant consideration.

(vi) 'Confirm'

This word should not be used because it implies a greater degree of certainty than is possible based on normal audit procedures. The certainty implied by the word 'confirm' may expose the auditor to negligence claims if it turns out that there are any material errors in the financial statements. A more accurate description of the level of assurance given by an audit is 'reasonable assurance'.

(vii) 'No liability for errors can be accepted by the auditor'

This disclaimer at first might appear to be useful in protecting the auditor against liability. However, the view is that general disclaimers should not be included in audit reports, as their use would tend to devalue the audit opinion.

(viii) 'The directors are wholly responsible for the accuracy of the financial statements'

This statement should not appear in the auditor's responsibility section of the report. The details of management's responsibilities are differently worded and should appear in an earlier separate section of the report outlining the responsibility of management for the preparation of the financial statements.

(Note: Only five errors required for full marks)

25 Glitch

There are several problems with the draft auditor's report.

Layout

The draft report contains a paragraph entitled 'Basis for opinion and disclaimer of opinion'. SLAUSs require two separate sections here, headed 'Basis for Opinion' and 'Opinion'.

The 'Basis for Opinion' section should be placed immediately after the 'Opinion' section, and its adjusted to say whether qualified or adverse.

Wording of report

A description of the scope of the audit is required but not the materiality level used as not required.

The paragraph states that 'procedures have proven conclusively that trade receivables are materially misstated'. This is misleading. Audit procedures provide reasonable assurance which is not the same as 'proven conclusively'.

The basis for modification paragraph should state the amount of the potential adjustment to receivables, along with its financial impact.

The paragraph includes the finance director by name. The statement that eh financial director refused to make an adjustment may leave the auditor open to legal damages if proven untrue by the courts.

Opinion

An inappropriate auditor's opinion has been given here. The draft report is correct that an unmodified opinion would be inappropriate because a material amount of the balance should be written-off. At 30% of profit, any write-off of the receivable would be material.

However, the receivable is unlikely to be judged as pervasive to the financial statements, so the level of modification is wrong. The opinion should the qualified on the grounds of there being a material misstatement.

Key audit matters (KAMs)

SLAUS 701 Communicating Key Audit Matters in the Independent Auditor's requires the auditor to include specified introductory language at the start of the KAMs section of the report. This has not been included here. The auditor's responsibilities section of the report would also discuss KAMs which is not included here, so needs to be checked.

SLAUS 701 requires the description of each KAM to include why the matter was considered to be a KAM and how the matter was addressed and the report includes neither of these points.

The draft report should state the factors that led the auditor to conclude that revenue recognition would require significant auditor attention and describe how the auditor addressed the assessed risks of material misstatement and procedures performed

Emphasis of Matter (EoM)

The use of an EoM paragraph is inappropriate. An EoM is used to refer to a matter which is already correctly disclosed in the financial statements, but which is in need of extra emphasis by the auditor. By contrast, here the EoM refers to a provision not included in the financial statements which is a misstatement. Rs400,000 is not material, so the draft report is correct not to modify the opinion in this respect. Ideally, Glitch should adjust and provide for this amount. If they do not, although it is immaterial on its own, it may become material alongside other uncorrected misstatements.

Part F Assurance and Related Services

Questions 27 to 28 cover Assurance and Related Services, the subject of Chapter 17 of the Study Text.

26 Batulo Ltd

(a) Lilac

An audit engagement partner would have to consider the following things before issuing a reference on behalf of a client.

(i) Is any additional work required to give such a reference?

(ii) If so, the need to contact the bank and discuss whether a separate engagement might be appropriate.

(iii) The inherent uncertainty of future income and expenditure and therefore the high risk which is associated with giving such an opinion.

(iv) The difficulty of issuing an opinion on current solvency. The auditors are about to commence the audit for the past year, meaning they will be investigating information up to 15 months' old.

(v) The fact that a duty of care to the bank is likely to arise if such a reference is given.

(vi) The need for disclaimers of liability, therefore, which will need to be reasonable in order to have legal force, perhaps the need for legal advice before such disclaimer is made.

(vii) Any need to negotiate a liability cap, although a disclaimer of liability should be sufficient/more appropriate.

(viii) Need for written clarification of the status of the reference, that is, explanation that there has been no engagement between the parties, that no fee has been paid, that it is given to the best of knowledge at the time.

(ix) The form of the reference. It is likely to be inappropriate to sign a bank's pre-printed document. The audit firm may have a standard reference document of its own, or may choose to compose each one according to the facts of the situation.

(b) Laurel

The directors of Laurel have expressed an interest in engaging the audit firm to undertake an assurance engagement in relation to their risk management and controls.

The following matters will be relevant.

Acceptance

Independence

The audit firm has to consider the issue of independence. It is vital that the provision of other services to the audit client does not impair their objectivity towards the audit. The CA Sri Lanka Code of Ethics states that provision of other services may impair objectivity.

The CA Sri Lanka Code of Ethics outlines that whether a threat to objectivity exists when providing any professional service will depend upon the particular circumstances of the engagement, and on the nature of the work that the professional accountant in public practice is performing.

The amount that audit independence would be affected will depend on the exact nature of the service provided (see below). However, an assignment testing the operation of controls could be complimentary to the audit.

Nature of the service

The firm would not be able to accept the engagement as it has been currently set out. An assurance engagement should exhibit certain elements, key of which are subject matter, suitable criteria and an engagement process. It is very difficult to give assurance on the effectiveness of risk management, as there are no recognised criteria by which to judge it. However, the firm could provide an assurance service checking that controls are designed according to management criteria and they operate according to management policy, for example. This would need discussing and agreeing in writing before the engagement could be accepted.

Planning

In terms of planning such an engagement, once the details of the engagement had been agreed, the following matters would be relevant:

(i) Is the firm sufficiently independent of the client to conduct the assurance service objectively? It may be that the fact that the company is an audit client would impair their objectivity towards this engagement.

(ii) Are all the elements of an assurance engagement present? This has been discussed above.

(iii) Have the firm and the parties agreed terms? In this case, the assurance service is likely to be carried out to benefit shareholders, so it may be necessary for a vote to be passed in general meeting to approve the service.

(iv) Are the criteria for assessing the subject matter suitable? In this case, management policy would be a suitable criterion for evaluating the operation of systems.

(v) The auditor must assess the materiality and risk of the engagement. These should be incorporated into a fee and into the detailed procedures planned for the engagement.

(vi) What form of report is required by the parties? There is no such thing as a standard report, so it is important for the parties to agree upon the format of the report that will be produced at the end of the engagement.

27 Verity

(a) SLAuS 3400 covers the examination of prospective financial information.

The factors that will affect the accountants' decision on whether to accept appointment are:

(i) Previous experience of client

The accountants should draw on their knowledge of the client as gained during the audit. In particular they will be interested in the willingness of the client to provide information, the integrity and knowledge of the directors, and the reliability of the forecasts prepared for financial accounting purposes, for example for assessment of going concern or deferred tax.

(ii) How prepared

The accountants will need to consider how the forecast is being prepared, in particular:

(1) How the forecast was compiled, and the staff who compiled it

(2) The extent to which the forecast is based on assumptions consistent with past events. The details given suggest that a more optimistic view is being taken than is warranted by the company's record in recent years.

(3) Whether the forecast represents management's best estimate of achievable results, or whether it represents hopeful targets or is based on certain hypothetical events taking place

(4) How the forecast takes account of factors which may invalidate the assumptions made

(5) The complexity of the forecast and the level of detail available supporting the forecast.

(iii) Examination of prospective financial information report

The report must include:

- A statement that management are responsible for the prospective financial information including the assumptions on which the prospective financial information is based. In this case, this will be a cash flow forecast.
- A statement of negative assurance is provided which means nothing has come to the attention of the auditor which indicates the cash flows forecast is not prepared on the basis of the assumptions stated by management. For example, a negative assurance report may state, based on the auditor's examination of evidence supporting the assumptions, nothing has come to the auditor's attention which causes them to believe the assumptions do not provide a reasonable basis for the cash flow forecast.
- The report will also provide an opinion whether the cash flow forecast and its assumptions have been properly prepared in accordance with Sri Lanka Accounting Standards.

(iv) Users

The report is restricted to those parties that have agreed to the procedures to be performed since others, unaware of the reasons for the procedures, may misinterpret the results.

(b) A major concern of the reporting accountant will be the assumptions on which the report is based. The level of evidence required will depend on the terms of the accountants' report, but some evidence will be required on the major assumptions made in the forecast.

(Only five procedures are required)

(i) Sales. It might be expected that the price increase would result in some lost sales, so extra sales will be needed from other customers to make up for the sales lost as well as achieving the planned increase. The auditor will need to focus on the plans to achieve that increase. Increases might be a result of a change in the sales mix or new products or customers; if these changes have already occurred, the accountants should consider what effect they have already had. Increased marketing and promotional activity may also be necessary, and this would need to occur rapidly in order to achieve the desired effect. This activity will probably be reflected in increased costs, and the accountants will need to check that these have been included in the forecast.

(ii) Cost of sales. The accountants will need to consider whether economies have been planned to improve margins, whether these economies are likely to be achieved, and whether there will be consequential other costs that need to be reflected in the plan. For example reduction in the labour force is likely to mean redundancy costs, investment in more up-to-date plant and equipment to mean capital investment costs.

(iii) Trade receivables. The accountants should consider whether the decrease in settlement period is likely to be achieved. They should consider whether emphasising new credit limits and prompt settlement discounts will help achieve the required target, and also the effectiveness of any other measures the company takes, for example tighter checks on new customers and more rigorous pursuit of slow payers. In particular the accountants will need to review the position of foreign customers, as they may be less flexible in reducing settlement periods. The accountants should also check that the consequences of the prompt settlement discount, a reduction in amounts received, have been reflected in the forecast. For foreign customers, the accountants should also check any exchange rate effects have been reflected in the forecast.

(iv) Trade payables. The accountants should check that the increase in payable days will not breach terms of business with suppliers, leading to possible supply problems or withdrawal of credit terms and demands for immediate cash payments. They should also check that the forecast reflects other possible consequences of the increase, for example a loss of early settlement discounts.

(v) Maximum finance. The accountants should check whether the estimated increase in finance is reasonable or whether other sources will be required, either because the Rs1,350m is an under-estimate or because other existing sources of finance will need to be repaid. The accountants should check that the consequences of the increase, particularly an increased interest burden, have been reflected. They should consider also whether the forecast shows that the company will be able to make the repayments comfortably, or whether the forecast margins are tight.

The accountants should also check that the forecast is internally consistent, for example that increased sales correspond with increased purchases, and reflects all non-trading cash flows. Consistency with forecasts made for other purposes, for example management accounting budgets, should also be checked.

Part G Audit Quality and Ethics Questions 28 to 33 cover Audit Quality and Ethics, the subject of Chapter 17 of the Study Text.

28 Maho (Pvt) Ltd

Threats and safeguards

(1) Ethical threats	(2) Possible safeguards
Familiarity	
Mr Son has been the engagement partner for Maho for the past nine years. This gives rise to a familiarity threat because of his long association with this one client which could impair his objectivity and independence.	Mr Son should be rotated off the audit. Ethical guidance states that for listed companies, engagement partners should be rotated after no more than seven years and not return to that client until a further period of two years has elapsed. Although Maho is not stated as listed, partner rotation should still be implemented in order to reduce the familiarity threat.
Mr Son's daughter Zoe will be part of the audit team of Maho. This also gives rise to a familiarity threat because her father is the engagement partner and this may impair objectivity. There is also a type of self-review threat, in that Mr Son will be reviewing his daughter's work and may not wish to highlight any errors she makes.	Whilst Mr Son is still the engagement partner for this audit, his daughter should not be part of the audit team of Maho.
Intimidation	
There may be an intimidation threat from the Finance Director of Maho who has made a statement regarding the calculation of the fees for taxation services. The audit firm may feel that it has to accept this in order to keep Maho as a tax client.	The engagement partner should explain to the Finance Director that although his firm can provide taxation services to Maho, the fees charged must be based on the time spent on the work.

(1) Ethical threats	(2) Possible safeguards
Advocacy	
An advocacy threat may arise as the Finance Director is expecting Ali & Co to represent his company in a dispute with the taxation authorities.	There are no safeguards which could be put in place to mitigate this threat and so the firm must decline to represent Maho in this dispute.
Self-review	
The firm also provides taxation services to Maho and this may give rise to a self-review threat as staff may end up reviewing their own work. The extent of the threat will depend on the nature of the services and in particular how any matters advised on will be reflected in the financial statements.	Depending on the level of the threat, Maho could use separate engagement teams for the audit and tax work to mitigate any threat arising.
Self-interest	
Mr Far, the audit senior, received investment advice from the company and intends to do so in the future. A self-interest threat may arise as a result which could impair his objectivity.	If Mr Far paid for the services received from Maho as any other customer would (and at the same rate), there is potentially no problem. However, this should be discussed with the engagement and ethics partners and he may be advised not to use the services of Maho in the future.
The client is expecting the tax fee to be based on a percentage of tax saved – this is a form of contingent fees. This gives rise to a self-interest threat because the firm will want to save as much tax as possible in order to charge as high a tax fee as possible.	There are no safeguards that can be put in place to mitigate this threat and so the firm should not agree to the proposed fee arrangement for taxation services.
The client has arranged a balloon flight for the audit team. This could give rise to a self-interest threat in the form of gifts and hospitality.	The CA Sri Lanka Code of Ethics for Professional Accountants states that gifts and hospitality should only be accepted where the value is clearly insignificant. In this case, it would be appropriate to decline the balloon flight so as not to impair the firm's independence.

(3) The responsibility of the auditor depends on the nature of the regulations. For those regulations that have a direct impact on material amounts and disclosures in the financial statements the auditor is required to obtain sufficient appropriate evidence that they have been complied with.

For those laws and regulations which do not have a direct effect on the financial statements but where non-compliance could lead to material misstatements in the financial statements, the auditor should undertake audit procedures to help identify non-compliance.

29 Independence

(1) Auditors are engaged to provide an independent report on the truth and fairness of the financial statements to shareholders. A company's audited financial statements are relied upon by shareholders in making decisions about their investment. Other stakeholders will also rely on the audited financial statements in making economic decisions, for example, a bank may use the audited financial statements to ensure loan covenants are being met.

If the auditor's report is to have credibility to stakeholders then it is vital that the auditor is independent of any concern on which he is required to report. Auditors must be independent and also be seen to be independent in order to promote the credibility of their report. An independent auditor's report will increase the confidence of all stakeholders in the company.

(2) (i) The audit partner has no shareholdings in the client company and so, all other things being equal, he could be seen as giving an objective audit opinion. However, the audit manager does have a shareholding in the client company which, while not material to the company (at 1% of issued share capital), could be material to the audit manager and certainly might be seen to influence his ability to give an impartial opinion in relation to the company's affairs. In fact the CA Sri Lanka Code of Ethics ('Code') does not permit a member of the audit team to have a direct financial interest in an audit client. As the partner will inevitably have to rely upon the work completed and controlled by the audit manager it is clearly undesirable for the manager to have such a financial involvement in the client's affairs. The audit manager should either be excluded from the audit team or requested to dispose of his shares.

(ii) The Code states that when a firm receives a high proportion of its fee income from just one audit client a self-interest or intimidation threat. The reason for this is that the fear of losing a major client, and thus a substantial proportion of fee income, could prejudice the auditor's objectivity and make him more likely to bow to pressures from the client.

The audit fee from Janet (Pvt) Ltd contributes some 14.3% of the total fees income of the practice which is a significant proportion. Depending on the other fees the firm would need to assess the threats to independence taking into account the operating structure of the firm and the significance of the client to the firm both qualitatively and quantitatively. The firm should consider what safeguards are necessary and these may include reducing the dependency on the client, arranging independent quality control reviews or consulting a third party on key judgements. The firm would need to keep this situation under constant review.

(iii) As another instance of where financial involvement in a client's affairs could be seen to impair an auditor's objectivity, the Code recommends that between an auditor and a client, there should be no loans or guarantees in respect of loans either way. Any such financial involvement could be seen to impair the auditor's judgement either because of a client putting pressure on the auditor or because of the auditor's own fear of suffering some financial loss.

However, the Code does allow for one exception in making the above recommendation and that is where the loan is in the normal course of business and on normal commercial terms. It is part of a bank's normal business to make personal loans and if the rate of interest being paid by the audit senior appears to be a commercial rate of interest, this transaction is unlikely to be seen as impairing the auditor's independence.

(iv) The Code also considers the problems that can be created when conflicts of interest arise between different clients and between clients and the auditor's own business interests. It concludes that every effort should be made to avoid conflicts of interest arising and that it would be unethical for an accountant to act in a situation where he knew that a conflict of interest existed.

The situation described in the question is a good example of the type of conflict of interest with which the Code is concerned. The audit partner must not act as advisor to Jean (Pvt) Ltd if the threats to independence and confidentiality are too high and cannot be reduced or eliminated via the application of safeguards. Permission must be sought from Harry (Pvt) Ltd before the audit partner can advise Jean (Pvt) Ltd on the tender. If permission is granted, additional safeguards may also be necessary such as the use of separate engagement teams, confidentiality agreements or the review of safeguards by an independent individual. The audit partner cannot act as advisor if permission is refused by Harry (Pvt) Ltd.

The audit partner can only advise Jean (Pvt) Ltd with regard to the contract tender received from Harry (Pvt) Ltd if all threats can be eliminated or reduced to an acceptable level via the application of safeguards. If not, the auditor should explain the professional reasons why he is unable to act on this occasion and suggest that Jean (Pvt) Ltd seek advice from another firm of accountants.

30 De Abrew Plc

(1) Threats to independence

Tax Fees Outstanding

There are taxation fees outstanding from De Abrew Plc for work that was done six months previously. In effect, Senasinge & Co are providing an interest-free loan to De Abrew Plc. This can threaten independence and objectivity of the audit firm as it may not want to modify the audit opinion in case the outstanding fees are not paid.

Fee Dependence

De Abrew Plc is one of Senasinge & Co's most important clients and the firm provides other services to this client as well as audit, including taxation services. Also the company is growing rapidly. Objectivity and independence may be threatened where a significant proportion of fees are from one client as a self-interest threat is created.

Relationship to Financial Director of De Abrew Plc

Allyson Mendis, the daughter of Mr Mendis, has recently been appointed the Financial Director of De Abrew. The independence of Mr Mendis could be threatened because of their close family relationship. The extent of the threat depends on the position the immediate family member holds with the client and the role of the professional on the assurance team.

As Financial Director, Allyson has direct influence over the financial statements and as engagement partner, Mr Mendis has ultimate responsibility for the audit opinion, so there is a clear threat to objectivity and independence.

Meal

The fact that Allyson Mendis wants to take the audit team out for an expensive meal before the audit commences could be considered a threat to independence as it might influence the audit team's decisions once they start the audit of the financial statements. The ethics rules state that gifts or hospitality from the client should not be accepted unless the value is clearly insignificant.

(2) Ways of mitigating the threats

Audit Partner

This threat could (and should) be addressed by appointing another audit partner to the audit of De Abrew Plc and rotating partners at suitable intervals thereafter.

Tax Fees Outstanding

This can be addressed by discussing the issue with the directors of De Abrew Plc and finding out why the fees have not been paid. If the fee is still not paid the firm should consider delaying the start of the audit work or even the possibility of resigning.

Fee Dependence

This threat could be mitigated by reviewing the total of the audit and recurring fee income from De Abrew Plc as a percentage of Senasinge & Co's total fee income on a regular basis and possibly limiting the provision of the other services if deemed necessary to maintain independence.

Relationship to Financial Director of De Abrew plc

As Financial Director, Allyson has direct influence over the financial statements and as engagement partner, Mr Mendis has ultimate responsibility for the audit opinion, so there is a clear threat to objectivity and independence.

This threat to independence could (and should) be mitigated by the appointment of another audit partner to this client.

Meal

This threat could be mitigated by declining the invitation.

31 Devapriya & Co

Ethical threats and steps to mitigate the threats

(1) Ethical threats	(2) Steps to mitigate threats
Devapriya guarantees that its audits will not last longer than two weeks. The amount of time required to complete an audit depends upon the nature of each audit client's business and the level of associated threat. To restrict the duration of all audits to two weeks, regardless of the level of complexity and risks of the business, will result in sufficient and appropriate	Devapriya should retract the 'two-week guarantee' immediately, and explain to its audit clients that the duration of audits will depend upon the level of complexity and threat associated with each business. The completion date of the audit will be agreed with each client at the planning stage, but this may need to change if any circumstances cause the auditor to re-evaluate the company's level of assessed threat.

(1) Ethical threats	(2) Steps to mitigate threats
audit evidence not being obtained. Devapriya would be at risk of giving incorrect audit opinions, leading to possible litigation.	
Devapriya is offering a free accounts preparation service to new audit clients. The preparation of the accounts, which the firm will then audit, gives rise to a self-review threat. In addition, the fact that the accounts preparation service is offered for free may be considered low-balling.	Devapriya should ensure that a separate team is allocated to the accounts preparation work. It must not offer the accounts preparation service to listed clients. It is important that the firm demonstrates that appropriate time and appropriately-qualified staff are assigned to its audit engagements, and that the SLAuS are adhered to.
Devapriya has decided not to update the engagement letters of existing clients. This goes against the requirements of SLAuS 210, Agreeing the Terms of Audit Engagements.	Devapriya should review the need for updating engagement letters on an annual basis.
An existing client has suggested that its audit fee should be based on a percentage of its final pre-tax profit. This constitutes a contingent fee. Contingent fee structures create a self-interest threat which cannot be mitigated. They are therefore prohibited by the Code of Ethics for Professional Accountants.	Devapriya should decline the client's proposal, and explain that audit fees would be based on the level work required to obtain sufficient appropriate audit evidence.

32 Dharsha and Saram

Colombo (Pvt) Ltd

In this case, the company wishes to switch auditor because of their concerns with the level of service provided. This is a perfectly legitimate reason for wishing to switch auditor, and companies are increasingly being encouraged to change auditors when they are unhappy with their existing auditor.

Where the previous auditors have fees owed to them, as in this case, the new auditors need not decline the appointment purely for this reason. Dharsha and Saram should decide how far they are prepared to help Kandy & Co recover their fees, as well as whether or not they should accept appointment.

Kandy & Co should hand over all the books and papers which are owned by Colombo (Pvt) Ltd, unless they have a legal right to hold on to these because of the unpaid fees. Co-operation between the old and new auditor is a matter of professional etiquette, and should Kandy & Co continue to refuse to be helpful, Dharsha and Saram are free to decide whether or not to take up the appointment if they suspect there might be something untoward.

Galle (Pvt) Ltd

In this case, Dharsha and Saram should decline the request to be appointed as auditor. An auditor's objectivity could easily be threatened as a consequence of a close family relationship. Almost as importantly, even if the auditor were able to maintain objectivity, the appointment would appear to third parties to be inappropriate. Galle has been set up by the sister of one of Dharsha and Saram's partners, which is considered a close family relationship, as would parents and adult children.

If the relationship was more distant, and the relative was not in a position to influence the financial statements, it might be possible to carry out an audit. For example, if a distant cousin of the partner was a junior in Galle's marketing department, it is likely that Dharsha and Saram would be able to take up the appointment, although it might be advised to make sure that another audit partner was appointed as the reporting partner.

Negombo (Pvt) Ltd

If the company was listed, it would not be possible for Dharsha and Saram to be involved in the preparation of the financial statements, as well as carrying out the audit. However, as the company is not listed, the firm is allowed under current rules to provide a client with accounting services as well as the audit. In practice, many firms will ask one member of staff to carry out the accounts preparation work, and another to carry out the actual audit. A suitable safeguard in this case would be to have separate teams for the accounts preparation and audit work.

33 Estarellas Plc

(1) The principle of confidentiality imposes obligations on professional accountants, including auditors. Specifically, auditors must refrain from:

- (i) Disclosing outside the audit firm confidential information acquired as a result of professional and business relationships without proper and specific authority, or unless there is a legal or professional right or duty to disclose; and
- (ii) Using confidential information acquired as a result of professional and business relationships to their personal advantage or the advantage of third parties.

An auditor shall maintain confidentiality even in a social environment. The auditor shall be alert to the possibility of inadvertent disclosure, particularly to a close business associate or a close or immediate family member.

An auditor shall maintain confidentiality of information disclosed by a prospective client or employer. An auditor shall also maintain confidentiality of information within the audit firm or employing organisation.

Auditors shall take reasonable steps to ensure that staff under their control and persons from whom advice and assistance is obtained respect the professional accountant's duty of confidentiality.

The need to comply with the principle of confidentiality continues even after the end of relationships between an auditor and a client or employer. When an auditor changes employment or acquires a new client, the auditor is entitled to use prior experience, but shall not use or disclose any confidential information either acquired or received as a result of a professional or business relationship.

(2) The following are circumstances where auditors are or may be required to disclose confidential information or when such disclosure may be appropriate:

(i) Disclosure is permitted by law and is authorised by the client or the employer;

(ii) Disclosure is required by law, for example:

- Production of documents or other provision of evidence in the course of legal proceedings; or
- Disclosure to the appropriate public authorities of infringements of the law that come to light; and

(iii) There is a professional duty or right to disclose, when not prohibited by law:

- To comply with the quality review of a member body or professional body;
- To respond to an inquiry or investigation by a member body or regulatory body;
- To protect the professional interests of a professional accountant in legal proceedings; or
- To comply with technical standards and ethics requirements.

In this case, disclosure is required by law to provide evidence in the course of legal proceedings, and so the auditor shall override the directors' objections, and must hand over the relevant documents to the court.

Section 3: Long Form Questions

Long questions

Questions 1 to 28 are 20-mark questions, each covering several different areas of the syllabus.

1 Puttalam (Pvt) Ltd

(1) Wages system management letter

ABC & Co
Chartered Accountants
29 High Street
Colombo

The Board of Directors
Puttalam Pvt Ltd
10 Low Street
Colombo

December 20X8

Dear Sirs,

Deficiencies in internal control

We set out in this letter deficiencies in the wages system, which we identified as a result of our review of the accounting systems and procedures operated by your company during our recent audit. The matters dealt with in this letter came to our notice during the conduct of our normal audit procedures which are designed primarily for the purpose of expressing our opinion on the financial statements. There may be other weaknesses which we did not identify.

(i) Deficiency	(ii) Consequence of deficiency	(iii) Recommendation
Shift workers can log in and out just by using their electronic identification cards.	Workers can be paid even if they are not working because the time recording system logs them in and out when their cards are scanned and they are paid from and to this time.	The shift manager should agree the number of workers with the computer records at the start and end of the shift.
Overtime is not authorised appropriately or monitored.	Workers could be paid at overtime rates when they are not actually working and could collude with the shift foreman for extra overtime	All requests for overtime must be authorised by the shift manager. Overtime costs should also be monitored

(i) Deficiency	(ii) Consequence of deficiency	(iii) Recommendation
	without actually working it.	regularly.
The code word for the time recording system is generally known within the department.	Unauthorised individuals could log onto the system and enter extra hours so that they are paid more than they should be. Fictitious employees could also be set up on the system.	The code word should be changed immediately to one containing random letters and numbers. The system should be set up so that the code word has to be changed on a regular basis, such as every six weeks.
Payments into workers' bank accounts are made by one member of accounts staff, without any authorisation.	Unauthorised payments into workers' and fictitious bank accounts could be made.	The payroll should be authorised by the Finance Director or another senior manager prior to payments being made.
Review of wages payments is done every few weeks by the financial accountant, seemingly on an ad hoc basis.	There is no regular monitoring of wages by senior management.	The Finance Director should review payroll costs on a weekly basis so that he can assess whether they are reasonable and any unusual amounts can be investigated.

This letter has been produced for the sole use of your company. It must not be disclosed to a third party, or quoted or referred to, without our written consent. No responsibility is assumed by us to any other person.

We should like to take this opportunity of thanking your staff for their co-operation and assistance during the course of our audit.

Yours faithfully

ABC & Co

(2) Substantive analytical procedures

(i) Perform a proof in total of the salaries charge for the year using the prior year charge and increasing it for the pay increase and taking account of any starters or leavers in the period.

The figures should be comparable with the exception of the salary increase and any starters or leavers in the year.

(ii) Perform a comparison of the annual charge to the prior year and to the budgeted figure. Where the variance is significant, investigate further to ascertain why.

The figures should be comparable with the exception of the salary increase of 3%.

(iii) Review monthly salaries month by month.

The figures should be about the same each month, except for July and November when the pay rise and annual bonus were paid respectively. Any starters or leavers would also be reflected in the relevant month.

2 Mannar (Pvt) Ltd

(1) Mannar – Tests of control and test objectives for the sales cycle

(Note: only 5 tests are required).

Test of control	Test objective
Enter an order for a fictitious customer account number and ensure the system does not accept it.	To ensure that orders are only accepted and processed for valid customers.
Inspect a sample of processed credit applications from the credit agency and ensure the same credit limit appears in the sales system.	To ensure that goods are only supplied to customers with acceptable credit ratings.
For a sample of invoices, agree that current prices have been used by comparing them with prices shown on the current price list.	To ensure that goods are only sold at authorised prices.
For a sample of invoices showing discounts, agree the discount terms back to the customer master file information.	To ensure that sales discounts are only provided to those customers the sales director has authorised.
For a sample of orders ensure that an order acceptance email or letter was generated.	To ensure that all orders are recorded completely and accurately.
Visit a warehouse and observe whether all goods are double checked against the GDN and dispatch list before sending out.	To ensure that goods are dispatched correctly to customers and are of an adequate quality.

Test of control	Test objective
With the client's permission, attempt to enter a sales order which will take a customer over the agreed credit limit and ensure the order is rejected as expected.	To ensure that goods are not supplied to poor credit risks.
Attempt to process an order with a sales discount for a customer not normally entitled to discounts to assess the application controls.	To ensure that sales discounts are only provided to valid customers.
Observe the sales order clerk processing orders and look for proof that the order acceptance is automatically generated (eg e-mail in sent folder)	To ensure that all orders are recorded completely and accurately.
Inspect a sample of GDNs and agree that a valid sales invoice has been correctly raised.	To ensure that all goods dispatched are correctly invoiced.
Review the latest report from the computer sequence check of sales invoices for omissions and establish the action taken in respect of any omissions found.	To ensure completeness of income for goods dispatched.

(2) Substantive procedures to confirm Mannar's year-end receivables balance

- Circularise trade receivables for a representative sample of the year-end balances. If authorised by Mannar's management, send an e-mail or reminder letter to follow up non-responses.
- Review cash receipts after the year-end in respect of pre year-end receivable balances to establish if anything is still outstanding. Where amounts are unpaid investigate whether an allowance is needed.
- Review the reconciliation of the receivables ledger control account (sales ledger control account) to the list of receivables (sales ledger) balances and investigate unusual reconciling items.
- Review the aged receivables report to identify any old balances and discuss the probability of recovery with the credit controller to assess the need for an allowance.

- Calculate average receivable days and compare this to prior year and expectations, investigating any significant differences.
- Select a sample of goods dispatched notes just before and just after the year end ensure the related invoices are recorded in the correct accounting period.
- Review a sample of credit notes raised after the year end to identify any that relate to pre year-end transactions and confirm that they have not been included in receivables.
- Review the aged receivables ledger for any credit balances and inquire of management whether these should be reclassified as payables.
- For slow moving/aged balances, review customer correspondence files to assess whether there are any invoices in dispute which require an allowance.
- Review board minutes to assess whether there are any material disputed receivables.
- Select a sample of year-end receivable balances and agree back to a valid GDN and sales order to ensure existence.

(Note: only 3 tests are required)

(3) Controls to reduce the risk of fraud re-occurring and explanation of how the risk is mitigated

(Note: only 4 controls are required)

Control	Explanation of how risk is mitigated by control
Related members of staff should not be allowed to work in the same department where they can seek to override segregation of duty controls.	The risk of related staff colluding and being able to commit a fraud without easily being discovered will be reduced.
Customer statements should be sent out each month to all customers. The receivables ledger supervisor should check that all customers have been sent statements.	Customers receiving statements may notice anomalies in the allocation of payments (either timing or amount) and may alert the company of these anomalies. This may draw attention to the sort of fraud that occurred at Mannar (known as 'teeming and lading').

Control	Explanation of how risk is mitigated by control
Bank reconciliations should be reviewed regularly by an appropriate level of management who is not involved in its preparation. Unreconciled amounts should be investigated and resolved at the time of review.	Any compensating material balances netted off to a small difference on the bank reconciliation will be discovered quickly, increasing the probability of uncovering fraud on a timely basis.
Two members of staff should process cash receipts.	This would mean another collusion would be necessary (on top of the one that has already occurred) to steal cash receipts. This therefore reduces the risk of re-occurrence.
Staff within the finance department should rotate duties on a regular basis.	Rotation will act as a deterrent to fraud. This is because staff will be less likely to commit fraudulent activities due to an increased risk of the next person to be rotated to their position uncovering any wrongdoing.
The receivables ledger should be reconciled to the receivables ledger control account on at least a monthly basis. The reconciliation should be reviewed by a responsible official and anomalies investigated.	This will increase the chance of discovering errors in the receivable balances and help to create a strong control environment likely to deter fraud.
Management should consider establishing an internal audit department to assess and monitor the effectiveness of controls, identify any deficiencies, and carry out specific fraud investigations.	The presence of an internal audit department would help to deter employees committing fraud and identification of fraud would be more likely due to ongoing monitoring of internal controls.

(4) Substantive procedures to confirm Mannar's revenue

- Compare the total revenue with that reported in previous years and the budget for the current year and investigate any significant fluctuations.
- For a sample of customer orders, trace the details to the related dispatch notes and sales invoices and ensure there is a sale recorded in respect of each (to test the completeness of revenue).

- For a sample of sales invoices for larger customers, recalculate the discounts allowed to ensure that these are accurate.
- Select a sample of dispatch notes in the month immediately before and month immediately after the year end. Trace these through to the related sales invoices and resultant accounting entries to ensure each sale was recorded in the appropriate period.
- Obtain an analysis of sales by major categories of toys manufactured and compare this to the prior year breakdown and discuss any unusual movements with management.
- Calculate the gross profit margin for Mannar for the year and compare this to the previous year and expectations. Investigate any significant fluctuations.
- Recalculate the sales tax for a sample of invoices and ensure that the sales tax has been correctly applied to the sales invoice.
- Select a sample of credit notes issued after the year end and trace these through to the related sales invoices to ensure sales returns were recorded in the proper period.

(Note: only 3 procedures are required.)

3 Pear Plc

(1) The auditor should obtain an understanding of internal controls relevant to the audit.

They should:

- Obtain an understanding of the entity and the risks it is exposed to
- Ascertain the nature of the entity's internal control system and assess the impact of this on the level of audit risk
- Decide whether the internal control system is sufficient to gather audit evidence through tests of control with reduced substantive testing or whether full substantive testing is required
- Report any significant deficiencies in internal control to those charged with governance

(2) Internal controls

(i) Deficiency	(ii) Control	(iii) Test of control
As the website is not integrated with the inventory system, inventory levels are not checked before an order is accepted. This means that orders may be accepted when goods are not in inventory resulting in delay in delivery. This could lead to loss of customer goodwill and/or loss of sales.	The website and the inventory system should be integrated so that inventory levels are checked before the order is processed. For items which are not in inventory customers should be given an indication of how long the delay will be.	Test data should be input into the order system via the website for items which are both in inventory and out of inventory. Only orders for items in inventory should be processed. Those out of inventory should be indicated as such.
Local couriers do not always obtain proof of receipt of goods from customers. Customers could claim that they have not received the goods when in fact they have and Pear may have to dispatch the goods again.	Pear should bring the matter to the attention of the courier companies and remind them of the importance of obtaining a customer signature on delivery of the goods. Pear could refuse to pay for any deliveries which are made without a signature.	A sample of dispatches made by the courier companies should be taken. These should be matched to goods dispatched notes returned by the couriers and reviewed for evidence of a signature.
Sales orders are not always fulfilled promptly. This may harm the reputation of the company and result in lost sales.	When goods are dispatched the sales order and dispatch note should be matched as evidence that the order has been fulfilled. Unmatched orders should be flagged by the system after a predetermined period	For a sample of orders which are not on the unmatched item report agree to the dispatch note and verify that the date of delivery is within the time limit set by the company. Review the report of unmatched items to assess whether there is still a significant delay. Discuss the report with

(i) Deficiency	(ii) Control	(iii) Test of control
	eg one week. A report of unmatched items should be reviewed by a supervisor and outstanding items followed up.	the supervisor and obtain an explanation as to why sales orders are still outstanding.
Credit limits are set by the sales ledger clerks. The sales ledger clerks are unlikely to be senior enough to make this type of decision. Also as more than one clerk is involved inconsistent decisions may be taken. If limits are too high this may lead to irrecoverable debts. If limits are too low sales may be lost as a result.	Credit limits should be set by the sales ledger department supervisor or manager, or another suitably senior member of staff.	The credit limits of a sample of new customers should be looked at to ensure that they are within the guidelines set and that they have been authorised by the relevant senior member of staff.
Sales discounts are determined by individual members of the sales team. This increases the risk that inappropriately high discounts may be given by the sales staff in order to achieve a sale. Profits would be reduced as a result.	A standard discount policy should be put in place by the sales director to be implemented by the sales staff. This should be reviewed on a regular basis. Any discounts in excess of these amounts should be authorised by the sales manager or sales director.	The discount policy document should be reviewed to confirm that it has been drawn up by the sales director and is regularly assessed. A sample of sales should be selected and any discounts given should be agreed to the discount policy. Where the discount exceeds the set limit evidence of authorisation by an appropriate member of staff should be inspected.

(i) Deficiency	(ii) Control	(iii) Test of control
Supplier statement reconciliations are not performed. This may mean that there are errors in the purchases and payables accounts which are not identified.	Supplier statement reconciliations should be performed on a monthly basis. Any major discrepancies should be reviewed by a senior member of staff.	Review the reconciliations to ensure that they are being performed on a monthly basis and that significant issues are being followed up by a senior member of staff.
The purchase ledger master file can be changed by the purchase ledger clerks. This increases the risk of error as master file information may be updated incorrectly. It also increases the risk of fraud as fictitious suppliers could be created and bogus payments made.	Only the supervisor should be able to change standing data on the master file. Hierarchical passwords should be used allowing clerks to access the master file but not to change the data. A report of changes to standing data on the master file should be produced on a monthly basis and reviewed by a senior staff member eg the purchasing manager. This review should be evidenced by signature.	Attempts should be made to change standing data on the master file using the hierarchical passwords. Only passwords with the appropriate authority should allow the data to be changed. The report of changes to the master file should be inspected for evidence of review by a suitable senior member of staff.
Pear has surplus plant and equipment. This indicates an inefficient use of company resources. For example these items could be sold and cash reinvested.	A capital expenditure plan needs to be developed by senior management which details not only the requirements for new plant and machinery but also details plans for the disposal of old or surplus items. The factory manager should perform a documented review of	Select a sample of capital expenditure forms and verify that the details comply with management policy. Inspect the plant and equipment review document and follow through the treatment of old or surplus items.

(i) Deficiency	(ii) Control	(iii) Test of control
	the plant and equipment held by Pear on a regular basis (eg quarterly) to identify old or surplus items.	
Purchase requisitions for new equipment are authorised by production supervisors. Production supervisors are not senior enough to authorise major items of capital expenditure. The company may be committed to the purchase of capital items not required.	Capital expenditure limits should be set so that major items of capital expenditure are authorised by the board. Production supervisors should only be able to authorise the purchase of low value items. Capital expenditure authorised by production supervisors should be reviewed on a regular basis by senior management.	Obtain a sample of capital expenditure forms and ensure that authorisation has been made by staff of an appropriate level based on the limits set.

(Note: Only four deficiencies are required to achieve full marks)

(3) Substantive procedures

(i) Additions

- Cast the list of additions and agree the details to the non-current assets register to ensure that additions have been completely recorded
- For a sample of additions physically inspect the asset to confirm existence
- For a sample of additions agree the cost of the asset to the purchase invoice to confirm their value
- For a sample of additions verify that the purchase invoice is made out in the name of Pear International to confirm rights and obligations
- Review the nature of additions to confirm that revenue expenditure has not been capitalised in error.

(ii) Disposals

- Cast the list of disposals and agree the details to the non-current assets register
- For a sample of disposals agree the sale proceeds to supporting documentation and trace receipt of payment to the cash book and bank statements
- Recalculate profits or losses on disposal and confirm that they have been correctly recorded

(Note: Only Six tests were required to achieve full marks)

4 Tempest

(1) Audit planning is important for the following reasons:

- It ensures that appropriate attention is devoted to important areas of the audit. For example, overall materiality and performance materiality will be assessed at the planning stage and this will mean that when the detailed audit plan is drawn up, more procedures will be directed towards the most significant figures in the financial statements.
- Planning should mean that potential problems are identified and resolved on a timely basis. This could be in the sense of identifying financial statement risks at an early stage, so allowing plenty of time to gather sufficient relevant evidence. It could also relate to identifying practical problems relating to the gathering of evidence and resolving those through actions such as involving other experts being built into the detailed audit plan.
- Planning helps ensure that the audit is organised and managed in an effective and efficient manner. This could relate to, for example, ascertaining from the client when particular pieces of information will be available so that the timings of the audit are organised so as to minimise waste of staff time and costs.
- Planning assists in the proper assignment of work to engagement team members. Once the main risk areas have been identified at the planning stage, the engagement partner can then make sure that staff with suitable experience and knowledge are allocated to the engagement team.
- Planning facilitates direction, supervision and review of the work done by team members. Once procedures have been designed and allocated to members of the team, it is easier for the manager and partner to decide when work should be completed and ready for review. It will also make it easier for them to assess during the audit whether work is going according to the original plan and budget.

(2) Materiality for the financial statements as a whole

Preliminary calculations of materiality for the financial statements as a whole are based on the forecast financial statements and are set out below. These materiality levels will need to be reassessed when the actual financial statements for the year ended 31 March 20X7 are available and performance materiality levels will also need to be determined.

Materiality for statement of profit or loss items should be set in the region of Rs. 40,000 (being at the upper end of the range based on profit before tax).

Materiality for statement of financial position items should be set in the region of Rs. 200,000, based on total assets.

Materiality levels for the financial statements as a whole are generally lower than those for the prior year, suggesting performance materiality levels will also be lower. This is likely to increase sample sizes for procedures; this is appropriate in light of the indications that there may an increased risk of error this year.

Materiality calculations

½ -1% of revenue (½% × 45,928 – 1% × 45,928)	230	to	459
5-10% of profit before tax (5% × 436 – 10% × 436)	22	to	44
1-2% of total assets (1% × 10,300 – 2% × 10,300)	103	to	206

(3) Higher risk areas

(i) Inventory

The forecast year end inventory figure is significantly lower than in the prior year. Coupled with the mid-year change in the accounting system for inventory there is a risk of material error in inventory quantities or valuation.

(ii) Sales

Sales are forecast to have increased by 12% over the prior year. Compared to the average year on year growth of only 7% for the industry in general there is a risk that sales may be overstated.

(iii) Profit

Gross profit margin has fallen to 17.3% (20X6 21.9%) and net profit margin has fallen to 0.9% (20X6 4.1%). This could indicate errors in cut off or allocation or that the company has been cutting prices in order to win market share and has let profitability suffer. Although there is no specific indication of immediate going concern difficulties, this strategy may not be sustainable in the longer term.

(iv) Receivables

Days' sales in receivables are forecast to have increased to 47 days (36 days in 20X6). This may indicate problems with the recoverability of the receivables and a risk that impairments in value of the receivables' balances are not recognised.

(v) Non-current assets

There is a decrease in this balance of Rs. 900,000. This is far in excess of what could be explained by depreciation of assets that comprise mainly properties. It may be that there have been disposals in the year. This raises the possibility of incorrect accounting or inadequate disclosures.

Also in relation to the non-current assets, if the inventory balance has genuinely decreased to approximately 15% of its previous level, some of the storage locations may be redundant. It could be that the reduction relates to impairment write-downs and it could be the case that further write-downs are needed.

(vi) Related party transactions

Given the information that one of the directors purchased a yacht during the year it may be that he has purchased fittings from Tempest. There is a risk that any related party transactions have not been fully disclosed.

(4) Audit approach

Wherever possible, evidence should be obtained from tests of control so that detailed substantive procedures can be reduced.

Special emphasis will be needed in respect of inventory accounting.

Procedures will include:

- Obtaining an understanding of how the transfer of balances to the new system was carried out. Direct testing of balances from the old to new systems may be needed as well as reviewing evidence of control procedures carried out by the client at the point of changeover.
- A sample of sales and purchase transactions should be traced through the new system to establish whether additions to and deletions from inventory are being made correctly.
- Test counts of inventory at the various locations should be performed at the year-end and agreed to the inventory records as at that date.

Testing of items in the statement of profit or loss will need to include:

- Consideration of the revenue recognition policies being used
- Cut-off testing on sales and costs of sales
- Comparison of expense classifications from year to year

The review of events after the reporting period should focus on:

- Any substantial adjustments to the inventory figure
- Evidence of recoverability of receivable balances
- Any information suggesting further reductions in profitability of the business
- Management accounts and cash flow projections for the post year end period

5 Ajantha

(1) Confidentiality

Due to confidentiality requirements set out in the Code of Ethics for Professional Accountants, members have an obligation to refrain from disclosing information acquired in the course of professional work unless their client gives permission for them to do so. Confidentiality is an implied term of auditors' contracts with their clients and this obligation continues even after the professional relationship between the auditor and client has ended.

The following are exceptions to this rule, where auditors are or may be required to disclose confidential information or when such disclosure may be appropriate:

(i) Disclosure is permitted by law and is authorised by the client or the employer;

(ii) Disclosure is required by law, for example:

- Production of documents or other provision of evidence in the course of legal proceedings; or
- Disclosure to the appropriate public authorities of infringements of the law that come to light; and

(iii) There is a professional duty or right to disclose, when not prohibited by law:

- To comply with the quality review of a member body or professional body;
- To respond to an inquiry or investigation by a member body or regulatory body;
- To protect the professional interests of a professional accountant in legal proceedings; or
- To comply with technical standards and ethics requirements.

Audit risks and responses

(Note: Only 6 risks and responses are required for full marks)

(2) Audit risk	(3) Response
Ajantha's finance director intends to capitalise the Rs. 2.2 million of development expenditure incurred. This material amount should only be capitalised if the related product is likely to generate future profits. There is a risk that at least some of the expenditure does not meet the criteria. This will mean assets and profits are overstated.	An analysis showing developments costs in relation to each product should be obtained and reviewed. Testing should be carried out to ensure the technical and commercial feasibility of each product and where it can't be proven that future economic benefits will result from the product developed, the related costs should be expensed.
At the year end it is anticipated that there will be significant levels of work in progress, likely to constitute a material balance. The pharmaceuticals production process is likely to be complex and the audit team may not be sufficiently qualified to assess the quantity and value of work in progress. Therefore they may be unable to gain sufficient evidence over a material area of the financial statements.	Nate & Co should assess their ability to gain the required level of evidence and if it is not sufficient, they should approach an independent expert to value the work in progress. This should be arranged after obtaining consent from Ajantha's management and in time for the year-end inventory count.
Ajantha uses standard costing to value inventory and under LKAS 2 Inventories the standard cost method may be used for convenience, but only if the results approximate actual cost. However, standard costs have not been updated since the product was first manufactured, leading to a risk that standard costs are out of date. If they are, this could mean inventory is over or under valued in the statement of financial position.	Standard costs used for inventory valuation should be compared to actual cost for an appropriate sample of inventory items. Any significant variations should be discussed with management to gain evidence that the valuation is reasonable and inventory is fairly stated.

(2) Audit risk	(3) Response
Approximately one-third of the warehouses storing finished goods for Ajantha belong to third parties. Sufficient and appropriate audit evidence will need to be obtained to confirm the quantities of inventory held in these locations in order to verify existence and completeness.	Additional procedures, including attending inventory counts at third party warehouses, will be required to ensure that inventory quantities have been confirmed across all locations.
In September a new accounting package was introduced. The fact the two systems were not run in parallel increases the risk that errors occurring during the changeover were not highlighted, and all areas of the financial statements could potentially be affected.	The new system will need to be fully documented by the audit team including relevant controls. Testing should be performed to ensure the closing data on the old system was correctly transferred as the opening data on the new system, and that transactions have not been duplicated on both systems and therefore include twice.
The IT manager who developed the bespoke system left the company two months after the changeover and his replacement is not due to start until just before the year end. Without an IT manager's support in the interim, errors may occur and may not be picked up due to a lack of knowledge or experience of the system. This could potentially result in misstatements in many areas of the financial statements.	This audit team will need to ascertain from the finance director how this risk of misstatement is being mitigated. During the audit the audit team should remain alert throughout the audit for evidence of errors, particularly when testing transactions occurring between September and March.
Rs. 1 million of equity finance and Rs. 2.5 million of long-term loans have been raised during the year. The accounting treatment and disclosure of these can be complex with the equity finance to be allocated to share capital, and the loan to be properly presented as a non-current liability. Disclosures need to be sufficient to comply with LKASs.	The audit team must the treatment of this finance is correct. Disclosures relating to the equity and loan finance should be reviewed to ensure compliance with relevant LKASs.

(2) Audit risk	(3) Response
The loan has covenants attached to it. If these are breached then the loan would be repayable straight away and would need to be classified as a current liability, potentially resulting in a net current liability position on the statement of financial position. If the company did not have sufficient cash available to repay the loan balance the going concern status of the company could be threatened.	Obtain and review (or re-perform) covenant calculations to identify any breaches. If there are any, then the likelihood of the bank demanding repayment will need to be assessed and the potential impact on the company considered. The need to avoid breaching the covenants reinforces the audit team's need to maintain professional scepticism in areas that could be manipulated.
The finance director has announced that all land and buildings will be revalued as at the year end. The revaluation surplus or deficit is likely to be material and if the revaluation is not carried out and recorded in accordance with LKAS 16 Property, Plant and Equipment, non-current assets may be under or over-valued.	Review the reasonableness of the valuation and assess the competence, experience and independence of the individual performing the valuation. The surplus/deficit should be recalculated to ensure that land and buildings are included at a reasonable amount in the statement of financial position.
The already short reporting timetable for Ajantha is likely to be reduced. This could increase detection risk because there is pressure on the team to obtain sufficient and appropriate evidence in a shorter time scale, which could adversely influence judgement on the size of samples and the extent of work needed.	If it is confirmed with the finance director that the time available at the final audit is to be reduced then the ability of the team to gather sufficient appropriate evidence should be assessed. If it is not realistically possible to perform all the required work at a final audit then an interim audit should take place in late February or early March to reduce the level of work to be done at the final audit.

(4) (i) Substantive procedures for inventory held at third party warehouses

- Attend any inventory count at the third party warehouses to review the controls in operation, to ensure the completeness and existence of inventory and to perform any necessary test counts.
- Request direct written confirmation of quantities of inventory balances held at year end from the third party warehouse providers and request confirmation of any damaged or slow moving goods.

- Review any available reports by the auditors of the third parties owning the warehouses in relation to the adequacy of controls over inventory.
- Inspect any documentation relating to third party inventory.

(ii) Substantive procedures to confirm standard costs used for inventory valuation

- Obtain an analysis of the standard costs used in inventory valuation and compare them with the costs shown on actual invoices or in wages records to see if they are reasonable
- Analyse the variances between standard and actual costs and discuss the reason for these with management and the action taken in respect of any variances.
- Discuss with management how standard costs are formulated and applied to the inventory valuation, and the procedures in place to ensure these are updated to account for movements in actual cost when necessary.

(Note: 4 points only are required.)

6 Glo-warm

(1) Materiality for the financial statements as a whole

It is never appropriate to apply the prior year's materiality figure to the current year figures. Materiality should be reassessed each year.

If the financial position has not changed much and the results are comparable with the prior year, it is possible that the materiality assessed year-on-year is very similar, but this does not mean that the auditors should not assess it for each audit. When assessing materiality, the auditor must consider all known factors at the current date. In this case, the financial position has changed considerably, increasing the risk of the audit, which may lower materiality itself.

As the position on the statement of financial position has changed considerably, when materiality is assessed, it is unlikely that it will be similar to the prior year. Using the information available, materiality is likely to be assessed extremely low in monetary terms, due to the overall decrease in assets and the loss that appears to have been made in the year. It is also possible that given the current position, the figures on the statement of financial position will not be used to assess materiality in this year.

(2) Specific audit areas of risk

A review of this statement of financial position suggests that audit work should be directed to the following areas:

Going concern

Total assets have fallen from Rs. 373,000 to Rs. 165,000. Although the statement of profit or loss has not been reviewed, the statement of financial position shows a retained loss for the year of Rs. 211,000.

Net assets show a reduction in both inventory and receivables, which suggests a decrease in activity, although trade payables do not seem to have fallen so considerably. However, this could be accounted for by Glo-Warm not paying its suppliers in a similar fashion to the previous year. It will be necessary to review the statement of profit or loss to substantiate whether activity has reduced.

The cash position has also worsened, with cash falling by Rs. 22,000. The statement of cash flows should reveal more detail about this fall. However, the company has paid off Rs. 5,000 of its bank loan, reducing overall net debt.

In summary, audit work should be directed at going concern as several indicators of going concern problems exist on the statement of financial position. This will be further amplified when the statement of profit or loss is available.

Inventory

Inventory has been mentioned above in the context of going concern. Audit work should be directed at inventory specifically as this balance has fallen significantly from the previous year, which seems odd in a manufacturing company.

There is no suggestion on the statement of financial position for why this should be so (for example, receivables are not correspondingly high, suggesting high pre-year end sales, and payables are not correspondingly low, suggesting low pre-year end purchases).

It may be that the inventory count did not include every item of inventory. Alternatively it could simply point to a fall in activity (discussed above).

Warranty provision

A provision of Rs. 20,000 has been included in 20X6 for warranties. The reasons for this must be investigated and the auditors must check that it has been accounted for correctly.

It seems odd that a warranty provision should suddenly appear on a statement of financial position. It suggests a change in the terms of contracts given to customers, or a change in the customers themselves (with different terms then applying).

Alternatively it suggests that LKAS 37 has been wrongly applied in the current year, or should have been applied in the previous year, and was not.

Other material items

As stated above, given the indications of loss and the reduction in total asset value, it is likely that materiality will be assessed low in monetary terms. In this case, most balances on the statement of financial position are likely to be material (excluding investments and cash-in-hand which appear to be very low risk).

However, as the bank loan is likely to be substantiated by good audit evidence, the most risky of the other balances are trade receivables and trade payables, for reasons discussed above in going concern.

More detail is required to make a judgement about the risk of tangible non-current assets.

(3) The impact of the material uncertainty regarding going concern depends on whether the situation has been adequately disclosed in the financial statements.

If the situation has been adequately disclosed then, in accordance with SLAuS 570, a section should be included in the auditor's report headed 'Material uncertainty related to going concern'. The section should highlight the importance of the issue. The audit opinion would not be modified in this respect.

If the situation has not been adequately disclosed the audit report would be modified on the grounds that the lack of disclosure has led to a material misstatement in the financial statements. This is likely to be considered material, and so a qualified report would be given.

If the lack of disclosure was considered to be both material and pervasive, such that the financial statements could not be considered to give a true and fair view, then an adverse report should be given.

7 Shantha Holidays

(1) Internal audit and the risk of fraud and error

(i) The management of an entity have the primary responsibility of preventing and detecting fraud and error. An internal audit function may assist them in this responsibility. The role of the internal audit function in respect of fraud and error will be decided by the entity's management but is likely to include some of the following:

- Risk assessment – the internal audit function may carry out risk assessments identifying the main risks of fraud and error or may review that process if it is carried out by management.
- Control recommendations – internal audit reports may recommend controls to address the risks of fraud and error identified by management.
- Control procedures – the internal audit function may be involved in carrying out certain control functions such as counting cash or inventories and comparing to book records. It may be management's objective to detect even low value frauds and misappropriations.
- Monitoring controls – the internal audit function may perform procedures to monitor whether the control procedures implemented by management are operating effectively. This could involve inspecting documents for evidence of appropriate authorisation or using test data to check the operation of computerised controls.

(ii) It would not be appropriate for the internal audit function to be involved in all of these areas in a particular entity, as they would effectively be checking their own work thus undermining their credibility.

(iii) The existence of an internal audit function within an entity is likely to act as a deterrent against fraud and error.

(2) External audit and the risk of fraud and error

(i) Responsibility. The ultimate responsibility of external auditors is to give an opinion on the truth and fairness of the financial statements. This means that the auditors give reasonable assurance that the financial statements are free from material misstatement.

(ii) Professional scepticism. The auditor is responsible for maintaining professional scepticism throughout the audit, considering the possibility of management override of controls, and recognising that audit procedures effective for detecting errors may not be effective for detecting fraud.

(iii) Discussion. The members of the audit team must also discuss the possibility of the entity's financial statements containing material misstatements resulting from fraud or error.

(iv) Risk assessment. When obtaining an understanding of the entity, the external auditor will consider any indications of frauds that may lead to material misstatements. This would involve inquiries of management, internal audit (if applicable) and analytical procedures. Any risks of material misstatement due to fraud will be treated as significant risks.

(v) Responses to assessed risk. The auditor must determine overall responses to address the assessed risks of material misstatement due to fraud at the financial statement level. This will involve:

- Assigning and supervising staff responsible taking into account their knowledge, skill and ability
- Evaluating whether the accounting policies may be indicative of fraudulent financial reporting
- Incorporating unpredictability in the selection of the nature, timing and extent of audit procedures

(vi) Specific audit procedures. Irrespective of the auditor's assessment of the risks of management override, audit procedures must be performed which test the appropriateness of journals and other adjustments. Accounting estimates must be reviewed for bias and, where significant transactions appear to be outside the normal course of business, the auditor must consider if they are concealing a fraud or are themselves fraudulent entries.

(vii) Written representations. The external auditor must obtain written representations from management:

- Acknowledging their responsibility for the design, implementation and maintenance of internal control to prevent and detect fraud.
- That they have disclosed to the auditor management's assessment of the risk of fraud in the financial statements.
- That they have disclosed to the auditor their knowledge of fraud/suspected fraud involving management, employees with significant roles in internal control, and others where fraud could have a material effect on the financial statements.
- They have disclosed to the auditor their knowledge of any allegations of fraud/suspected fraud.

(viii) Limitations. It is not reasonable to expect external auditors to identify all instances of material misstatements where fraud is involved even when the audit is properly planned and performed in accordance with the Sri Lankan auditing standards. Where a fraud has been perpetrated, particularly if it is at management level, it is likely to be carefully concealed and collusion may be involved.

(ix) Reporting. Where the external auditor detects or suspects that a fraud has occurred, this should be reported to the appropriate level of management. In certain circumstances, for example in matters subject to legislation such as money laundering, the auditor may have to report to external bodies.

(3) Risks affecting Shantha Holidays arising from fraud and error

(i) Staff are paid on a commission basis. This may result in deliberate overstatement of sales figures as individuals try to inflate their own income.

(ii) The use of the networked reservations system introduces the risk that information may be lost or corrupted in transmission.

(iii) Errors may occur in the computerised accounting system if the controls within that system are not operating effectively. It may also be the case that certain employees have discovered how to circumvent the controls and are able to amend records perhaps to hide misappropriations of assets.

(iv) Some payments are received in cash. This introduces the risk that cash may be misappropriated and the records falsified to conceal this.

(v) The amount that the entity is required to pay in to the central compensation fund is based on the sales figure for the year. There may be management bias towards understating sales to reduce the amounts payable or delaying revenue recognition thus deferring the due date of the payment.

(vi) Customers may attempt to defraud Shantha holidays by using stolen credit or debit cards.

8 Minty Cola Plc

Audit risk and response

(1) Audit risk	(2) Auditor's response
Significant investment in updating the cola and fizzy drinks production process: risk that capital and revenue expenditure is incorrectly classified, leading to over- or under-statement of non-current assets and profit or loss expense.	Review a breakdown of costs and carry out substantive testing on a sample of the expenditure.
Inventory being held at a larger number of different locations, some of which are not owned by Minty: risk that inventory is misstated. The spread of geographical location increases the risk that the inventory count procedures may be inconsistent.	Attend inventory counts at the locations where the greatest proportion of inventory is held, or where there have been a history of errors. Review supporting documentation from all warehouses to confirm ownership of the inventory, particularly inventory held by third parties.
A new general ledger being introduced: risk of records being incomplete and increased risk of errors as a result of staff being unaccustomed to the system.	Analytical procedures and comparisons with prior year trends, to identify any areas where figures in the financial statements appear to be inconsistent. Agree the opening balances to prior year closing balances, to confirm that they have been correctly recorded in the new system. Substantive testing of a sample of transactions and balances recorded over the transitional period and immediately after. Substantive testing of any accounts identified by analytical procedures as unexpected.
New general ledger: increased detection risk as the related system of internal controls has not been documented and tested by the auditor.	Document and test the new system. Review management reports produced over the transitional period to identify any issues with the recording of financial information.

(1) Audit risk	(2) Auditor's response
Release of the allowance for receivables: risk that truly irrecoverable debts are no longer provided for, giving rise to the overstatement of profit and receivables.	Obtain documentation from management to support the release of the allowance. Make enquiries of the new credit controller to gain an understanding of the likelihood of recovering the Rs. 1.5m of receivables. Carry out extended testing of post year-end cash receipts and review the aged receivables ledger to determine the need for an allowance.
Rs. 4.5m expenditure on the development of a new fizzy drink product: risk that research costs (required to be expensed under LKAS 38 Intangible Assets) and development costs (to be capitalised) are incorrectly classified, giving rise to the overstatement of intangible assets and understatement of expenses.	Obtain a breakdown of development costs and research costs. Undertake detailed testing to determine the nature of the costs. Make enquiries of management regarding the basis on which the costs have been classified.
Defective cola products remain unsold and no adjustments have been made: risk that inventory is overstated.	Carry out detailed testing of the cost and NRV of the defective cola products to determine the level of inventory write-off required.
There is a risk that customers would be unwilling to pay for the defective batch of cola products, causing receivables to be further overstated.	Obtain details of any credit notes issued and returns in relation to the cola products and agree them to revenue and receivables. Obtain correspondence with major retail customers to whom the cola products have been sold, and identify whether any discounts/credit notes have been agreed.

(1) Audit risk	(2) Auditor's response
The management is paid a bonus based on the value of the company's assets: risk that the value of assets is overstated through inappropriate judgements applied in accounting estimates (such as the releasing of the allowance for receivables).	Apply professional scepticism throughout the audit. Review management assumptions in relation to accounting estimates. Work to a lower level of performance materiality to assets susceptible to judgement (for example, receivables, non-current assets and intangible assets).

(Note: Only 6 risks and responses are required)

(3) Substantive procedures

(i) Rs. 5m expenditure on improving the factory production process

- Obtain a schedule of the Rs. 5m expenditure and check that it casts
- Agree items in the schedule to invoices to ascertain that items have been correctly classified
- Inspect the result of work done where necessary
- Agree items on the schedule to the non-current assets register and statement of profit or loss, respectively

(ii) Release of Rs. 1.5m allowance for receivables

- Enquire of the finance director the rationale for releasing the allowance
- Review the aged receivables listing to identify old outstanding receivables balances, and discuss the likelihood of payment with the credit controller
- Obtain details of receipts after the year-end
- Review correspondence with customers to identify any balances in dispute
- Review board meeting minutes for evidence of doubts concerning the recovery of any receivable balances
- Based on the above procedures, calculate the potential level of unrecoverable receivables and assess whether this is material. Discuss the adjustment with management

(iii) Damaged inventory

- Obtain a schedule of the Rs. 1m damaged inventory and cast
- Attend the inventory count. Inspect the damaged goods and agree the quantity to the schedule
- Discuss with management the company's plans for the damaged goods – whether they are to be scrapped or whether any net realisable value can still be assigned to them
- Obtain the sales invoices for any damaged goods sold post year-end to assess the net realisable value
- Determine the cost of the inventory by obtaining supporting documentation with regards to the raw material, labour and attributed overhead costs.
- Quantify the level of adjustment required to value the damaged inventory at the lower of cost and net realisable value and discuss with management

9 Vakarai (Pvt) Ltd

(1) (i) Additional ratios

		20X4	20X3
Operating margin	PBT/Revenue	4.5/23 = 19.6%	4/18 = 22.2%
Inventory days	Inventories/COS × 365 days	2.1/11 × 365 = 70 days	1.6/10 × 365 = 58 days
Payable days	Payables/COS × 365 days	1.6/11 × 365 = 53 days	1.2/10 × 365 = 44 days
Current ratio	Current assets/Current liabilities	6.6/2.5 = 2.6	6.9/1.2 = 5.8
Quick ratio	(Current assets – inventories)/Current liabilities	(6.6 – 2.1)/2.5 = 1.8	(6.9 – 1.6)/1.2 = 4.4

(Note: Only two ratios were required.)

Audit risks and responses:

(1) Audit risk	(2) Audit response
Management were disappointed with the 20X3 results and are under pressure to improve the trading results in 20X4. There is a risk that management have a greater incentive to manipulate the results by adopting a more aggressive approach in relation to accounting estimates (ie provisions).	The audit team will need to remain alert to the risk of creative accounting throughout the audit. It is important that they exercise professional scepticism and evaluate any assumptions made by management in auditing accounting estimates. Current year balances should be compared to the prior year to highlight any unusual trends.
A generous sales-related bonus scheme has been introduced for the company's salesmen. This increases the risk of misstatements arising from sales cut-off as the sales staff seek to maximise their bonus.	Increased sales cut-off testing will be required. Post year-end sales returns should be reviewed, as they may provide evidence of incorrect cut-off.
Revenue has grown by 28%, while cost of sales has only increased by 10%. The gross profit margin has increased significantly. Although the bonus scheme and the advertising campaign may explain the growth in revenue, the fact that the cost of sales has seen a corresponding increase need to be investigated.	Inquiries should be made of management regarding the reason why cost of sales has not increased in line with sales. Substantive procedures should be performed on an increased sample of costs, with an aim to identify any costs omitted or misclassified.
Although the gross margin has increased from 44.4% to 52.2%, the operating margin has decreased from 22.2% to 19.6%. This trend is unusual. While the bonus scheme and advertising campaign could account for some of the increase in operating expenses, there is a possibility that costs may have been misclassified from cost of sales to operating expenses.	The classification of costs between cost of sales and operating expenses will be compared with the prior year to ensure consistency. A detailed breakdown of operating expenses and cost of sales should be reviewed for evidence of misclassification. The main components of costs of sales and operating expenses should be identified and compared to the prior year. Any unusual trends (for example, significant costs in the prior

(1) Audit risk	(2) Audit response
	year not present in the current year, and vice versa) should be discussed with management.
The inventory valuation policy has been changed, with additional overheads to be included within inventory. Inventory days have increased from 58 to 70 days. There is a risk that inventory is overvalued.	The change in the inventory valuation policy should be discussed with management. The additional overheads included should be reviewed, to confirm that they are related to production. Detailed cost and net realisable value testing should be performed and the aged inventory report should be reviewed to assess whether a write-down is required.
Receivables days have increased from 61 to 71 days and management have extended the credit period given to customers. This leads to an increased risk of unrecoverable receivables.	Extended post year-end cash receipts testing and a review of the aged receivables ledger should be performed to assess the need for any write-offs or provision.
The current ratio and quick ratio have both decreased significantly. In addition, the company's positive cash balance of Rs. 2.3m in 20X3 has become an overdraft of Rs. 0.9m. Taken together with the growth in revenue and the increase in operating expenses, this may indicate overtrading. A going concern risk should be considered.	Detailed going concern testing to be performed during the audit. Cash flow forecasts covering at least twelve months from the year end should be reviewed, and the assumptions discussed with management.

(Note: only five risks and responses were required.)

(3) Going concern procedures

- Obtain Vakarai's cash flow forecast and review the cash payments and receipts. Assess the assumptions for reasonableness and discuss the findings with management to understand if the company will have sufficient cash flows.
- Review any current agreements with the bank to determine whether any covenants in relation to the overdraft have been breached.

- Read minutes of the meetings of shareholders, the board of directors and important committees for reference to financing difficulties and for evidence of any future financing plans.
- Review the company's post year-end sales and order book to assess the levels of trade. Evaluate whether the revenue figures in the cash flow forecast are reasonable.
- Review post year-end correspondence with suppliers to identify any restriction in credit that may not be reflected in the cash flow forecasts.
- Inquire of the lawyers of Vakarai as to the existence of litigation and claims.
- Perform audit tests in relation to subsequent events to identify any items that might indicate or mitigate the risk of going concern not being appropriate.
- Review post year end management accounts to assess if it is in line with cash flow forecast.
- Consider whether any additional disclosures as required by LKAS 1 Presentation of Financial Statements in relation to material uncertainties over going concern should be made in the financial statements.
- Confirm the existence, legality and enforceability of arrangements to provide or maintain financial support with related and third parties and assess the financial ability of such parties to provide additional funds.
- Consider Vakarai's position concerning any unfulfilled customer orders.
- Obtain a written representation confirming the director's view that Vakarai is a going concern.

(Note: only four procedures were required.)

(4) Auditor's reports

(i) Where the use of the going concern assumption is appropriate but a material uncertainty exists, provided that the auditor agrees with the basis of preparation of the accounts and the situation is adequately disclosed, an unmodified opinion is issued. The audit report will however include a going concern paragraph highlighting the uncertainty to the user and referring them to the details in the disclosure note.

(ii) Where the material uncertainty exists but the situation is not adequately disclosed the opinion should be modified on the grounds that there is insufficient disclosure and the financial statements are materially misstated. Depending on the specific circumstances this may be a qualified 'except for' or adverse opinion.

(iii) If in the auditor's judgement the company will not be able to continue as a going concern and the financial statements have been prepared on a going concern basis the auditor shall express an adverse opinion.

(iv) If the auditors are unable to form an opinion because they were not able to obtain sufficient appropriate audit evidence they shall issue an 'except for' qualified opinion or a disclaimer.

(v) If management is unwilling to extend its assessment where the period considered is less than twelve months from the reporting date the auditor shall consider the need to modify the opinion as a result of not obtaining this evidence. As this constitutes a lack of audit evidence, a qualified opinion or disclaimer is required.

10 Fonseca Distributors (Pvt) Ltd

(1) Purchase transactions posted to the general ledger

I have been asked to verify whether items are being accurately recorded in the general ledger of Fonseca Distributors in the year. CAATs will need to be used when carrying out substantive testing over the computerised elements of system, for example in extracting listings of invoices from the purchases ledger and matching these to the general ledger postings. For manual postings, samples of supporting documentation will need to be observed and enquiries made of management if any anomalies are found.

Valuation/accuracy

An examination of the analysis and coding of purchase invoices will be carried out to establish the level of accuracy achieved.

Presentation and classification

When carrying out the above examination of the analysis and coding of purchase invoices, particular care will be taken to see that the expense category 'purchases' is correctly identified and coded from invoices and is not confused with other categories, for example stationery, rates, gas and telephone.

Completeness

I would verify that the bookkeeper was up to date with the monthly posting of all purchases transactions to the general ledger.

Specific tests on purchase transactions will include the following:

(i) Purchase transactions will be traced from the invoice to the general ledger and the analysis and analysis code will be checked.

(ii) The total invoice value will be traced to the general ledger.

(iii) The category of invoice expense and the expense amount will be examined to confirm that it appears correctly on the detailed computer list for the month concerned.

(iv) The total of the items on the detailed list will be matched to the general ledger.

Any errors would be fully investigated as to their type, cause, materiality and pattern.

The tests on the detailed list and total postings of cash payments, discounts received and adjustments will follow the same procedure as for invoices and credit notes. The monthly cash book total will be agreed to the total posted from the purchase ledger to the general ledger.

Occurrence

Large variations between actual and budget on expense categories should be examined further to verify that they are not due to errors in analysis, coding or posting. Incorrect analysis and/or coding may be indicated where the expense category is high or low in comparison with its budget to date.

Transactions will be traced backwards from the entries in the general ledger making up the monthly total posted to the purchase ledger back to both the detailed analysis and the individual invoice. The amount of the invoice expense will be agreed with the amount posted to the general ledger. Any errors would be fully investigated as to their type, cause, materiality and pattern.

(2) Journals posted to the general ledger

To verify key assertions for journals posted to the general ledger I would carry out the following tests:

- Firstly, I would check the opening balances at the start of the financial year from the opening trial balance back to the closing entries on the previous year's accounts. After this, each item would be agreed to the general ledger ensuring that both the value and analysis are correct. These opening postings should be the first entries in the new accounting year as all general ledger balances should have been set to zero, and this should be confirmed.

- Other cash book items would be agreed to the general ledger to confirm that postings are correct as to value and expense category. Large items would require a larger sample size and large, unusual or suspicious items should all be checked and evidenced by supporting documentation or Board approval.
- The year-end balances of cash and bank on the general ledger should be agreed with the year-end balances in the cash book. This would require the last month to be scrutinised as the closing balances at all previous month-ends will have been agreed already.
- The tests on petty cash payments transactions would include the following:

  (i) Check that transactions are supported by vouchers and correctly posted to the right general ledger account. This would include checking that transactions are valid and coded to the correct expense category.

  (ii) Check that petty cash transactions are within any limits, regarding the type of expenditure or maximum value, established by management.

  (iii) Agree that the petty cash balance in the general ledger at the end of each month and at the financial year-end matches with the balance in the petty cash book.
- The wages expense is posted manually to the general ledger from the monthly payroll summaries by means of a journal. To verify that the journals are correctly posted I would select several journals and check the following matters:

  (i) The totals of the analysis columns on the monthly summary shown on the spreadsheet should be posted to the journal, and forwarded to the general ledger.

  (ii) The breakdown of wages expense into directors and the several departmental categories will be checked. The correct identification of directors' pay is important as this requires statutory disclosure. I would obtain the current list of directors. I would add up the totals in the analysis columns to confirm the summary total and consider its reasonableness.

  (iii) Amounts owing at the year-end for income tax, accrued pay and other deductions will be verified and any reconciliation drawn up by the bookkeeper agreed.

  (iv) Any additions to, or amendments of, weekly wages records posted to the general ledger through the adjustments journal will be fully investigated and their validity established.

  (v) The analysis of wages expense for the year will be compared with the budget and an explanation will be sought for any significant variances.

- Adjustment journals are potentially a high-risk area and any tests would include the following:
  - (i) Check that all the manually written adjustment journals were authorised by the managing director and supported by documentation and proper narratives.
  - (ii) Check journals are posted in numerical order and there should be no missing numbers gaps in the postings.
  - (iii) Examine all large adjustments and the reasons given for the errors. These will be traced to the general ledger to ensure that postings do correct the errors.
  - (iv) Investigate closely recurring errors to establish their cause and whether these can be avoided in future by management action.
  - (v) Examine the purchase ledger suspense account (payables suspense) and trace all postings in and out.
  - (vi) Where there was no account in the general ledger, agree back to the purchase invoice, establish the account number and verify that the item has been posted from the suspense account to the correct account.
  - (vii) Where the adjustment is due to the wrong account number being used, agree that the journal correctly transfers the item to the right account.
  - (viii) Where the bookkeeper has created contra entries between the purchase ledger and the sales ledger, check that the supplier/customer company concerned is posted with a purchase ledger and sales ledger contra of the same value.
  - (ix) All other adjustments will be checked for validity and supporting documentation. Reasons will be established for postings that increase or reduce purchase ledger balances.

(3) Year-end balances on the general ledger

Year-end balances on the general ledger would be tested as follows:

(i) Any balances remaining on the purchase ledger and sales ledger suspense accounts should be itemised on a supporting schedule and the existence of each item justified.

(ii) General ledger balances for the cash book, petty cash book, sales ledger and purchase ledger should agree to, or be reconciled to, the cash book, petty cash book, total sales ledger and total purchase ledger balances at the year-end. I will investigate further to confirm that any difference is reconciled and explained. It may be that further adjustments are required to reduce or eliminate a difference.

(iii) All non-current asset movements should be checked, including purchases, sales, revaluations and depreciation.

(iv) All outstanding liabilities should be verified and their size reviewed for reasonableness.

(v) The bank reconciliation should establish the correctness of balances on all types of bank account, ie loan, current, deposit, special transactions and so on.

(vi) A review of the financial statements would be carried out to ensure that material changes in assets, expenses, revenues, liabilities and share capital are justified and explained. Justification would be sought in both relative and absolute terms.

11 Kelanyia Joinery (Pvt) Ltd

(1) (i) Builder in liquidation after year end

SLAuS 560 Subsequent Events states that the auditor shall perform audit procedures designed to obtain sufficient appropriate audit evidence that all events up to the date of his report that may require adjustment or disclosure in the financial statements have been identified. Since the customer went into liquidation after year end but before the audit report was signed, the auditor does have a responsibility to look for events of this kind.

This could be achieved by, for example, reading minutes of board meetings, reviewing the entity's latest interim accounts, reviewing procedures that management have for identifying subsequent events, and obtaining written representations that all subsequent events requiring adjustment or disclosure have been adjusted or disclosed.

The customer going into liquidation represents an adjusting event under LKAS 10 Events after the Reporting Period. The trade receivable of Rs. 15,000 needs to be adjusted since the liquidation confirms that the loss existed at the year end date.

(ii) Fire at factory after auditor's report has been signed

The auditor has no obligation to undertake audit procedures or make inquiries regarding the financial statements after the date of the auditor's report. It is the responsibility of Kelanyia's management to inform the auditors of the fire at the factory. If Kelanyia do make the auditors aware of the factory fire, the auditors shall consider whether the financial statements need amending, discuss the matter with management and take appropriate action. If the financial statements are amended, a new audit report must be issued. If management refuses to make any amendments required, the auditor shall modify the audit opinion.

Under LKAS 10 Events after the Reporting Period, the factory fire is a non-adjusting event as it is not indicative of conditions that existed at the reporting date. Since the factory fire is a non-adjusting event, no amendments to the figures given in the financial statements are necessary. Note that although this is a non-adjusting event, the financial statements may still need to be amended to include a disclosure describing the factory fire.

(2) The various factors in the accounts which may be indicative of going concern problems are as follows:

(i) Only losses or low profits are being made and the company is not generating sufficient funds to finance the expansion required.

(ii) There has been a dramatic increase in the level of overdraft over the last year and there seems little prospect of the borrowing being reduced and the security is threatened.

(iii) There are signs of overtrading as the expansion has been financed by borrowings and the increase in current assets is being financed by trade accounts payable.

(iv) The leverage is low and decreasing, with very little security being available for the loans.

(v) There is a low current ratio and short-term funds are being used to finance long-term assets.

(vi) The liquidity ratio is low and decreasing and the company's ability to meet its liabilities on demand must be very questionable.

(vii) Inventory levels are increasing, suggesting that one or more of the following problems may exist: deteriorating sales, poor inventory control, obsolete or slow-moving inventories.

(viii) The value and age of trade accounts payable are increasing; some suppliers are probably having to wait a considerable time before being paid and it can only be a matter of time before pressure is put on the company by one or more of its creditors.

(ix) High and increasing interest charges make the company very vulnerable, especially in a period of recession and high interest rates.

(x) The fluctuating gross profit would suggest that the company's profit margins are under pressure. The present level of gross profit does not seem sufficient given the company's high level of expenses.

Workings

The following significant accounting ratios are based on the accounts provided in the question.

	20X2	20X3	20X4	20X5	20X6
Gross profit (%)	23.50	10.90	14.20	20.20	19.70
Other expenses: sales (%)	14.10	10.90	14.40	14.40	15.30
Interest: sales (%)	0.90	1.10	5.20	5.50	6.20
Net profit (%)	8.50	(1.10)	(5.40)	0.30	(1.80)
Current ratio	1.39	0.91	0.73	0.73	0.76
Liquidity ratio	0.80	0.59	0.46	0.37	0.34
Leverage (%)	84.71	57.14	9.52	9.45	4.83
Inventory (months)	1.68	2.28	2.26	2.77	3.57
Receivables (months)	1.75	3.66	3.24	2.26	2.32
Payables (months)	2.26	5.43	4.43	4.43	5.09

(3) The other important steps to be taken by the auditors in determining whether or not the company may be properly regarded as a going concern at the year-end would include:

(i) Review carefully the cash and profit forecasts for the next year to see if they suggested any improvement in the company's position.

(ii) Seek some evidence that the company's bank is prepared to continue supporting the company.

(iii) Review the level of post year-end trading to see if this supports the forecasts and show any signs of improvement in the company's position.

(iv) Examine correspondence files for any evidence that suppliers might be putting pressure on the company for repayment of monies owing.

(v) Consider how the company's position compares with similar companies in the same business.

(vi) Discuss generally the situation with management and review any recovery plans which they may have in mind.

(vii) Discuss the impact of the factory fire with management, including whether the company has an insurance policy for the factory building or any business interruption insurance.

12 Turbo Plc

(1) The overall audit strategy is a document that outlines the general strategy of the audit. It sets the direction of the audit, describes the expected scope and conduct of the audit and provides guidance for the development of the audit plan.

The audit plan is a more detailed document than the overall audit strategy and includes instructions to the audit team that set out the audit procedures the auditors intend to adopt. The audit plan may also contain references to other matters such as audit objectives, timing, sample sizes and the basis of selection for each account area. It also serves as a means to control and record the proper execution of the audit work.

Key contents of an overall audit strategy:

- Section on understanding the company's environment
- Section on understanding the company's accounting and internal control system
- Risk and materiality considerations
- Nature, timing and extent of audit procedures
- Section on co-ordination, direction, supervision and review
- Any other matters

(2) Performance materiality

Performance materiality is the amount or amounts set by the auditor at less than materiality for the financial statements as a whole (see below) to reduce to an appropriately low level the probability that the aggregate of uncorrected and undetected misstatements exceeds materiality for the financial statements as a whole.

It also refers to the amount or amounts set by the auditor at less than the materiality level or levels for particular classes of transactions, account balances or disclosures.

Materiality for the financial statements as a whole

The materiality level for the financial statements as a whole is set for the purposes of evaluating the effect of misstatements on the financial statements and will generally exceed performance materiality levels used while carrying out audit procedures.

Misstatements are considered material to the financial statements as a whole if they, individually or in aggregate, could reasonably be expected to influence the economic decisions of users. Therefore a misstatement in isolation that exceeds performance materiality may not necessarily be considered material to the financial statements as a whole.

Determining materiality for the financial statements as a whole involves the exercise of professional judgement but generally a percentage is applied to a chosen benchmark) as a starting point for determining materiality for the financial statements as a whole (eg 5% of profit before tax).

When setting all materiality levels and judging the materiality of misstatements the auditor will consider both qualitative and quantitative effects.

Factors influencing the materiality benchmark for Turbo

Turbo's revenue has been declining and the company is expected to make a small profit this year. The company owns a large number of assets in the form of printing equipment. Since revenue and profits have been volatile and the company has a large asset base, total assets may be the most appropriate benchmark for determining materiality.

When calculating materiality using total assets a benchmark of 1-2% is used. The auditors will use their judgment in deciding whether to set materiality at the lower or higher end of this scale. The fact that Turbo is a longstanding client may persuade the auditors to set materiality at the higher end of this scale, particularly if Turbo is known to have a strong control environment with few audit adjustments in prior years. However, given that the auditors are aware the bank will be using the financial statements in making a decision on the loan, they may be more inclined to set materiality at the lower end of the scale this year. Therefore, 1% of total assets is the recommended benchmark for materiality in the audit of Turbo.

(4) Risks and responses

Risk	Response(s) to risk
SLFRS 15 requires that revenue on contracts delivered over time by stage of completion of the contract. Contracts for adverts may span the year end and the timing of invoicing does not necessarily reflect the timing of adverts. Invoicing for half or the whole contract coincides with the advert start date which is not necessarily the stage of completion as required by SLFRS 15. Therefore, there is a risk that sales are recognised early, overstating revenue in the financial statements.	In relation to a sample of contracts in place at the year-end or commencing near to the year end, it should be checked that revenue is recognised in the financial statements according to the timing embedded in the contract for the adverts. Any deferred or accrued income should be recalculated and traced to the financial statements.
If recurring contracts have not been re-signed by the date advertising is meant to start an invoice is raised for the same amount as before, but it is known	Procedures planned for the audit should include a review of renewal invoices close to the year end and these should be traced to contracts to ensure the correct amount and

Risk	Response(s) to risk
that key customers are renegotiating contracts. Key contracts are to be renewed on 31 March and invoiced amounts for these may not reflect the revenue due if contracts are still being negotiated.	proportion of revenue has been included in respect of these.
Receivables may be overvalued as newsagents are taking credit beyond the agreed 45 day limit. This could indicate poor credit control which could result in uncollectable receivable balances.	The auditors should undertake external confirmation of receivables balance to ensure they exist and extend cash-after-date testing to test recoverability of receivables. Customer correspondence files should be reviewed for evidence of any disputes.
Journalists' and photographers' invoices are often received after their services have been provided. As a result liabilities and related costs may be incomplete, understating the amounts included in the financial statements.	Review payments made to journalists or photographers after the year end to identify any payments which relate to pre year-end articles/pictures.
There is a risk that Turbo may not be a going concern due to falling revenues, losses and poor cash flow.	Ask management for their assessment as to whether Turbo is a going concern and how they arrived at their conclusions, and obtain written representation on their conclusion. Review any contracts that have recently been renegotiated and compare to previous contract to ascertain the extent to which revenues are falling.

Risk	Response(s) to risk
Turbo's bank intends to rely on the audited financial statements when making a decision to provide loan finance. As a result, management have an incentive to overstate profits by manipulating balances which are reliant on an element of judgment.	Particular attention should be directed to judgmental areas in the financial statements (eg any provisions reversed and revenue recognition policies). An independent partner review should be undertaken for judgmental areas of the financial statements.
Material refurbishment of printing equipment has taken place and there is a risk some repair costs have been included as non-current assets and vice-versa. Non-current assets and repair costs could be misstated.	An analysis of the refurbishment costs should be reviewed and traced to invoices. The invoice descriptions and supporting documents should be reviewed so as to assess the nature of the expenditure. Once established as either capital or revenue, it should be traced to the general ledger and the financial statements to ensure it has been classified correctly as an asset or repairs.
The potential going concern issues and the reliance of the bank on the unaudited financial statements increase the risk of fraud within Turbo. There is an incentive for management to manipulate the financial statements as mentioned above with the opportunity provided during the production of the financial statements and the potential for justification on the basis of keeping the business solvent means that all key factors for increase fraud risk are present.	The auditor should ensure that the whole team is aware of the higher risk nature of the engagement and are suitably qualified and experienced to work on the engagement. The whole team should act with increased professional scepticism throughout the audit and retain awareness of the risk in all areas of the financial statements. High risk areas such as Revenue should be sufficiently considered with an assumption that revenue recognition in particular is high risk unless there is evidence available to the contrary.

13 Ratnapura Manufacturing (Pvt) Ltd

(1) Risk in the tangible non-current asset audit

Control risk

The controls over non-current assets at Ratnapura appear to be strong. The company maintains and reconciles a non-current asset register and there are authorisation procedures in operation. These controls should be tested, and if they prove effective, control risk could be assessed low.

Inherent risk

The tangible non-current assets are material on the basis of the proposed materiality level. There has been a substantial movement on the plant and equipment account this year, but this appears to be supported by the information given by the management accountant. There appear to be no disposals in the year, which may indicate that they have been omitted, or that obsolete items are included in the register. It is also unclear whether land is being depreciated. It would be inappropriate if it was being depreciated. Overall, the inherent risk seems to be medium.

Detection risk

Given that inherent risk has been assessed as moderate and control risk has been assessed as low, detection risk will be assessed as higher. However, there is usually good evidence in relation to the existence and valuation of non-current assets and these are the key assertions which the auditors are interested in. There will also be scope to carry out good analytical procedures, such as proof-in-total of depreciation.

Conclusion

The audit of non-current assets appears to be medium to low risk.

(2) The sufficiency of audit evidence relates to the quantity of evidence required by the auditor.

The sufficiency of audit evidence is influenced by:

- The risk assessment of the audit – a high risk audit will require more evidence to be gathered.
- The materiality of the item – a material item will require more audit evidence.
- The results of audit procedures – where results of audit procedures are consistent with each other and assess the auditor's initial expectations then less additional audit evidence is required.

The reliability of audit evidence is influenced by the source of the audit evidence.

- Audit evidence from external sources is more reliable than that obtained from the entity's records because it is from an independent source.
- Evidence obtained directly by auditors is more reliable than that obtained indirectly.
- Evidence in the form of documents (paper or electronic) or written representations are more reliable than oral representations, since oral representations can be retracted.

(3) Audit procedures

(i) Existence

In many cases it is self-evident that land and buildings exist. However, it is important for the auditors to verify all components of land and buildings contained within the statement of financial position, if they are on a site different to the one which the auditors are primarily attending, for example.

The other classes of asset should be inspected. A sample of assets from the register should be agreed to the physical asset. The auditors should make use of any identification marks on assets recorded in the register, for example, security tags or bar codes which are kept on assets to distinguish them. The auditor should inspect the condition of the assets and ensure that they are in use.

The motor vehicles should be reconciled in terms of number of vehicles existing at the opening and closing positions.

For all the above assets, the external auditor should also review the insurance provision for the assets. This gives third party evidence of the existence of assets as the insurer would not insure an asset which did not exist.

(ii) Valuation (excluding depreciation)

Land and buildings appear to be stated at historic cost as the schedule does not contain the words 'at valuation'. The auditors should confirm that this is the case with the management accountant. The cost can then be agreed to brought forward figures as there have been no additions in the year. These figures will have been audited in the previous year. If the assets are held at valuation, the auditors must ensure that the requirements of LKAS 16 in relation to revaluations are being complied with.

Similarly, as there have been no movements in the year, motor vehicles can be agreed to the opening position.

To audit the valuation of plant and computers, the auditors should agree the opening position. They should then obtain a schedule of additions to non-current assets, which can be agreed to purchase invoices to verify valuation.

Lastly, the auditors should investigate whether the cost figures include any fully-written down assets. This is implied by the fact that the depreciation charge on plant, excluding additions, is low. If so, the auditor should find out whether these assets are still in use, and if not, consider whether they should be excluded from the cost and accumulated depreciation figures contained within the notes to the accounts. Excluding them would have a net effect on the reported figure of Rs. 0.

(iii) Completeness

The schedule of non-current assets prepared should be reconciled to:

- The opening position (that is, the previous statement of financial position)
- The closing position (what is disclosed in the financial statements)
- The underlying records (the nominal ledger)

If the non-current asset register contains details of the cost and accumulated depreciation of each asset, the register should also be reconciled to the schedule. Explanations should be sought for any differences.

The additions of the schedule should also be checked to ensure that the opening and closing positions reconcile within the schedule.

The auditors should also carry out a test on some of the individual additions, tracing the transaction through the system, from purchase orders to delivery notes and invoices and through the ledgers to the financial statements to ensure that additions have been included completely.

14 Snu

(1) Importance of year-end inventory counts

Auditors are required to obtain sufficient appropriate evidence to support the inventory figure stated in the accounts. This is particularly relevant where inventories are material to the financial statements. Where perpetual inventory systems are not maintained the year-end count is the most reliable means by which the auditor can obtain the following audit evidence:

- Quantity and existence of inventory
- An indication of the value of inventory and the means by which management identify slow and obsolete items
- Cut-off details
- The overall control environment in which the inventory system operates
- Evidence of fraud or misappropriation

(2) Principal risks associated with the financial statement assertions for inventory

One of the risks associated with inventory is its appropriate valuation. Inventory should be valued at the lower of cost and net realisable value per LKAS 2 Inventories. Inventory can be a material figure in the financial statements of many entities, particularly manufacturing companies, and therefore appropriate valuation of inventory is very important, particularly for obsolete and slow-moving items. The valuation can also be a matter of judgement and this increases the risk associated with inventory.

Inventory in the statement of financial position must exist – this is another key assertion. Inventory can be subject to theft and misappropriation, and is often held at more than one location, and so controls to safeguard it are very important.

Cut-off is another key issue for inventory. All purchases, transfers and sales of inventory must be recorded in the correct accounting period as again inventory can be a material figure for many companies. Incorrect cut-off can result in misstatements in the financial statements at the year-end and this can be of particular concern where inventory is material. Auditors therefore need to consider whether the management of the entity being audited have implemented adequate cut-off procedures to ensure that movements into and out of inventory are properly identified and reflected in the accounting records and ultimately in the financial statements.

(3)

Deficiency and implication	Why difficult to overcome
The count is due to take place on New Year's Day. This is unlikely to be popular with staff. Resentment and a desire to get the job done as quickly as possible may mean that the counts are not done thoroughly. There is also little time given to preparation before the count, a problem exacerbated by the fact that	As the company operates seven days a week it would be difficult to find an alternative date for the inventory count. In addition it is at this time of year to coincide with the company's December year end. It would be expensive and difficult to find alternative staff to perform the task and it is unlikely that the business

Deficiency and implication	Why difficult to overcome
both the shops and warehouse are very busy in the period leading up to the count.	will change its year end simply because the inventory count is inconvenient. It may be possible to perform the count a week before or a week after the year end and roll forward/back the inventory calculation. This would involve closing the business for an extra day and would also involve a degree of reliance on inventory records.
There is a lack of segregation of duties. Mr Sneg is the inventory controller as well as being the count supervisor and count checker. This means that he is responsible for the physical assets as well as maintaining the book records. It would be possible therefore for Mr Sneg to cover up theft of inventory or mistakes made by himself. This situation affects the control environment of the overall performance of the inventory count.	In some respects this situation could be resolved if an alternative senior member of staff were made the inventory supervisor. However in family businesses it is common for a small number of loyal and trusted staff to bear the majority of the responsibility. There is likely to be strong resistance from Mr Sneg himself who would feel that his good character was being questioned. Other senior members of staff are also likely to be reluctant to take on a role for which they may feel they have little experience and understanding.
Counters will work on their own. Normally counts should be performed by pairs of counters as this reduces the risk of error.	Where there is a limited number of staff it may be difficult to work in pairs and get the count completed in the available time scale. Due to the timing of the count it will not be easy to get staff from other areas of the business to volunteer to take part.
There is a high turnover of staff. Counters are likely to be inexperienced and may not be motivated to do a good job.	Where staff turnover is high it is difficult to resolve the problem of inexperience in the short term. Management could consider the factors which contribute to staff leaving eg poor pay to determine whether these can be addressed in the medium term. However

Deficiency and implication	Why difficult to overcome
	warehouse work is often unskilled and therefore an element of staff turnover is inevitable.
The treatment of inventory delivered to customers that has not yet been paid for is incorrect. The inventory should not be added back and the unpaid balances should be included as receivables. If this is not done, inventory will be overstated and receivables understated.	There is no reason why this matter cannot be dealt with. The treatment of inventory not paid for should be corrected.

15 Homes'r'Us

(i) Customer going into liquidation

Audit procedures

- Assess the likelihood of recovery of this amount by discussion with the directors of Homes'r'Us.
- Confirm the amount of the amount outstanding as at the year end by inspection of the receivables ledger and correspondence with the customer.
- Review any correspondence between the company and the customer to assess the likelihood of recovery of any amounts.
- Obtain a written representation point regarding the amount outstanding from the customer from the directors of Homes'r'Us.
- Confirm the details of the bankruptcy to documents received by Homes'r'Us from the liquidator.

Impact on financial statements

The financial statements will need to be amended, as this is an example of an adjusting event after the reporting period. It provides additional information concerning the recoverability of the debt at the reporting date.

Revenue, profit and net assets will all be overstated by Rs7.5m if the accounts are not adjusted. The amount represents 10.7% of profit before tax and 1.4% of revenue so is clearly material.

An adjustment is required in the financial statements to reduce the receivables balance and profits.

Effect on auditor's report

The effect of the matter on the financial statements is clearly material. If the adjustments required are made, then there would be no effect on the auditor's report.

If the directors refused to make the adjustment required, the audit opinion would be modified on the basis that the accounts are not free from material misstatement and a qualified 'except for' opinion would be issued, as the matter is material but not pervasive.

(ii) Claim for unfair dismissal

Audit procedures

- Discuss the case for unfair dismissal with the directors of Homes'r'Us to find out background of case, date when claim was lodged and assessment of success.
- Review lawyer's correspondence regarding this case, as it may have an impact for next year's audit.
- Review any press reports in the local or national papers about this claim against the company.
- Review minutes of board meetings regarding this case and any other claim cases against the company.
- Obtain written representations on this matter from the directors of Homes'r'Us.

Impact on financial statements

A provision for this claim is not required since the requirements for recognising a provision under LKAS 37 *Provisions, Contingent Liabilities and Contingent Assets* are not met. Under LKAS 37 (para. 14), a provision should be recognised when there is a present obligation as a result of a past event, it is probable that a transfer of economic benefits will be required to settle it and a reliable estimate can be made.

In this case, it appears unlikely that Mr Evans will be successful in his claim and so no provision should be recognised in the financial statements for the year ended 31 December 20X7.

Disclosure of a contingent liability is also unlikely to be required since the possibility of any transfer in settlement appears to be remote.

Effect on auditor's report

There would be no effect on the auditor's report as a result of this matter, as no amendment would be required to the financial statements. An unmodified report on the financial statements could therefore be issued.

(iii) Fire

Audit procedures

- Discuss fire with management of Homes'r'Us to clarify facts of the situation.
- Read minutes of board meetings and any reports submitted by insurers.
- Review insurance documents to confirm that damage cause by the fire is covered.

Impact on financial statements

The fire at the storage depot is a non-adjusting event after the reporting period – it does not relate to conditions which existed at the year end. It is unlikely that the fire is significant enough to impact on the going concern of the company. Disclosure of the event surrounding the fire should be made, together with an estimate of the financial effect.

Effect on auditor's report

Provided that adequate disclosure has been made of the event and its financial impact, there would be no need to modify the audit opinion as a result of this incident. An emphasis of matter paragraph drawing attention to this issue is unlikely to be required, unless it is viewed as being fundamental to the users' understanding.

16 Chandan

Top tips. This is an example of an exam question examining an assurance service that the candidate may not be familiar with. In such a situation, some might panic and earn no marks. Make sure that you apply the basic principles of assurance provision that you have learnt and your common sense and business knowledge and be one of the candidates who gives an 'excellent' answer. Make sure you read all parts of the question. In this case, even if parts (a) and (b) put you off, any business advisor who had not studied for this paper should have been able to gain marks in parts (b) and (c). For part (d), simply explain the need for a separate audit engagement and likely alterations to the statutory auditor's report to recognise a different framework of preparation.

(a) Agreed Upon Procedures

In an engagement to perform agreed-upon procedures, an auditor is engaged to carry out those procedures of an audit nature to which the auditor and the entity and any appropriate third parties have agreed and to report on factual findings. The auditor is not providing assurance over the matter and the report will not express an opinion.

The recipients of the report must therefore form their own conclusions from the report by the auditor. The report is restricted to those parties that have agreed to the procedures to be performed since others, unaware of the reasons for the procedures, may misinterpret the results.

In this case, the auditor will carry out agreed procedures over the validity of the receivables balance as directed by the client and provide them with a report outlining the results of such testing. Chandan will then draw their own conclusions based on that report as to what actions may be appropriate or not.

(b) Matters to consider

- Whether there are any ethical reasons why the work cannot be undertaken

  For example if there is a close relationship between Felix Chandan and any of the partners of Chileshe objectivity would be impaired.

- Whether there are any conflicts of interest

  This would be the case if Chileshe was already acting on behalf of another client also interested in acquiring ZTI.

- Whether Chileshe has the relevant expertise in this type of work and this type of industry

  Availability of resources and timing of deadlines would also need to be considered, particularly if work will need to be carried out on the international businesses in Africa and Asia.

- Why Chileshe has been approached to perform the work

  Often in this case it would be the company's auditors who are asked to perform the work on the target company. Chileshe will need to consider the size of the fee and the ability to obtain additional work as a result of this review.

- Status of Felix Chanda

  As chief finance officer it is not clear if he is acting with the authority of the main board.

- The nature of the assignment

Felix Chanda has asked Chileshe to 'advise' on a bid. Whilst Chileshe can provide relevant information about factors affecting the bid, it would not be appropriate for the firm to take executive decisions. Ultimately the decision to purchase ZTI must be taken by the board.

- The scope of the assignment

  The precise terms of the agreed upon procedures would need to be clarified to ensure that the extent of the engagement is understood by both parties. Chileshe will need to be clear that the report provided will not provide an opinion but will report on the facts uncovered with conclusions to be drawn by the user.

- Availability of information

  This will depend on the access that Chileshe will be given to the records of ZTI. The procedures to be carried out will rely on ZTI providing the information that Chileshe will require in order to undertake the procedures required.

- Relationship with Chanda's auditors

  Chileshe should be free to communicate with the auditors of Chanda to inform them of their intention to carry out the agreed upon procedures and to ask them to confirm whether there are any reasons why they should not accept the assignment.

(c) Procedures to carry out:

- Review after-date cash receipts by inspecting bank statements and cash receipts documentation.
- Examine the customer's account and customer correspondence to assess whether the balance outstanding represents specific invoices and confirm their validity.
- Examine the underlying documentation (purchase order, despatch documentation, duplicate sales invoice etc).
- Enquire from management explanations for invoices remaining unpaid after subsequent ones have been paid.
- Observe whether the balance on the account is growing and if so, find out why by discussing with management.
- Compare the aged analysis of receivables from the aged receivables listing to the previous year.
- Review the adequacy of the allowance for uncollectable accounts through discussion with management.

- Compare the irrecoverable debt expense as a % of sales to the previous year and/or to industry data
- Compare the allowance for uncollectable accounts as a % of receivables or credit sales to the previous year and/or to industry data.

(d) Principle requirements of SLAuS 800, Audits of Financial Statements prepared in accordance with Special Purpose Frameworks

Terms of Engagement

The terms of the audit engagement will be separate to the statutory audit and reflect the managements responsibility for the financial statements prepared under the expected fair presentation framework provided by the regulator.

Audit Planning and risk assessment

The auditor must plan for the special framework regulator required audit as a separate engagement to the statutory audit. Given that management will be implementing a new reporting framework for the first time then audit risk is likely to be raised. Separate materiality needs to be determined based on this level of risk and sufficient and appropriate audit testing must be planned to address this risk

Also, SLAuS 800 provides a number of requirements for a special purpose frameworks auditor's report.

Basis of Preparation

The auditor's report must state that the financial statements have been prepared by management based on fair representation framework provided and required by the Sri Lanka Government regulator.

Managements responsibilities

The auditor's report must state that management is responsible for the preparation of the regulator required financial statements prepared under the regulators fair presentation framework.

In addition, the auditor's report must state that management have determined that necessary internal control is in place to enable the preparation of regulator required financial statements that are free from material misstatement.

Auditors responsibilities

The auditor's report must state that an audit has been performed to obtain reasonable assurance that the regulator required financial statements are free from material misstatement.

Auditors opinion

The audit opinion will confirm whether or not the financial statements present fairly, in all material respects, a true and fair view in accordance with the required Sri Lanka Government Regulator fair presentation framework.

Basis of Accounting and purpose

The purpose of the financial statement needs to be include included in the auditor's report. Here, the auditor's report will state the financial statements are prepared to assist the company is meeting the requirements of the Sri Lanka Government Regulator and clearly state, the financial statements may not be suitable for another purposes.

Other Matter Paragraph

The other matter paragraph is reserved for anything the auditor is required to disclose, which isn't already included in the financial statements. Here, it is helpful to confirm that company has been audited separately in accordance with Sri Lanka Accounting Standards for statutory auditing purposes.

17 Axis & Co

(1) Lorenze Co

The company has changed its accounting policy for goodwill during the year and failed to disclose this in the financial statements. In accordance with LKAS 8 Accounting policies, changes in accounting estimates and errors, the change in policy should be disclosed in the accounts.

An unmodified opinion on the financial statements with the inclusion of an emphasis of matter paragraph is therefore not suitable as the opinion should be modified on the grounds of a misstatement regarding disclosure – depending on the materiality of the issue, the modification would either be qualified ('except for') (if material) or adverse (if pervasive).

(2) Abrupt Co

Although the auditors are not required to provide an opinion on other information in documents containing financial statements, they are required to read the other information and consider its consistency with the accounts in accordance with SLAuS 720 The auditor's responsibility in relation to other information in documents containing audited financial statements.

There is a material inconsistency between the financial statements and what is stated in the directors' report. It is the directors' report that contains the misstatement. If the directors refuse amend their report so that it is consistent with the accounts, then although an unmodified opinion on the financial statements can be issued, an Other Matter paragraph should be included in the report to highlight this inconsistency.

(3) Jingle Co

A wholly-owned subsidiary of Jingle has commenced trading on 7 July 20X8, subsequent to Jingle's year end. It is not clear whether the company was incorporated prior to 30 June 20X8.

The auditors should obtain more information about Bell. It should be possible to obtain details about its registration from the companies' registry. If this information is unavailable, this would represent an inability to obtain sufficient appropriate audit evidence in respect of which the auditors would have to qualify their auditor's opinion in respect of it.

If the company was incorporated after 30 June 20X8, it requires disclosure in the financial statements as a non-adjusting event after the end of the reporting period. If these disclosures are not made, the auditors would have to qualify the auditor's opinion for 20X8 due to a misstatement regarding the disclosure. However, assuming the subsidiary was accounted for correctly in the 20X9 financial statements, the 20X9 auditor's report would be unaffected.

If the company was incorporated before 30 June 20X8 then the subsidiary needs to be consolidated in Jingle's financial statements and the relevant disclosures have to be made. If this is not the case, then the auditor's opinion for 20X8 would have to be qualified over a misstatement in respect of the accounting treatment of the subsidiary Bell. This would also result in the 20X9 auditor's opinion having to be qualified over the same issue if it was not corrected, as the problem would affect the comparative financial information in the following year.

(4) (i) SLAuS 700 Forming an opinion and reporting on financial statements requires that the audit report only be signed once sufficient appropriate audit evidence has been obtained on financial statements.

Written representations from management are audit evidence, so logically there is not sufficient appropriate audit evidence until these are received.

It is therefore not appropriate to sign the report and date it before these are received.

(ii) It is not generally appropriate to refer to third parties in an auditor's report, as this may give the impression that someone other than the auditor is responsible for the report.

However, SLAuS 710 Comparative information – corresponding figures and comparative financial statements permits reference to be made to a predecessor auditor's report; this is the auditor's own choice.

This reference should be made in an Other Matter paragraph, included directly after the Opinion paragraph, which states that the financial statements for the prior period were audited by a predecessor auditor, states what opinion was expressed, and the date of their report.

18 Colombo

(1) Revising materiality

Auditors must reassess materiality if they become aware of new information that would have resulted in a different materiality level being set at the planning stage.

Planning materiality is likely to have been based on draft financial statements, but during the course of the audit it could become clear that the final financial statements will be substantially different. For example, the carrying amount of assets held at fair value could be much lower than originally expected, which would affect the amounts in the statement of financial position. In that case, the auditor would need to set materiality again, on the basis of the actual results and position.

Alternatively, something could happen during the audit, eg the client could decide to dispose of a subsidiary. This could change the appropriate materiality level, as well as performance materiality. The auditor should take this into account and revise materiality.

(2) Statement of profit or loss and other comprehensive income

Galle revenue

Galle's 25% drop in revenue indicates that goodwill relating to this subsidiary may be impaired. There is a risk that this goodwill has not been impaired when it should have been.

Property disposal

At Rs. 2 Mn, the property disposal is material.

The option to repurchase the property in five years' time points to the possibility that this could not be a genuine sale, but a finance arrangement whose economic substance is that of a secured loan. In this case the audit evidence obtained is inadequate, and further evidence needs to be obtained to determine the substance of the transaction.

If this is indeed a secured loan (in substance), then the asset will be recognised in the statement of financial position, and the cash receipt will be recognised as a loan (liability). Finance costs will be accrued over the period of the loan – five years.

If this is the case, then profit has been materially overstated, and liabilities understated.

Property revaluation

The gain of Rs. 800,000 was just below initial materiality of Rs. 900,000, but above the current materiality level of Rs. 700,000. Audit procedures must now be performed in this area, as it is possible that there could be a material misstatement here.

Actuarial loss

The actuarial losses are material, at Rs. 1.1 Mn, as is the defined benefit liability of Rs. 10.82 Mn.

Axle Plc is a service organisation, and SLAuS 402 Audit considerations relating to an entity using a service organisation requires the auditor to obtain an understanding of this organisation. This can be obtained:

- From the Group itself, we should gain an understanding of how Axle Plc arrives at its valuation, its systems and its controls.
- By obtaining a report from the auditor of Axle Plc (the service auditor), which contains an opinion on the description of Axle Plc's systems and controls.

This has not been done, and we have no information about how the plan assets and liabilities were valued, or how reliable their valuation might be. The audit team must therefore obtain this information before the service organisation's representation can be relied upon.

Goodwill impairment

There is an indicator that goodwill relating to the Galle subsidiary is impaired, but this does not appear to have been considered by the audit team. Audit procedures must be performed on the assumptions used by management in conducting this review. The reasons why the 25% fall in revenue has not resulted in impairment must be specifically addressed.

Associate

The statement of profit or loss includes Rs. 1.01 Mn share of profit of associate. The figure in the statement of financial position should include (at a minimum) the amount brought forward, plus any profit attributable, less any dividends received. It is thus highly unlikely that this figure would not have changed since last year.

Trading division held for sale

The division held for sale is part of a subsidiary. Therefore, some of the goodwill relating to this subsidiary may need to be reclassified as part of the disposal group of assets held for sale. Although it is possible that no goodwill

will need to be reclassified, evidence needs to be obtained that this is the case.

The statement of financial position contains one line within assets for 'assets classified as held for sale'. This disclosure is incorrect: the assets held for sale should be a separate section within 'assets'.

It appears that this Rs. 7.8 Mn could be a net figure, which again is incorrect – there should also be a separate section within 'liabilities' showing the liabilities from the disposal group. Audit procedures should be performed to ascertain whether this in fact a net figure, in order to get the classification right.

Although there are assets held for sale from a trading division, the statement or profit or loss shows no discontinued operations. SLFRS 5 Non-current Assets Held for Sale and Discontinued Operations requires the post-tax profit or loss of discontinued operations to be shown as a single line. This appears to be a material misstatement, and audit procedures should be performed to determine whether it is or not – whether there are any discontinued operations.

Non-controlling interest

There is no disclosure in relation to the non-controlling interest in the statement of profit or loss and other comprehensive income. Both profit for the year and total comprehensive income attributable to the non-controlling interest should be disclosed.

New loan

Finance costs should be included of Rs. 8 Mn × 2% × 9 / 12 = Rs. 120,000. However, finance costs have only risen by Rs. 40,000. No loans appear to have been paid off during the year, as long-term borrowings have increased by exactly the Rs. 8 Mn received for the new loan. Therefore, finance costs appear to be understated.

The amount is not material in itself, but should be accumulated together with any other misstatements that are discovered as they could become material in aggregate.

19 Beech

(1) Fir Plc

Matters to consider

LKAS 16 Property, plant and equipment requires that where there is an obligation to dismantle an asset, then the costs of doing so should be provided for, and included in the cost of the asset. The question here is whether an obligation exists in accordance with LKAS 37 Provisions, contingent assets and contingent liabilities. It is not sufficient for Fir merely to 'intend' to incur the costs, rather; there must be a legal or constructive obligation as a result of a past event. If there is no such obligation, then no provision should be recognised.

The provision should be for the present value of the future outflow of economic benefits. Measuring a provision for costs to be incurred in 20-years' time is inherently risky. For example, the cost to be incurred may only be an estimate; the remaining useful life of the power stations is definitely just an estimate; the selection of a discount rate to calculate the present value involves judgement and is therefore not certain.

The provision has decreased in value since last year, which is unusual as provisions normally increase over time as the present value is built up. This could mean that circumstances have changed, or may signal new measurement assumptions being made. It may also be a sign of profit-smoothing, as earnings have effectively been shifted from last year's statement of profit or loss into this year's. The reasons for this need to be investigated.

The note to the financial statements does not conform to LKAS 37's requirement to provide narrative information, including disclosure of the reasons for making the provision together with any uncertainties in relation to them. The notes should also analyse the movement in the year. Unless this is remedied then this is a material misstatement which may lead to a qualified audit opinion.

Audit evidence

- Review of evidence that there is an obligation to dismantle, eg from regulatory authorities.
- Review of management's calculations used to measure the provision, considering their consistency with other audit evidence obtained (eg that the remaining life of the assets is 20 years).
- Review of documentation supporting management's assumptions (eg to support the estimated cost of decommissioning).
- Discussion with management about reasons for the fall in the provision, and evaluation of these reasons (eg regarding SLFRS, knowledge of the entity).

(2) Spruce Plc

The expert should have been provided with clear written instructions covering the objectives of the work and any specific issues to address. The first procedure would therefore be assessing whether the work done meets these objectives, whether it has been performed in accordance with any standards specified, and that it is consistent with the applicable financial reporting framework.

The expert's work should be reviewed to confirm that the correct source data was used, and that it relates to the right financial instruments in the right period. Any assumptions made by the expert should be compared with eg similar assumptions used by management in preparing the financial statements.

Any evidence contained in the report should be reviewed for consistency with our understanding of the entity and with other audit evidence obtained.

Evidence used by the expert should be agreed to supporting documentation, and any calculations contained in the work should be reperformed, eg fair value movements.

The appropriateness of any models used by the expert should be evaluated.

(3) Pine Plc

LKAS 8 Accounting policies, changes in accounting estimates and errors requires a change in accounting estimate to be accounted for prospectively, not retrospectively as has been done here; retrospective accounting should only be used for a change in accounting policy.

There should be no change to opening assets or equity; these are therefore materially misstated here (overstatement). The extension of the properties' useful life would probably decrease the depreciation expense, resulting in an overstatement of profit. Also it is not clear why all of the properties' useful lives have been extended; LKAS 16 requires that the useful life is the period over which an asset is expected to be used. There is a risk that the useful lives used are not appropriate, and that the financial statements are materially misstated.

LKAS 8 requires disclosure of the nature and amount of the change in estimate; as this has not been done, there is a material misstatement in respect of LKAS 8's disclosure requirements.

The matter should be discussed with management, who should be asked to amend the financial statements. If satisfactory amendments are not made then the auditor's report will contain a qualified opinion. This will be 'except for' a material misstatement, as the amount is material but not pervasive.

The opinion paragraph in the auditor's report is headed 'Qualified opinion'. Immediately before this is a paragraph headed 'Basis for qualified opinion', which describes the matter giving rise to the qualification and quantifies the effects of the misstatement.

(4) Poppy Plc

- Inspection of the written instructions given to the valuer by Poppy which should include the objectives and scope of the work, the intended use of the valuer's work and the extent of the valuer's access to records and files.
- Consideration of the assumptions and methods used by the valuer to ensure they are reasonable based on other audit evidence and the auditor's previous knowledge of Poppy.
- An evaluation of the method used to measure fair value to ensure consistency with LKAS 40.
- Examination of the valuation report to ensure each property has been valued consistently and that the date of valuation is reasonably close to Poppy's year end.
- Physical inspection of the valuation properties to ensure their condition is in line with the valuation report.
- Inspection of purchase documentation for the investment properties to ensure that any revaluations made in the year of purchase are reasonable and not significantly different from the purchase price.
- A review of subsequent events for additional evidence on the valuation of the investment properties.
- Written representations from management concerning the reasonableness of any stated assumptions in determining fair value.
- Evaluate the appropriateness of that expert's work as audit evidence for the relevant assertion.

20 Gills Group

These notes consider the principal audit risks to be considered in planning the audit of the Gills Group financial statements for June 20Y0.

Gills Co

Non-controlling interests

There is an inherent risk that these investments have been classified incorrectly as associates. LKAS 28 Investments in associates and joint ventures requires Gills to have significant influence over the investee. If this is not the case, the investments should be treated as trade investments. Alternatively they may be joint arrangements if control is shared jointly with one or more other entities.

These two investments are in areas quite different from the group's core activity. There is thus a risk that the group's finance team may not have applied appropriate accounting policies – e.g. deferring revenue for the travel agent – resulting in misstatement of the group accounts.

Bonuses and accounting estimates

The existence of profit-based bonuses for directors represents an inherent risk of manipulation, with income and profit being overstated, and expenses being understated.

The fact that the group finance director left after a disagreement over accounting estimates may indicate that senior management have indeed attempted to manipulate the financial statements. It is crucial that professional scepticism is exercised in this area. There is a risk that LKAS 8 Accounting policies, changes in accounting estimates and errors has not been adhered to, for instance if change in accounting policy has been mistaken for a change in accounting estimate.

Group finance director resigned

There is a risk that the financial statements, and in particular the consolidation, have not been properly prepared in the absence of a finance director overseeing the preparation process.

Moreover, the audit team may find it difficult to obtain appropriate explanations from management if there is no finance director, or if a new one is appointed who is not responsible for the accounts being audited.

Shark Co

New factory

The relocation to a new, very large factory may represent an increase in Shark's operational gearing, which may create a business risk to going concern if cash flow problems result. These could be exacerbated by any teething problems resulting from the new factory.

Dismantling costs

LKAS 16 Property, plant and equipment requires the dismantling costs to be capitalised as non-current assets, and a provision created against them. Account should be taken of the effect of discounting if this is material, and a finance charge included in the statement of profit or loss to represent the unwinding of the discount. The risk is that the provision has not been created, and that assets and liabilities are therefore understated, and that the depreciation expense is understated, which would result in profit being overstated. There is also a risk that the provision has not been measured correctly in accordance with LKAS 37 Provisions, contingent liabilities and contingent assets, e.g. in respect of the effect of discounting.

Barracuda Co

Government grant

LKAS 20 Accounting for government grants and disclosure of government assistance requires that the grant income is matched to the costs it is intended to compensate for. This will result in deferred revenue being held on the statement of financial position. There is a risk that this has not been done, leading to liabilities being understated and profit being overstated.

LKAS 20 also requires that a grant is recognised only when there is reasonable assurance that Barracuda will meet the condition specified by the government. Where there is doubt over this, a provision should be recognised in line with LKAS 37. The risk is that this has not been done, and that liabilities are understated and profits overstated.

Piranha Co

Consolidation

The subsidiary was acquired mid-year, and there is a risk that its results have not been consolidated from the correct date. If they are included from too early a date and the company is profitable, then group profits may be overstated.

The acquisition should be accounted for in line with SLFRS 3 Business combinations. There is a risk that goodwill has not been calculated correctly, and that the fair values of Piranha Co's assets and liabilities have not be estimated reliably.

Accounting standards

Piranha Co's accounts must be restated so that they are in line with the group's accounting policies, which should conform to SLFRS. This is a risky process, particularly in the absence of a group finance director, and there is a risk that Piranha Co's accounts may not be in line with SLFRS.

Intra-group trading

Piranha Co supplies about half of Shark Co's ingredients. There are therefore a significant number of intra-group transactions which need to be eliminated from the group accounts. There may also be inventories containing unrealised profit, which needs to be provided for. The risk is that this has not been done, potentially overstating revenues, expenses, assets and liabilities.

Conclusion

There are a number of risks which must be addressed during the planning of the audit of the Gills Group financial statements for June 20Y0.

21 Dragon Group

(1) Matters to include in the tender document

Fees

The proposed fee should be included, along with an explanation of how it is calculated. This would include details of the charge-out rates of the staff likely to be used on the audit, along with estimates of the amount of time the audit would be likely to take.

Dragon Group's needs and how Unicorn & Co could meet them

(i) An explanation of the need for each subsidiary (as well as Dragon Plc) to have its own individual audit, and for the consolidated financial statements then to be audited too.

That Unicorn & Co is a large firm and would be capable of auditing a large group such as this.

(ii) The Dragon Group may also need some non-audit services (see below).

That Unicorn & Co can provide a variety of non-audit services, should they be required.

(iii) Several subsidiaries prepare accounts under local accounting rules, so the auditor of these

That Unicorn & Co is a global firm with offices in over 150 countries. It would well placed to audit under local accounting rules, and to audit their consolidation into the group accounts.

(iv) The Dragon Group operates in the furniture retail trade.

That Unicorn & Co has a specialist retail department and therefore has the experience to audit the group efficiently.

Proposed audit approach

This section should include a description of the methodology to be used in the audit. For instance:

(i) How the firm would acquire knowledge of the business
(ii) Methods used in planning and risk assessment
(iii) Procedures used to gather audit evidence

Brief outline of Unicorn & Co

A short history of the firm, including a description of its organisational structure, the services it can offer and the locations in which it operates.

Other services

A description of any other services Unicorn & Co can offer, such as offering advice in relation to the proposed stock exchange listing. Careful consideration should be given to ethical requirements relating to independence when offering other services to a potential audit client.

Key staff

Details of the proposed engagement partner and of his experience that is relevant to this audit. Details should also be given of the approximate size and composition of the audit team, together with a description of the relevant experience of key members of that team.

Communication with management

An outline of the various communications will be made to management over the course of the audit. This may include information on the way in which these reports could add value to the Dragon Group's business, for instance the production of a written report on the effectiveness of internal control procedures.

Timing

Details should be provided of the timeframe envisaged for the various aspects of the audit. This might include details of when the subsidiaries would be audited, when the consolidation process would be audited, and an estimate of by when the group audit opinion could be completed.

Conclusion

This is a large, transnational group, carrying a high level of risk. Unicorn & Co should take on the audit only once it is sure that it is able to do so, and is assured of a fee that adequately compensates it for the level of risk involved in undertaking the audit.

(2) Matters to consider before accepting engagement

Size of Dragon Group

The Dragon Group is large and expanding group of companies, and would therefore require a high level of resources to audit. Unicorn & Co must consider whether it has sufficient staff available to audit a growing group of this size.

Overseas subsidiaries

Half of the subsidiaries are located overseas. Unicorn & Co has a large number of overseas offices which could perform some or all of the overseas audits. However, these offices may not all have specialist retail audit departments, so consideration needs to be given to whether there is enough experienced staff to carry out the audit.

If some of the overseas audit work needs to be done by auditors outside of Unicorn & Co, then this work would need to be evaluated in order to express an opinion on the group financial statements.

Relevant expertise

As Unicorn & Co has a department specialising in retail audits, it is likely that it will have sufficient expertise in this country.

As a large auditing firm, it is also likely that Unicorn & Co will have staff sufficiently experienced in auditing the consolidation process to audit the consolidation of the Dragon Group's results.

Time pressure

The group's year end is 30 September 20X9, and management wants the audit completed by 31 December 20X9. This represents a tight deadline, given that the audit involves a large number of subsidiaries located in several different countries and reporting under a number of different accounting rules. The fact that this would be the first year that Unicorn & Co would have audited the group also makes the deadline tight. There is also a possibility that management do not fully understand what is required for an audit.

Planned listing

Management are planning a new listing on a foreign stock exchange. This will increase the risk of management manipulation of the accounts, as management may under pressure to report favourable results. Audit risk is also increased by the fact that as a result of the listing, the financial statements will be subject to heavy scrutiny by regulators.

Previous auditor

Unicorn & Co should consider the reason for the group seeking to change its auditor, as this might affect the decision to accept the engagement. On the face of it, it appears likely that the quickly-growing group has outgrown its previous auditors, but Unicorn & Co should still seek to obtain the reason for the change from the previous auditors.

Mermaid Pvt Ltd

Mermaid Pvt Ltd's previous auditors expressed a qualified audit opinion. Unicorn & Co should gather information about the related contingent liability, part of which would involve contacting the previous auditors.

Management's refusal to disclose the contingent liability may indicate a lack of integrity on their part, which would increase audit risk. Consideration then needs to be given to whether any future non-disclosure would be material to the group financial statements.

Minotaur Plc

Minotaur Plc operates in a different business area from the rest of the group, so Unicorn & Co must consider whether it has staff available with the appropriate level of expertise. This difficulty should be straightforward for a firm of Unicorn & Co's size to overcome.

(3) Ethical and professional issues

There are a number of possible threats to Unicorn & Co's independence here:

- Familiarity: Kia may fail to exercise professional scepticism.
- Intimidation: the financial controller may be able to intimidate and influence Kia's work.
- Self-interest: Kia may have an interest in not causing problems for her relative, and may be unwilling to challenge them if required to do so.

To assess the severity of the threat, the degree of influence held by the family member and by Kia must be considered. As financial controller and audit senior respectively, both would have some influence over the financial statements. It would therefore be unlikely that Kia would be able to be assigned to this audit engagement.

Furthermore, allocation of staff to audit teams should be the decision of Unicorn & Co alone. Staff should be allocated on the basis of their experience and skills. There is a risk of the audit team possessing an inappropriate mix of experience and skills for this audit if Unicorn & Co were not able to select the audit team, which may impair audit quality. It is therefore crucial that Unicorn & Co exercise a free choice over the composition of the audit team.

22 Faster Jets

(a) SLAUS 510 Initial engagements—opening balances covers auditor responsibilities for initial engagements. The auditor must obtain sufficient, appropriate audit evidence that the opening balances do not contain misstatements that materially affect the current period's financial statements. The auditor must obtain evidence that the prior period's closing balances have been brought forward correctly to the current period or have been restated, if appropriate. The auditor should also obtain sufficient, appropriate audit evidence that appropriate accounting policies are consistently applied or changes in accounting policies have been properly accounted for and adequately disclosed.

If this evidence cannot be obtained, the auditor's report should include a qualified opinion (inability to obtain sufficient appropriate audit evidence) or a disclaimer of opinion or, in those jurisdictions where it is permitted, a qualified opinion or disclaimer of opinion regarding the results of operations, and an unmodified opinion on the financial position.

If the opening balances contain misstatements that could materially affect the current period's financial statements, the auditor should inform the client's management and the predecessor auditor. If the effect of the misstatement is not properly accounted for and disclosed, a qualified or adverse opinion will be expressed.

If the current period's accounting policies have not been consistently applied to the opening balances and the change not accounted for properly and disclosed, a qualified or adverse opinion will be expressed.

If the prior period's auditor's report was modified, the auditor should consider the effect of this on the current period's financial statements. If the modification remains relevant and material to the current period's accounts then the current period's auditor's report should also be modified.

An Other Matter paragraph should be included in the auditor's report in the case of the prior period financial statements not having been audited at all, or having been audited by another auditor. This is irrespective of whether or not they are materially misstated, and does not relieve the auditor of the need to obtain sufficient appropriate audit evidence on opening balances.

(b) (i) Additional information includes:

- Details of the reason for the purchase, to understand the business purpose, eg whether the land is held for capital appreciation. This will help determine whether it is classified correctly as investment property.
- Whether management has any specific plans for how Faster Jets Co may make use of the land in the future, eg to construct buildings and if so, what their purpose will be.
- The date of purchase, to ascertain how long it has taken for the land to increase in value and whether this is in line with the auditor's understanding of the entity and its environment.
- Whether the land was purchased for cash, or if finance was taken out to raise the Rs125 million paid.
- Details of who is renting the land, in order to establish whether the arrangement is with a related party.
- The type of rental arrangement, to determine whether it represents a lease.

- What the land is being used for. As the legal owner, Faster Jets Co should be aware of its use and any associated risks, eg activities close to airports may convey security risks, eg terrorism.
- The location of the purchased land, in order to plan the logistics of the audit.
- Whether the company holds any other investment property, and if so, whether it is also held at fair value. This will help determine whether the accounting treatment is consistent for all investment property.
- Information on management's reasoning behind the accounting policy choice to measure the land at fair value.
- Details of who holds the title deeds to the land as this may need to be inspected.

(ii) SLAUS 620 Using the work of an expert covers reliance on the audit work on an expert and the standard set out the requirements in respect of independence, competence and scope of work on which reliance by the auditor is placed.

Independence

The auditor must evaluate whether the expert is independent of the client, and so should enquire into whether they have any interests or relationships which may threaten their independence.

For example, the expert must not be connected to Faster Jets Co, and must not be a related party of anyone having influence over its financial statements. Less reliance will be placed on their work if they are not independent.

Competence

The expert's competence must be evaluated, eg by considering whether they are members of any relevant professional bodies. The expert's relevant experience should also be considered. An expert with extensive experience of valuing land and investment properties will be more reliable than a newly-qualified one with relatively little experience.

In this case, an expert valuer may be a Chartered Surveyor, which would give the auditor confidence in the reliability of their work.

Scope of work

The auditor should agree the scope of the work with the expert, include its objectives, how it will be used (in relation to the audit), the methodology and any key assumptions to be used. These assumptions should agree with the auditor's understanding of the entity and its environment.

The scope should be agreed at the start of the engagement. If the expert deviates from it, then their work will be less useful to the auditor.

Conclusions

The auditor considers the source data used by the expert, focusing whether it is reliable and consistent with the auditor's understanding. The auditor then evaluates the conclusions drawn by expert, and whether they are warranted by the evidence obtained. Any inconsistencies should be investigated.

23 Lychee

(1) (i) The restructuring does not relate to conditions at the reporting date, so under LKAS 10 this is not an adjusting event. LKAS 10 requires that this event be disclosed in the financial statements, usually by way of a note explaining the event and its financial effect.

Audit procedures would include:

- Verifying that management have included a note disclosing this event in the financial statements, and that it is drafted in line with LKAS 10
- Agreeing the estimated cost of the closure to underlying calculations and supporting documentation, such as staff employment contracts
- Reviewing the announcement for details, and agree these details to the disclosures made in the financial statements
- Reviewing board minutes for details of the plan and to verify that it has been approved by the board
- Discussing the reasons for the plan with management and consider whether it is consistent with the auditor's knowledge of the business

(ii) If the financial statements are not amended then they are not in accordance with LKAS 10. Considering the materiality of the cost of closure:

Based on revenue: Rs. 58m/Rs. 3.500m = 1.66%

Based on profit: Rs. 58m/Rs. 700m = 8.3%

Based on assets: Rs. 58m/Rs. 18,500m = <1%

The cost of closure is material to the statement of profit or loss, so non-disclosure of this event is a material misstatement. In line with SLAuS 705 Modifications to the Opinion in the Independent Auditor's Report, the auditor should express a qualified 'except for' opinion, as the misstatement is material but not so pervasive as to render the statement of profit or loss meaningless.

The auditor's report should contain a paragraph discussing the reasons for the modified opinion, in which the auditor would explain the nature of the costs not disclosed, state the financial effect of the costs and state that this is in breach of LKAS 10. It would also be helpful for the auditor to state that this does not affect profit for the year, but is a disclosure only.

(2) (i) An Emphasis of Matter (EoM) paragraph is a paragraph in the auditor's report that is appropriately presented or disclosed, but which is so important that special emphasis is needed for users.

An EoM is different from a modification to the auditor's opinion. An EoM paragraph does not modify the opinion; indeed, it should state clearly that this is the case. An auditor should only include an EoM if s/he has sufficient appropriate audit evidence that the matter is not materially misstated.

The EoM should provide a clear reference to the matter, and to where the appropriate disclosures and other information can be found in the financial statements.

In this case of Lychee, a draft EoM paragraph may state:

Emphasis of Matter

We draw attention to note [x] to the financial statements which describes and sets of the expected costs of the restructuring of Lychee Co, which is occurring after the 31 March year end and which will take place over the next six months. The restructuring will involve the closure of a factory, and its relocation to another part of the country closure of the factory. Our opinion is not modified in this respect.

(ii) An Other Matter (OM) paragraph has in common with the EoM the fact that it does not modify the auditor's opinion. However, whereas the EoM refers to a matter within the financial statements, an OM refers to information that is rightly not present in the financial statements, but which is so important for users' understanding of them that it needs to be highlighted in the auditor's report.

The OM provides the means for the auditor to communicate with users, and should state explicitly that the matter referred to is not required to be included in the financial statements. In this case of Lychee, a draft OM paragraph may state:

Other Matter

The financial statements of Pomelo Co. show revenue of Rs. 420 million, net profit of Rs. 65 million or the year ended 30 September 20X9 and had total assets at the year-end of Rs. 1,900 million and were audited by another firm of auditors, whose reports have been furnished. Our opinion has been solely on the reports of the other auditors and our opinion is not modified in this respect of this matter.

24 Willow

(1) Matters raised by audit senior

(i) Inventory

This area is not material to net assets or to income and expenses, but could become so in combination with any other immaterial misstatements detected. Unless this is the case, there would be no effect on the audit report.

LKAS 2 Inventories requires inventory to be measured at the lower of cost and net realisable value (NRV). If the NRV is zero, then an expense of Rs. 130,000 will be incurred, reducing both and assets by the same amount.

SLAuS 580 Written representations states that a written representation is not of itself sufficient appropriate audit evidence. Therefore further evidence must be obtained.

The assertion that must be tested here is that NRV is not less than Rs. 130,000. The finance director's claim that the inventory can be recycled would therefore need to be supported by evidence that the NRV of this recycled inventory would not be less than Rs. 130,000.

Further procedures include:

- Making enquiries from an operations director to ascertain whether or not the materials could be recycled.
- Obtaining documentary evidence of the costs of recycling together with the potential selling price of recycled materials.
- Reviewing invoices raised after the period end for evidence that the materials have in fact been recycled and sold on.

(ii) Provisions

This area is not material to net assets or to income and expenses, but could become so in combination with any other immaterial misstatements detected.

LKAS 37 Provisions, contingent liabilities and contingent assets requires that a provision be recognised where it is probable that there would be an outflow of resources embodying economic benefits, as is the case here. If this adjustment is not made then liabilities and expenses are both understated. There is also unlikely to be adequate disclosure of the circumstances surrounding the case.

When combined with the inventory misstatement, the result is a total misstatement of Rs. 255,000, which is material to income and expenses. If neither adjustment is made then the audit opinion is qualified.

The verbal confirmation that the case will probably be paid is not sufficient, and written confirmation from the lawyers is required. The finance director's refusal to provide this evidence may constitute a limitation on the scope of the audit if the evidence cannot be obtained elsewhere, and throws into question management's integrity. This should trigger a re-assessment of any written representations from management relied on elsewhere in the audit, for example in relation to inventory.

Further procedures include:

- Review correspondence with lawyers for evidence regarding the outcome of the legal claim.
- Review board minutes for evidence about the claim.

(iii) Current assets

A loan to a director is material by nature, irrespective of its monetary value. In line with LKAS 24 Related party disclosures Cherry is key management personnel and thus a related party. The financial statements must therefore disclose the loan principal amount, the amount outstanding at the year end, together with the terms of the loan including details of any security offered.

As the loan is not disclosed in the financial statements, there is a material misstatement in respect of LKAS 24. If no adjustment is made then the audit opinion is qualified.

It is possible that the interest payment has not been made or accrued for. If not, then interest of 4% $\times$ Rs. 6,000 = Rs. 40 should be accrued (the adjustment is immaterial).

Further procedures include:

- Review the written terms of the loan to confirm the interest rate and any other conditions.

- Review list of accruals to see whether interest has been accrued.

(2) Property

A move from recognising properties at cost to at fair value would be acceptable in line with LKAS 16 Property, plant and equipment, as long as it is applied across an entire class of assets. The committee should be aware of the benefits and drawbacks of such a change. Benefits include more relevant information on the values of properties, and quicker recognition of fair value gains in the financial statements. But the drawbacks include the need to remeasure fair value at each period end. It may also be necessary to employ an external expert to estimate fair values, which could be costly.

Asset register

The delay in receiving the non-current asset register would have impaired audit efficiency, and potentially resulted in greater audit costs and therefore fees.

The fact that the issue was discussed with the committee last year but then recurred, suggests some sort of controls failure; either the last year's discussion was not acted upon by the committee, or at some other point. In both cases the reason for this needs to be ascertained.

The fact the financial controller has been on holiday at the start of the audit for two years running is not just unhelpful, but may be a cause for concern eg indicative of fraudulent behaviour.

Procurement

No explanation is actually given for why invoices are not matched to goods received notes; there is no reason why this cannot be done if suppliers are changed frequently, for example. Without this control, it is possible that invoices are paid without goods ever being received. There is also a risk of fraud if this is done intentionally, either delivering goods to another address or using dummy invoices. The committee should seek to improve controls in this area as a matter of some urgency.

Frequently switching suppliers is not itself a problem, but again this would not seem to totally preclude maintaining a list of approved suppliers – it only means that such a list would be a long one. If totally new suppliers really are being used so frequently, then there may be issues with quality rather than price.

Financial controller

There are a number of ethical issues here. First, the offer of three weeks' use of her holiday home needs to be considered in light of the CA Sri Lanka Code of Ethics requirements on gifts and hospitality. In this case the value of the offer is likely to mean that no safeguards could prevent the auditors' independence being impaired, so the offer should be declined. If the team considers that Mia Fern intends to influence the outcome of the audit by making the offer, then this casts doubt on her integrity. The audit committee should be notified of this situation.

The gifts of lunches are unlikely to impair independence as they are likely to be of an insignificant monetary value. Provided that this is the case, they may be accepted.

25 Lapwing

(1) The terms of the engagement to report on the business plan should be agreed in an separate engagement letter to the statutory audit for this assurance engagement. The following matters should be considered.

Intended use of the business plan

It should be confirmed that the report will be provided to the bank, as this may establish Lapwing & Co as potentially liable to the bank.

Distribution of report

Clarification should be sought over whether the report will be distributed to any other parties. It may be necessary for the report to include a liability disclaimer.

Elements of business plan covered

The engagement is to report on the business plan, but clarification is needed about whether this means the business plan as a whole, or merely the forecast financial statements included in it. This will affect the extent of Lapwing & Co's possible liability, and the extent of procedures required.

Nature of assumptions

It should be clarified whether the plan's assumptions are best estimates or hypothetical. If the assumptions are clearly unrealistic, then SLSAE 3400 The examination of prospective financial information states that the auditor should not accept the engagement.

Period covered

The forecast financial statements are for 12 months. It should be clarified that this is the only period on which assurance is to be provided. Clarification is also needed over whether the other elements of the business plan refer to only this period.

Fees and practical matters

The level of fees should be confirmed, together with billing arrangements. Practical matters to confirm include the timing of the report, which will enable Lapwing & Co to ensure that it has adequate resources (eg staff) available to perform the engagement.

Form of report

The planned form of the report should be agreed in advance in order to avoid any misunderstandings. The report would use a negative form of words to provide limited assurance.

Respective responsibilities

It should be confirmed that management is responsible for preparing the business plan, and for providing the auditor with all relevant information.

(2) General procedures

- Re-perform calculations to check arithmetical accuracy.
- Agree unaudited figures for period to May 20X2 to management accounts to assess their reliability.
- Confirm that accounting policies applied consistently between the periods and audited financial statements.
- Assess accuracy of past forecasts by comparison with actual figures.
- Consider reasonableness of trends in light of auditor's understanding of Hawk.
- Review correspondence with bank about negotiated terms of the loan, and confirm major terms and interest rate directly with bank.

Statement of profit or loss

- Discuss 21.4% increase in revenue with management, and consider if reasonable.
- Operating margin rises from 30% to 33.8%. Ask for explanation from management and consider if reasonable.
- Discuss sale of Beak Retail, including likelihood of sale and any likely terms. Review board minutes for details about the sale.
- Recalculate profit on disposal, and agree proceeds to any draft legal documentation.
- Consider reasonableness of finance costs. New loan should add Rs. 1 Mn (Rs. 30 Mn × 4% × 10 / 12), but finance costs are up by only Rs. 960,000 – need to ascertain the reason for this.

Statement of financial position

- Non-current assets are up Rs. 37.15 Mn, but the loan which financed this investment was only for Rs. 30 Mn. Enquire about other possible sources of finance used for this increase.

- Review reconciliation of movement in non-current assets, confirming that Beak Retail assets are derecognised.
- Confirm that any assets relating to the joint venture with Kestrel are accounted for in line with SLFRS 11 Joint arrangements.
- Discuss the planned Rs. 5 Mn increase in equity (is this to help finance the increase in assets?). Discuss what form this will take (ie rights issue, or at full market price).
- Agree the increase in non-current assets to capital expenditure budgets.
- Agree cash figure at May 20X2 to bank reconciliation and statement.
- Receivables days are predicted to fall from 58 days (3,300 / 20,600 × 365) to 53 days (3,600 / 25,000 × 365), improving the company's cash position. The reasons for this should be discussed with management, and considered for reasonableness.
- Payables days are predicted to fall from 137 days (5,400 / 14,420 × 365) to 124 days (5,600 / 16,550 × 365), worsening the company's cash position. The reasons for this should be discussed with management, and considered for reasonableness.
- Agree the increase in long-term borrowings to documentation obtained for the new loan
- Discuss the deferred tax provision, and establish why there has been no movement (which is unexpected, given the capital expenditure).
- Discuss the movement on retained earnings, which have risen only by Rs. 0.8 Mn, in spite of a profit before tax of Rs. 10.52 Mn. It may be that a dividend is planned.

(3) Ethical issues

The key issue with the provision of other services is that independence of the auditor may be impaired as a result. In principle, CA Sri Lanka Code does not prohibit the provision of other services. However, the fundamental principles apply to all professional assignments. Therefore the audit firm must assess the threats to which it is exposed in performing the engagement and consider whether safeguards are necessary. In this instance appropriate courses of action would include:

- Ensuring that the review is performed by staff other than those involved in the audit eg stag in a business advisory department.
- Obtaining a second partner review of the audit opinion.

26 Baltimore

(1) The following are the matters which Goleen & Co should focus on in providing agreed upon procedures assurance services of Mizzen Pvt Ltd to Baltimore

Equity owners

It is crucial to determine the identity of Mizzen's majority shareholder. It appears likely that this is Bizgrow, but further information is needed.

This is important because if Bizgrow does own the shares then it is with Bizgrow that Baltimore would need to negotiate the purchase of Mizzen. If Bizgrow does not want to sell its shares then Mizzen cannot be bought. However, it is unclear how Baltimore came to identify Mizzen as an acquisition target in the first place, and it is possible that Bizgrow may have had something to do with this.

Funding

It is noted that Vic and Lou secured funds from Bizgrow. The nature of any agreement that was made needs to be ascertained, as it is possible that Mizzen may owe Bizgrow a substantial amount of money. This would be material to any decision Baltimore might make about the acquisition.

The precise nature of the ongoing relationship between Mizzen and Bizgrow is unclear. It is possible that Bizgrow is involved with Mizzen at an operational level. Any agreements between the two parties should be obtained and scrutinised.

Examination of the statement of profit or loss reveals a finance cost of Rs. 250,000 which appears to be fixed. It is unlikely that this is interest on a loan because loan interest would change as the balance is repaid. It is therefore possible that this is a management charge from Bizgrow, which would be indicative of ongoing involvement. We would need to understand the nature of any liabilities Mizzen may have in relation to this charge.

Reputation

Mizzen's good reputation, and its having won awards for website design, is key evidence for its expertise in this area. This should be verified to external evidence. Customer satisfaction could be gauged by obtaining the results of any customer satisfaction surveys that may have been conducted.

Vic and Lou

Vic and Lou appear to be crucial to the success of Mizzen, so Baltimore would want them to be involved in future. It is not certain, however, that they would want to be involved with Baltimore and its website, and they may wish to concentrate on their own more innovative work. The acquisition would be much less attractive to Baltimore were they to leave.

Vic and Lou's intentions post-acquisition should be determined. It may be possible to structure any future deal in such a way that Vic and Lou would be required to continue working at Mizzen for a set period after the acquisition.

Staff

Mizzen is a business with few tangible assets, which relies heavily on the expertise of its employees, who may leave after any acquisition – particularly if Vic and Lou were to leave. It would make little sense to acquire Mizzen for its staff, only to find that they leave on acquisition.

An organisational structure should be obtained in order to identify management and key personnel within Mizzen.

It is also possible that Baltimore may wish to restructure Mizzen after acquisition. In this case it is likely that redundancy payments would need to be made to staff members losing their jobs. The amount of any possible liability in this eventuality should be estimated as part of the review.

Freelancers

Mizzen has been using freelancers recently, which may result in a drop in the quality of work done by comparison with established staff. This should be investigated as it may affect Mizzen's ostensibly impeccable reputation.

Intangible assets

Mizzen has few assets, but is likely to have important intangible assets which would form part of any goodwill paid on acquisition. Vic and Lou have developed new website interfaces, and it should be determined whether any resulting intellectual property belongs to them personally or to Mizzen. Valuing these assets is likely to be difficult.

Customer databases should also be valued, which again is likely to be difficult owing to the absence of any active market for assets of this kind.

Premises

It is apparent that the Rs. 1,000 nominal rent paid to Bizgrow would increase after the acquisition, so it should be determined what an equivalent market rent might be for the premises. Alternatively, the premises may no longer be available, in which case the rent should be ascertained for premises meeting Mizzen's needs. It may be possible for Mizzen to operate from Baltimore's premises, in which case any opportunity costs should be considered.

Tangible assets

Mizzen's tangible assets need to be valued, and it should be determined whether they are owned or held under lease, as it is possible that Mizzen may be liable for any future lease payments.

Revenue recognition

The first revenue stream should be split into two components, with the revenue relating to maintenance being recognised as deferred income and spread over the contract period. There is a risk that revenue is recognised too early, inflating Mizzen's profit in the short term.

Relevance of revenue

Baltimore needs Mizzen to develop a website for it, and it should be asked whether Baltimore might be better off simply paying Mizzen Rs. 10,000 to develop a website rather than acquiring the whole company.

It is clear that Mizzen would have the expertise to do this because it operates its own subscription-based website. It should therefore be able to create something of a similar nature for Baltimore.

The third revenue stream in particular does not appear relevant to Baltimore, and it should be considered how this revenue stream would be managed after the acquisition.

Revenue increase

Revenue rose 23.7% from 20X2 to 20X3, which is an impressive increase although it is lower than the 60.4% increase from 20X1 to 20X2. The question is whether such a growth rate might feasibly be achieved in the future. It will therefore be necessary to scrutinise Mizzen's forecasts and plans for future growth.

Operating expenses

Operating expenses in 20X2 were 58.3% of revenue, but only 49.6% in 20X3. This is unusual, and may be indicative of efficiencies being achieved as Mizzen grows. It does not, however, tally with the fact that freelancers have been used this year, which would be expected to increase operating expenses in relation to revenue.

A detailed review needs to be performed on operating expenses to ensure that expenses are complete and are recorded accurately.

Cash

Mizzen's cash position should be confirmed to its bank statement. Although the company is not lacking cash, from its statements of profit or loss one would expect it to be in a better cash position than it is in. It is possible that cash has been paid out in dividends to shareholders.

Further information

- Copy of Mizzen's register of shareholders, to determine the identity of the majority shareholder.
- Copy of any agreement between Bizgrow and Vic and Lou, to help understand their ongoing relationship as well as Bizgrow's planned exit route.
- Agreements of any loans received by Mizzen.
- Full audited financial statements of Mizzen.
- Details of awards won for website design, including press reports, trade journals, for evidence of Mizzen's good reputation.
- Details of any customer satisfaction surveys conducted by Mizzen.
- Copies of contracts with Vic and Lou.
- Copy of organisational structure.
- Copies of contracts with key employees containing details of any redundancy payments that might be due in the future, along with other employee benefits and entitlements that are due to them.
- List of freelance designers used by Mizzen, together with copies of contracts.
- Details of any copyrights or patents owned by Vic and Lou or Mizzen.
- Copy of rental agreement with Bizgrow, to be scrutinised for details of possible rental payments after acquisition.
- Details of tangible non-current assets owned or operated by Mizzen.
- Copies of any lease agreements for non-current assets such as computers or fixtures and fittings.
- Copies of projected financial information for the next year.
- Detailed management accounts, including breakdown of operating expenses to ascertain reasons for rising operating margin.
- Details of any dividend payments made over the last three years.

(2) Agreed upon procedures type assurance work is covered by SLSRE 4400 Related Services, which is a completely separate assurance engagement to a statutory audit. No assurance is provided on an agreed-upon procedures engagement as only factual findings based on procedures performed are reported. The Directors of Baltimore can then draw their own conclusions from the findings provided in the agreed-upon procedures assurance report.

By contrast an external auditor's report gives reasonable assurance, which is a higher level of assurance. This is because review engagements and agreed-upon procedures engagements involve obtaining less evidence than is required for an external auditor's report, and conducting procedures which are less thorough.

The auditor's report should state the following, as required by SLSRE 4400.

- Identification of the information on which the agreed upon procedures have been applied.
- A statement that the procedures performed were those agreed with Baltimore.
- A statement that the agreed upon procedures were performed in line with SLSRE 4400.
- A listing of the agreed upon procedures performed.
- The purpose of each of the agreed upon performed.
- A description of the auditor's factual findings including details of any errors and omissions. Note, no assurance is provided by the auditors as judgement is left to Baltimore based on the facts presented in the assurance report.
- A statement that the agreed-upon procedures report extends only to the information stated and does <u>not</u> constitute a full audit of Mizzen Pvt Ltd.
- A statement that the procedures performed do not constitute either an audit or a review and so no assurance is expressed.

(3) Professional and ethical issues

Providing a recruitment service to a client is not specifically prohibited by the CA Sri Lanka Code. However, the Code does say certain threats to independence could be created. These are examined below.

Self-interest threat

Goleen & Co are considering the provision of recruitment services to audit clients, earning fees based on a percentage of the salary of the person recruited. This creates a financial self-interest threat to independence. The firm may be tempted to recommend an individual to a client in order to earn a fee, and not consider whether that individual is suited to the role.

Familiarity threat

The provision of recruitment services will create a familiarity threat. During audits, Goleen & Co will have to assess the work of individuals they helped recruit. The firm may be or may be perceived to be less likely to criticise or challenge such individuals because this could discredit their recruitment services.

Self-review threat

A self-review threat occurs where an audit firm makes management decisions for an audit client. Goleen & Co could be seen to be making such decisions by providing recruitment services to audit clients. The firm could review candidates' CVs and recommend individuals to interview but the final decision of who to recruit should always rest with the client.

This threat is increased with the seniority of the individual being recruited, for example if Goleen & Co were to advise on a new finance director. The threat could be reduced by only providing services for the recruitment of junior staff members.

Demand for services

Goleen & Co would need to carry out market research to ensure that there is a demand for recruitment services before embarking on any new business venture.

Training costs

The firm should also consider whether it has the time and resources to enter into a new area of business. Ingrid Sharapova only worked in recruitment for a year and seems to be the only employee with any experience. She may require further training in order to recruit finance professionals and update her skills.

An additional member of staff at Goleen & Co will also require some training so the recruitment business can be kept running whilst Ingrid is away or on sick leave.

If successful, the recruitment business may prove too much for Ingrid to handle alone and the firm will have to either train or hire additional staff to assist her.

Damage to reputation

Goleen & Co's reputation could be damaged if the quality of recruitment services is low. This risk can be reduced by setting up the recruitment services as a separate company.

27 Banana

(1) (i) Matters to consider

Materiality

Materiality on revenue: $\frac{\text{Rs.500,000}}{\text{Rs.12.5 Mn}} = 4\%$

Materiality on net profit: $\frac{\text{Rs.500,000}}{\text{Rs.400,000}}$ = 125%

Materiality on total assets: $\frac{\text{Rs.500,000}}{\text{Rs.78 Mn}}$ = <1%

The training costs are not material to the statement of financial position. They would, however, be material to revenue and profit if they were reclassified as expenses, turning a profit into a loss.

Accounting treatment

The training costs are currently recognised as non-current assets. This is not in accordance with LKAS 16 Property, plant and equipment, which states that the costs of training staff should always be treated as an expense, as they do not meet the definition of an asset, which requires that the entity has control of the asset. This is very unlikely to be the case with training costs, as the staff will probably have the right to leave the company, meaning that Banana would not receive any subsequent economic benefit from having trained them.

The training costs should be treated as an expense in the statement of profit or loss.

Audit opinion

If Banana does not amend its financial statements, the audit opinion will be modified due to a material misstatement. This would probably be an 'except for' qualification as the misstatement is material but not pervasive.

Evidence

The file should contain:

- A review of the nature of the expenses themselves to verify that they are classified correctly and that they are in fact training costs.
- Testing of entries selected according to sampling procedures detailed in the audit plan to supporting documentation, such as purchase invoices, and agreement of payment of related payables to the cashbook and to bank statements.
- Evidence that a sample (selected according to audit plan) of entries are included in the accounts in the correct period.

Testing for completeness and that all invoices that should have been accrued for were in fact accrued for.

(ii) Matters to consider

Materiality for whole receivable

Materiality on revenue: $\frac{\text{Rs. }30{,}000}{\text{Rs. }12.5\text{ Mn}}$ = 2.4%

Materiality on net profit: $\frac{\text{Rs. }300{,}000}{\text{Rs. }400{,}000}$ = 75%

Materiality on total assets: $\frac{\text{Rs. }300{,}000}{\text{Rs. }78\text{ Mn}}$ = <1%

The receivable is not material to the statement of financial position. It would, however, be material to the statement of profit or loss if an impairment loss were recognised in relation to it.

Accounting treatment

SLFRS 9 Financial Instruments requires receivables to be recognised at fair value. The fair value of the Cherry receivable is the 25% that the administrators suggest it may be able to pay, ie Rs. 75,000. Rs. 225,000 should therefore be recognised as an impairment loss in the statement of profit or loss.

Calculating materiality for the impairment loss:

Materiality on revenue: $\frac{\text{Rs. }225{,}000}{\text{Rs. }12.5\text{ Mn}}$ = 1.8%

Materiality on net profit: $\frac{\text{Rs. }225{,}000}{\text{Rs. }400{,}000}$ = 56%

This is clearly material to profit for the year.

Inventory

As Cherry is a customer, it is possible that Banana is holding inventory or work in progress that was ordered by Cherry. Grape & Co needs to ascertain whether this is the case, and if so whether the inventory can in fact be sold. If it cannot be, then it may be impaired and should be written down, recognising the loss in profit for the year.

Audit opinion

If Banana does not amend its financial statements, the audit opinion will be modified due to a material misstatement. This would probably be an 'except for' qualification as the misstatement is material but not pervasive.

If the misstatement in respect of the receivable is taken together with the misstatement in respect of the training costs, the overall result may be that Grape & Co judges the statement of profit or loss to be rendered meaningless (pervasive effect). In this case it would issue an adverse audit opinion.

Audit evidence

- External documentation confirming the insolvency of Cherry and the possible repayment of only 25% of the receivable.
- Confirmation from the administrator of the 25% to be paid, including an indication of when this is likely to happen.
- Agreement of the amount owed from the receivables listing to the ledger.
- Review of inventory documentation, and evidence of enquiries made of management, regarding the value and the potential recoverability of any inventory relating to contracts with Cherry.
- Calculations regarding the amount to be recognised as an impairment loss.

(2) Selection of engagement staff

The fact that the junior had only worked on two audits before this is not a problem. However, it is important that they be given work appropriate to their level of skill and experience. This does not appear to have happened here, as detailed below.

No audit planning meeting

The audit planning meeting, led by the partner, is a crucial part of the audit. It is the best way of giving the team an understanding of the client, and should discuss both the overall strategy and the detailed audit plan, perhaps going into difficulties that have been experienced in previous years and which could come up again. The discussion should focus on what individual members of the team need to do. This is particularly important for less experienced and junior members of the team.

Audit manager away

The manager should not have given the senior responsibility for the audit while they were away on holiday for three weeks. It is important that an audit is properly supervised, and it may have been more appropriate for another manager to take responsibility for the audit.

Senior busy

Not only is there a question mark over whether they have the experience to manage the audit, but the senior is also busy with other assignments and thus unable to devote sufficient time to this one. It is very important that someone is available to supervise junior members of the audit team. This is not happening here.

It is also possible that the lack of attention paid by both the manager and the senior has led to the misstatements in respect of the trading costs and trade receivables not being picked up by the audit team.

Junior auditing goodwill and inventory

Goodwill is a complex accounting area to audit, and should not be given to a junior to do. The same can be said of inventory and in particular work-in-progress. A junior is very unlikely to have developed the judgement needed to audit these areas. This seems to be the case here, as shown by the junior's error at the inventory-take (see below).

Inventory-take

The junior helped the client's staff to count raw materials at the inventory-take, when they should instead have been observing that the client's staff were counting them correctly and in accordance with the count procedures. This would seem to imply that the junior had not been properly briefed on their responsibilities at the inventory-take, as this is a relatively basic error.

It is likely that more audit evidence will be needed to be done on inventory as a result of this error.

Junior asked to challenge FD

It is not appropriate for a junior to be asked to challenge a client's finance director regarding an accounting issue that they are unlikely to understand fully. This should have been done by either the audit manager or the partner, as they would be in a position to understand the technical issues involved, and would carry sufficient authority with the client to make the challenge effective.

Running out of time to complete procedures

Pressure of time is an important contributor to audit risk. Audit time budgets should allow staff enough time to complete the audit to the required quality. It is also possible that the lack of supervision of the audit team's work has led to the audit being conducted inefficiently, with inadequate monitoring of progress and discussion of issues as they arise.

Reduction of sample sizes

It is clearly unacceptable to reduce sample sizes as a way of saving time. The sample sizes detailed in the audit plan should have been designed to gather sufficient appropriate audit evidence. Reducing the sample size beneath this point increases detection risk, and the risk of the auditor giving the wrong opinion.

Basis of sample selection

Selecting a sample on the basis of the ease of finding evidence for an item, is not an appropriate basis. Indeed, this might actively increase detection risk as it means by definition that those items for which evidence is not readily available, or might not even exist, are not tested.

Conclusion

The failures above suggest that this engagement has not been adequately supervised, and that the audit work performed is inadequate in some areas. A detailed review should be performed so that any other shortcomings can be addressed.

Doubt is also cast over the sufficiency of the firm's quality control procedures. This matter should be referred to the relevant partner for consideration.

28 Retriever

(1) The Group obtained a listing during the year which means that its financial statements will be the subject of particular scrutiny. This raises the overall risk level of this assignment, which means it should be subject to especially stringent quality control. This does not appear to have been the case.

Engagement quality control review

The fact that there is an engagement quality control review taking place is an encouraging sign, as it summons the prospect of some of the more egregious failings of quality control being made good before the auditor's report is signed.

Time pressure

The existence of time pressure points to poor planning. The purpose of the audit plan is not only to direct audit work to appropriate areas of the financial statements, but also to decide on the resources and deadlines necessary to complete the audit satisfactorily.

Time pressure increases detection risk. Procedures are likely to be rushed, resulting in a lack of professional scepticism and misstatements going undetected. This seems to be what has happened here.

Directors' emoluments

The audit manager described these as low risk, but they are material by nature. Not only are they related party transactions, they carry a high risk of manipulation as directors may attempt to conceal their remuneration from shareholders and other users of the financial statements.

There will also be additional reporting requirements as this is a listed group, which only increases the risk to the auditor.

Even if they were low risk, planned audit procedures would still need to be performed. The fact they are high risk only heightens this necessity.

Share capital

If the group were not listed, then share capital might be low risk. However, the fact it obtained a listing during the year means that share capital could have changed significantly. This is a highly visible area, and is therefore high risk.

Sampling method

SLAuS 530 Audit Sampling does allow samples to be selected haphazardly, which is effectively the exercise of judgement which the manager appears to be advocating. However, several points can be made against the manager's advocacy of judgmental sampling.

Firstly, the audit plan prescribes statistical sampling. It is possible to deviate from the audit plan, but only if this would provide better evidence. Yet this is not the manager's stated argument, so the suggestion should not have been made.

Secondly, haphazard sampling requires the exercise of judgement which juniors are unlikely to possess in view of the fact that their firm usually samples statistically. There is a risk that juniors will not understand how to select samples in this way, and will simply select eg large balances.

Thirdly, the manager's claim that haphazard sampling is quicker is manifestly false. When done properly, haphazard sampling requires the exercise of judgement and this takes time. Statistical sampling is much quicker to implement as it is relatively mechanical.

In fact the manager's suggestion that this would save time amounts to an incitement to the juniors to select the samples without due care, perhaps only picking the items that are close to hand. This is a serious breach of the CA Sri Lanka Code of Ethics.

Trade payables

It is acceptable for juniors to be involved in the audit of trade payables, however the suggestion appears to be that one junior has been made responsible for the whole of trade payables on a listed company audit. This is clearly unacceptable, as the junior would possess neither the skills nor the time to perform the work to a satisfactory standard.

Going concern

Going concern is a difficult area to audit as it usually involves making judgements about a business's future prospects, which requires substantial experience. Juniors are very unlikely be able to do this and so should not have been assigned going concern.

A more senior member of the audit team should have been assigned going concern, such as the audit manager or partner.

Taken together with trade payables, this reveals a disturbing failure of direction on the audit, which is a key aspect of quality control.

Review

It may well be good training for juniors to review each other's work, but this is no substitute for proper supervision and monitoring by more senior members of the audit team. Being at the same level, juniors are unlikely to be able to spot any errors or invalid conclusions drawn, so the reviews are likely to be of little use. Moreover, the juniors are likely to be very familiar with each other and may be unwilling to criticise each other's work. The work should have been reviewed by the audit manager.

Financial controller

The financial controller of a listed company should be able to calculate deferred tax, so the fact that she could not raises issues about the Group's internal controls. The audit team should therefore revisit the risk assessment done at the audit planning, as deficient internal controls may mean that more substantive testing will be required.

The junior should not have been discussing the tax position with the financial controller in the first place. Given that the time on the audit is so short, what time there is would be better allocated to performing audit procedures. This points to a lack of supervision, and also to a need for further training for the audit junior.

Deferred tax asset

This is a good example of the principle of professional competence and due care, which the junior appears to have breached. Although the junior has studied deferred tax in college, they lack the experience to know that in practice the recognition of deferred tax assets is rare. Given that the Group's subsidiaries have been suffering losses it is not certain that any such asset will be recoverable; making the judgement over the asset's recoverability requires experience that the junior does not yet possess.

The key ethical issue here is that the auditor must not provide accounting services such as this to listed clients. The self-review threat so created – whereby the firm would then be auditing accounts that it has itself prepared – would be deemed by the Code to be insurmountable in this instance.

The audit manager said that this would save time and that the figure would not need to be audited. This is wrong. Now that the junior has calculated the figure it will need to be carefully reviewed and re-performed, and discussed with the management of the Group. The audit manager's suggestion is indicative of a lack of due care.

Tax planning

The audit junior should not be providing tax planning recommendations. This is a non-audit service, which the junior is providing free of charge and without the required professional skills. There is a self-review threat here because the tax balances calculated on the basis of the junior's advice would be included in the audited financial statements. There is a danger that the junior has been taking management decisions. It would usually be possible for a tax planning service to be provided to a listed client, but the auditor would have to put in place safeguards such as separate engagement teams which clearly do not exist here.

There is a risk that the firm may be the subject of litigation as well as reputational damage if the client relies on wrong advice given by the junior. Steps should therefore be taken to inform the Group of the situation and to prevent it from relying on this advice.

(2) It would be helpful to arrange a meeting with Group management in order to help obtain an understanding of the theft and the circumstances around it, and to clarify matters in relation to the engagement.

The objective should be specified precisely, and clarification may be needed regarding whether quantification is to be made of the amount to be claimed from the insurer, or of the amount of the loss.

It should be clarified whether the Group wants us to investigate the crime itself and to identify the perpetrator, as this would be a radically different type of investigation which may be outside the scope of Kennel & Co's professional competence.

Clarification should be sought on whether the Group has already made any calculations of the amount to be claimed, in which case it may simply want us to audit its calculation. Alternatively it may want us to calculate the loss ourselves from scratch. This would have an effect on fees, which should also be discussed at the meeting.

Kennel & Co appears likely to have sufficient resources to conduct the investigation as it has an internal audit services department. It should, however, be determined whether the firm has the requisite staff available for this assignment.

It will be necessary to discuss timings with the Group, and in particular any planned deadlines for submission of the insurance claim. Any such deadlines should allow enough time for the work to be completed without sacrificing quality. This will in turn affect the consideration of whether sufficient staffing resources are available at the right times.

It must be confirmed that the assurance team will have full access to any information required to conduct the investigation.

The Group should have reported the theft to the police, and it may be helpful to obtain a copy of any police reports available. It should be established whether the perpetrator(s) have been caught, and if so, whether they are likely to be prosecuted. Kennel & Co should bear in mind that there is a possibility that the Group might ask it to act as an expert witness if there were a court case, in which case there may be an advocacy threat to the firm's independence.

It is possible that the perpetrator(s) have been caught and that some of the assets have been recovered. This should be ascertained, and any recovered assets excluded from the calculation of the loss. It is also possible that these assets may have been damaged, in which case this should be taken into account.

From the circumstances described it is possible that the thieves may have been Group employees. This information should be obtained from management.

Finally, the output of the investigation should be confirmed. The Group may require a report to the insurance company for example, or alternatively a report addressed to itself but which it can use for the purposes of the insurance claim. It should be clarified that the report would not be distributable to any other parties.

(3) Procedures

- Watch the CCTV to determine the quantity of goods stolen, eg how many boxes loaded onto lorry.
- If possible determine if the boxes contain mobile phones or laptops.
- Inspect boxes of goods in the warehouse to determine how many finished goods are in each.
- Agree cost of an individual phone and laptop to accounting records, eg cost cards.
- Perform inventory count on boxes of goods in the warehouse and reconcile to latest inventory movements.
- Discuss the case with police to establish if any goods have been recovered and if this is likely to happen.
- Obtain details of stolen lorry, eg licence plate, and agree the lorry to non-current asset register.

- Review the insurance policy to confirm that assets lost as a result of thefts are covered and to confirm that the date of the theft falls within the period insured.
- Determine by inspecting the insurance policy whether there are any restrictions in the case of thefts perpetrated by Group employees, as this may affect the amount that can be claimed.

(4) SLAuS 4400 related services engagements to perform agreed-upon procedures regarding financial statements.

The objective of an agreed-upon procedures engagement is for the auditor to carry out procedures of an audit nature to which the auditor and the entity and any appropriate third parties have agreed and to report on factual findings.

Both Retriever Group and Golden Bank will need to agree on the procedures performed on the account payable balance and the format of the report as part of engagement acceptance.

The report provided is not an assurance report, and the auditor does not provide an opinion. Instead, users of the report assess for themselves the procedures and findings reported by the auditor and draw their own conclusions from the auditor's work.

Agreed upon procedure can cover specific aspects of financial information or internal controls which are not covered by the statutory audit and where additional reporting is required. For example, this may be over financial information disclosed in the annual report, but not audited, such as key performance indicators, or other summary financial information.

The level of work carried out by the auditor may vary depending on the extent to which sufficient and appropriate evidence could be obtained.

For any SLAuS 4400, agreed-upon procedures engagement, a report must include:

- A description of the auditor's factual findings including sufficient information of all significant errors and exceptions;

- A statement that the procedures performed do not constitute an audit or assurance engagement, and therefore no opinion is expressed.
- A statement that the report is restricted to those parties that have agreed to the procedures to be performed;
- A statement that the report relates only to accounts payable information specified and that it does not extend to the entity's financial statements taken as a whole.

  Explain the main reporting requirements of agreed upon procedures engagement and provide a draft report format for an accounts payable report to the management of Retriever Group which will need to be agreed as part of engagement acceptance.

The following provides a draft report specific to Management Retriever Group for accounts payable as at 28 February 20Y0.

Report of Factual Findings in Connection with Accounts Payable

We have performed the procedures agreed with the management of Retriever Group in respect to the accounts payable of Retriever Group of Rs 15 million as at 28 February 20Y0

Our engagement was undertaken in accordance with the Sri Lanka Standard on Related Services applicable to agreed-upon procedures engagements.

The procedures were performed solely to assist you in evaluating the validity of the accounts payable and are summarised as follows:

- For the balances listed in this report, we agreed each Accounting payable balance to the nominal ledger and trial balance for Retriever Group as at 28 February 20Y0.
- We obtained suppliers' statements or requested suppliers to confirm balances owing at 28 February 20Y0.
- We compared supplier statements or supplier confirmations to the amounts the respective balance in Laurel Accounts Payable ledger. For amounts which did not agree, we obtained account reconciliations from Laurel and agreed each reconciling item to supporting evidence.
- The findings of this agreed upon procedures engagement are listed below.

  [to insert once the agreed upon procedures have been performed]
- The report is restricted to Retriever Group and R Bank as the parties which have agreed to the procedures to be performed.

29 Megabon

(i) Internal Audit Software

The internal audit system has the potential to have a substantial impact on the external audit, through a combination of a reduction in the need for substantive testing and for tests of control. However, this is based on the assumptions that the software is working in the way that is expected by Megabon, and that it does in fact have the claimed capability to identify anomalous transactions.

SLAuS 610 Using the Work of Internal Auditors does allow the external auditor to rely on the work of internal audit, but the auditor must first judge whether it is appropriate to do so. SLAuS 610 allows the work of internal audit to be used in 'substantive procedures involving limited judgement'. The nature of the testing carried out by the internal audit software would seem to fall under this description, so it could be relied upon if the auditor judged that the system was reliable.

The auditor is required to act with professional scepticism, and to exercise professional judgement when making an assessment of how much reliance to place on the systems in place and in internal audit. Viastrom will need to apply the requirements of SLAuS 610 in determining whether to place reliance on the work carried out by internal audit. This will require them to gain an understanding of the software and its capabilities before making a decision about whether to rely on the results of the testing carried out by it.

Assuming that the system is reliable, the external auditor will have a significant reduction in the need for substantive testing and could reduce the time taken to complete the audit.

(ii) Automated Investment Software

The automated investment decision making software is an example of robotic process automation where software uses pre-determined parameters and rules to complete invesyment trading decisions more efficiently and quickly than is possible using manual processes

This software will certainly have an impact on the audit to the extent that it interacts with the blockchain ledger which feeds into Megabon's financial reporting system and in relation to the assessment of going concern. The treatment of the investments in the financial statements will be based upon the information that is produced by the automated software, so transactional integrity will carry greater audit risk and the auditors will need to plan a greater level of audit work to confirm effectiveness of general IT controls and authorisation and system access controls to gain sufficient assurance.

The auditor will need to increase reliance on IT security controls to confirm only transactions are processed within pre-authorised investment policy trading limits decided by the directors of Megabon. The audit of investment trading parameters and confirmation of who can access and change investment trading parameters, in line with authorised personnel, will be critical. Furthermore, the auditor will need to incorporate the audit of IT controls designed to prevent and detect hacking and fraud as audit risk in these areas will be higher with introduction of new systems.

The auditor will need to consider how Computer Assisted Audit Techniques (CAATs) can test the system transactional data and other information that is automatically produced by the system to ensure all transactions lie within authorised investment parameters and are processed completely and accurately.

Data analytics are also likely to lead to an improvement in audit quality, although this is of course dependant on data analytics processes being implemented intelligently. The use of automated data analytics can analyse overall investment activity to confirm activity lies with accepted parameters and trends. Automated data analytics can also report specific groups of transactions which lie outside expected parameters, in terms of high value, material profit or loss, unexpected trading patterns of investment profit or loss which exceptional or is unusual given the over market trends at the time of the transaction.

Automated data analytics may also help the auditors in the following ways:

- Analyses of revenue trends into investment products, region or by timeframe.
- Matches of investment orders to cash settlement and report exceptions.
- Testing of user codes for any inappropriate combinations of users have been involved in processing transactions.

Furthermore, the use of test data through the system could be used to test investment parameters on the system and observe whether it performs in the way expected by the auditor. It would be essential that the auditor can ensure that the introduction of test data does not affect actual transaction data and all test data can be removed.

In addition, the auditor should consider whether the risks associated with important new systems have been adequately taken into account in the directors assessment of effective internal controls operating throughout the year and ongoing going concern.

The auditors will also need to consider how to acquire, access and store Megabon's data in order to carry out data analytics and CAAT's, and consider if the audit of data creates any data security or data protection concerns.

(iii) Blockchain transaction recording

The auditor will also need to gain an understanding of the interaction between Megabon's financial reporting system and the automation software. By tracing a number of transactions from purchase of investments by the system, investment valuation changes due to market changes, sale and cash settlement and the recording of gains and losses, the auditor will be able to test whether the system is correctly recording the investment performance. Where there is a large number of investment transactions the it may be more efficient for the auditor to use audit software to automate this testing.

The use of block-chain technology theoretically reduces the risk of misstatement related to the new system as the ledger is unalterable and cannot be manipulated. Again, it is crucial that the auditor obtain a thorough understanding of exactly how this system works and has full access to the ledger.

The 'real time' nature of using blockchain technology to record transactions means that the auditor will need to consider incorporating continuous transaction monitoring (CTM) into the audit strategy. The distributed nature of the technology means that a copy of the blockchain will be instantly available to the auditor as it is created allowing for real time audit of transactions, which could be audited against investment policy and supporting documentation, with checks that investment gains or losses are accurately recorded.

The auditor will need to consider the need to rely on the work of other auditors if it cannot satisfactorily audit IT controls around the blockchain. The blockchain is likely to be audited by a firm on behalf of the exchanges who operate it. The auditor of Megabon will need to consider the requirement of SLAUS 600 Using the work of another auditor, in its reliance on IT controls related to the blockchain ledger.

Ultimately the impact on the audit will be in the risk of misunderstanding the system or not picking up a problem that exists, leading to the auditor not detecting a misstatement.

The auditor will need to consider its overall audit approach, reliance on IT controls and any training needs for its audit staff in order to perform and evaluate the results of IT based audit techniques.

However, the automated nature of the investment system, the use of blockchain and reliance on internal audit software may well make it easier to identify errors and misstatement than the previous manual system as there is less room for intentional manipulation or human error, which may have a positive effect on overall audit risk.

(2) Given both the nature of the business and the data held on behalf of customers, the main cyber security risks to Megabon and ways to mitigate those risks will be as follows.

Cyber Security Risk	Control to Mitigate
Hacking Hackers gaining access to IT systems from outside the organisation to steal data	• All networks protected by firewalls. • All user accounts protected by passwords and user names. • Sensitive documents password protected. • Access restrictions amongst employees. • Detailed audit trail of all access to each area of the system.
Insider Threat Mistaken or malicious leaking of data by employees	• Provision of mandatory training on the risk of leaks due to mistakes. • Limiting staff access to the system to the minimum required to undertake their roles. • Restrict use of portable storage devices. • Immediate removal of access for employees who leave the company.
External disks and Drives Loss of data or introduction of threats via external data storage devices	• Restrict all such devices to those owned and purchased by the company. • Restrict the use of company devices with third party computers. • Track who is using all company owned devices via a logging system and erase after use. • Scan all devices with anti-malware software each time they are connected to a company computer.

Mock Exam

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SECTION 1

All 10 questions are compulsory.
Each question is worth 2 marks.
Total marks for section 1 is 20 marks.
Recommended time for the section is 36 minutes.

The following scenario relates to questions 1–5.

Note. Assume it is 1 July 20X5

You are an audit senior of Viola & Co and are currently conducting the audit of Poppy Ltd for the year ended 31 March 20X5.

Materiality has been set at Rs50,000, and you are carrying out the detailed substantive testing on the year-end payables balance. The audit manager has emphasised that understatement of the trade payables balance is a significant audit risk.

Below is an extract from the list of supplier statements as at 31 March 20X5 held by the company and corresponding payables ledger balances at the same date along with some commentary on the noted differences:

Supplier	Statement balance	Payables ledger balance
	Rs'000	Rs'000
Carnation Ltd	70	50
Lily Ltd	175	105

Carnation Ltd

The difference in the balance is due to an invoice which is under dispute due to faulty goods which were returned on 30 March 20X5.

Lily Ltd

The difference in the balance is due to the supplier statement showing an invoice dated 29 March 20X5 for Rs70,000 which was not recorded in the financial statements until after the year end. The payables clerk has advised the audit team that the invoice was not received until 2 April 20X5.

1 The audit manager has asked you to review the full list of trade payables and select balances on which supplier statement reconciliations will be performed.

Indicate on the table below if the following items should be included in, or excluded from, your sample.

Suppliers with material balances at the year end	Include	Exclude
Suppliers which have a high volume of business with Poppy Ltd	Include	Exclude
Major suppliers with nil balances at the year end	Include	Exclude
Major suppliers where the statement agrees to the ledger	Include	Exclude

2 Which of the following audit procedures should be performed in relation to the balance with Lily Ltd to determine if the payables balance is understated?

- ☐ Inspect the goods received note to determine when the goods were received
- ☐ Inspect the purchase order to confirm it is dated before the year end
- ☐ Review the post year end cash book for evidence of payment of the invoice
- ☐ Send a confirmation request to Lily Ltd to confirm the outstanding balance

3 Which of the following audit procedures should be carried out to confirm the balance owing to Carnation Ltd?

(1) Review post year end credit notes for evidence of acceptance of return

(2) Inspect pre year end goods returned note in respect of the items sent back to the supplier

(3) Inspect post year end cash book for evidence that the amount has been settled

- ☐ 1, 2 and 3
- ☐ 1 and 3 only
- ☐ 1 and 2 only
- ☐ 2 and 3 only

4 The audit manager has asked you to review the results of some statistical sampling testing, which resulted in 20% of the payables balance being tested.

The testing results indicate that there is a Rs45,000 error in the sample: Rs20,000 which is due to invoices not being recorded in the correct period as a result of weak controls and additionally there is a one-off error of Rs25,000 which was made by a temporary clerk.

What would be an appropriate course of action on the basis of these results?

- ☐ The error is immaterial and therefore no further work is required.
- ☐ The effect of the control error should be projected across the whole population.
- ☐ Poppy Ltd should be asked to adjust the payables figure by Rs45,000.
- ☐ A different sample should be selected as these results are not reflective of the population.

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5 To help improve audit efficiency, Viola & Co is considering introducing the use of computer-assisted audit techniques (CAATs) for some audits. You have been asked to consider how CAATs could be used during the audit of Poppy Ltd.

Which of the following is an example of using test data for trade payables testing?

- ☐ Selecting a sample of supplier balances for testing using monetary unit sampling
- ☐ Recalculating the ageing of trade payables to identify balances which may be in dispute
- ☐ Calculation of trade payables payment period to use in analytical procedures
- ☐ Inputting dummy purchase invoices into the client system to see if processed correctly

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The following scenario relates to questions 6–10.

Note. Assume it is 1 July 20X5

You are an audit manager at Blenkin & Co and are approaching the end of the audit of Sampson Ltd, which is a large listed retailer. The draft financial statements currently show a profit before tax of Rs6.5m and revenue of Rs66m for the financial year ended 31 March 20X5. You have been informed that the finance director left Sampson Ltd on 28 Feb 20X5.

As part of the subsequent events audit procedures, you reviewed post year end board meeting minutes and discovered that a legal case for unfair dismissal has been brought against Sampson Ltd by the finance director. During a discussion with the human resources (HR) director of Sampson Ltd, you established that the company received notice of the proposed legal claim on 10 April 20X5.

The HR director told you that Sampson Ltd's lawyers believe that the finance director's claim is likely to be successful, but estimate that Rs150,000 is the maximum amount of compensation which would be paid. However, management does not intend to make any adjustments or disclosures in the financial statements.

6 Blenkin & Co has a responsibility to perform procedures to obtain sufficient, appropriate evidence that subsequent events are appropriately reflected in the financial statements of Sampson Ltd.

Indicate, on the timeline, up until which date the auditor should perform subsequent events procedures.

The date the subsequent events review is performed	The date of approval of the financial statement	The date of the auditor's report	The date the financial statements are issued
☐	☐	☐	☐

7 If, after the financial statements have been issued, Blenkin & Co becomes aware of a fact which may have caused its report to be amended, the firm should consider several possible actions.

Which TWO of the following are appropriate actions for Blenkin & Co to take?

☐ Discuss the matter with management and, where appropriate, those charged with governance

☐ Obtain a written representation from management

☐ Consider whether the firm should resign from the engagement

☐ Enquire how management intends to address the matter in the financial statements where appropriate

8 Which of the following audit procedures should be performed to form a conclusion as to whether the financial statements require amendment in relation to the unfair dismissal claim?

(1) Inspect relevant correspondence with Sampson Ltd's lawyers

(2) Write to the finance director to confirm the claim and level of damages

(3) Review the post year end cash book for evidence of payments to the finance director

(4) Request that management confirm their views in a written representation

- [ ] 1, 2 and 3
- [ ] 1, 2 and 4
- [ ] 1, 3 and 4
- [ ] 2, 3 and 4

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9 You are drafting the auditor's report for Sampson Ltd and the audit engagement partner has reminded you that the report will need to reflect the requirements of SLAuS 701 Communicating Key Audit Matters in the Independent Auditor's Report.

According to SLAuS 701, which of the following should be included in the 'Key audit matters' paragraph in the auditor's report?

- [ ] Matters which required significant auditor attention
- [ ] Matters which result in a modification to the audit opinion
- [ ] All matters which were communicated to those charged with governance
- [ ] All matters which are considered to be material to the financial statements

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10 Which of the following audit opinions will be issued if the unfair dismissal case is NOT adjusted for or disclosed within the financial statements?

- [ ] A qualified audit opinion as the financial statements are materially misstated
- [ ] A qualified audit opinion as the auditor is unable to obtain sufficient appropriate evidence
- [ ] An unmodified opinion with an emphasis of matter paragraph
- [ ] An unmodified audit opinion

SECTION 2

All four questions are compulsory.
Total marks for section 2 is 40 marks.
Recommended time for the section is 72 minutes.

11 Zen (Pvt) Ltd

Zen (Pvt) Ltd (Zen) is a new client of Adams and Co, an audit firm. Zen runs a spa, trading as Zen. The spa is open to non-members and members. Members pay an annual membership fee that entitles them to 50% off spa rates for individual treatments and sessions. The spa employs lifeguards, masseuses, beauty therapists and nursery nurses for its crèche facilities. In addition, there is also an administrative staff, including a finance controller, who reports to the managing director, Li Smith (who is also the major shareholder).

The spa has been in business five years. Its major local competitor is Revitalise, a large members-only spa, which started in business two years ago. Adams and Co has just been invited to tender for the audit of the company which owns Revitalise.

The finance controller at Zen is Elizabeth Warnapura, who was employed 18 months ago. Since then she has instituted control procedures outlined in a controls manual and formalised a budgeting system so that budgets are now prepared and approved annually.

Elizabeth introduced Adams and Co to Li Smith through her husband, Chamani Warnapura, who is a manager at Adams and Co. The audit engagement partner assigned to Zen is Carol Gamage. Since agreeing audit terms with Adams and Co, Li has:

- Invited Carol to advertise to employees of Adams and Co a staff membership rate, which is 50% of standard membership rates and then entitles the member to 75% off spa rates.
- Asked Carol if she will sit on the board of directors at Zen as a non-executive director.
- Asked Carol if the firm will confirm the figures on an insurance claim to be submitted in respect of a fire in the treatment centre just prior to the year end.

Required

(1) Analyse FIVE ethical threats which may affect the independence of Adams and Co's audit of Zen. (5 marks)

(2) Outline for each threat how it might be avoided. (5 marks)

(LO 7.4.1) (Total = 10 marks)

12 Chuck Industries (Pvt) Ltd

Introduction and client background

You are the audit senior of Blair & Co and your team has just completed the interim audit of Chuck Industries (Pvt) Ltd (Chuck Industries), whose year end is 31 January 20X2. You are in the process of reviewing the systems testing completed on the payroll cycle, as well as preparing the audit programmes for the final audit.

Chuck Industries manufactures lights and the manufacturing process is predominantly automated; however there is a workforce of 85 employees, who monitor the machines, as well as approximately 50 employees who work in sales and administration. The company manufactures twenty-four hours a day, seven days a week.

Below is a description of the payroll system along with deficiencies identified by the audit team:

Factory workforce

The company operates three shifts every day with employees working eight hours each. They are required to clock in and out using an employee swipe card, which identifies the employee number and links into the hours worked report produced by the computerised payroll system. Employees are paid on an hourly basis for each hour worked. There is no monitoring/supervision of the clocking in/out process and an employee was witnessed clocking in several other employees using their employee swipe cards.

The payroll department calculates on a weekly basis the cash wages to be paid to the workforce, based on the hours worked report multiplied by the hourly wage rate, with appropriate tax deductions. These calculations are not checked by anyone as they are generated by the payroll system.

Each Friday, the payroll department prepares the pay packets and physically hands these out to the workforce who operate the morning and late afternoon shifts, upon production of identification. However, for the night shift workers, the pay packets are given to the factory supervisor to distribute. If any night shift employees are absent on pay day then the factory supervisor keeps these wages and returns them to the payroll department on Monday.

Sales and administration staff

The sales and administration staff are paid monthly by bank transfer. Employee numbers do fluctuate and during July two administration staff joined; however, due to staff holidays in the HR department, they delayed informing the payroll department, resulting in incorrect salaries being paid out.

Required

For the deficiencies already identified in the payroll system of Chuck Industries:

(i) Analyse the possible implications of these.

(ii) Outline a recommendation to address each deficiency.

(LO 1.2.2 & 1.2.3) (10 marks)

13 Balotelli Beach Hotel Plc

Balotelli Beach Hotel Plc (Balotelli) operates a hotel providing accommodation, leisure facilities and restaurants. Its year end was 31 October 20X4. You are the audit senior of Mario & Co and are currently preparing the audit programmes for the year end audit of Balotelli. You are reviewing the notes of last week's meeting between the audit manager and finance director where two material issues were discussed.

Depreciation

Balotelli incurred significant capital expenditure during the year on updating the leisure facilities for the hotel. The finance director has proposed that the new leisure equipment should be depreciated over 10 years using the straight-line method.

Food poisoning

Balotelli's directors received correspondence in September from a group of customers who attended a wedding at the hotel. They have alleged that they suffered severe food poisoning from food eaten at the hotel and are claiming substantial damages. Balotelli's lawyers have received the claim and believe that the lawsuit against the company is unlikely to be successful.

Required

(1) Explain the difference between tests of controls and substantive procedures. (2 marks)

(2) Outline substantive procedures to obtain sufficient and appropriate audit evidence in relation to the above two issues. (8 marks)

(Note: The total marks will be split equally between each issue.)

(LO 3.5.1) (Total = 10 marks)

14 New Visions

You are the audit manager of Figures & Co and your audit team is coming to the end of the audit of New Visions, a company which develops and manufactures glasses which it then sells to major high street opticians.

The audit senior is preparing the financial statements for your final review but has told you that there are a few outstanding issues. At present, the draft financial statements for the year ended 31 December 20X1 show a profit before tax of Rs. 6m.

(i) On 1 October 20X1, New Visions began the commercial production of a new range of lightweight frames which have been proven to keep their shape regardless as to how roughly they are treated. Up to 30 September 20X1, the company had correctly capitalised development costs of Rs. 2 million relating to this project. The directors feel that the new frames will generate revenue over the next 3 years with 60% of revenue coming in year 1, 20% in year 2 and 20% in year 3. The statement of financial position shows the development costs at their current carrying value of Rs. 2 million. (4 marks)

(ii) The majority of New Visions' revenue relates to credit sales, although this year the company has made some cash sales for the first time. The audit senior has not been able to find any supporting documentation to substantiate the cash sales for the year. Cash sales amount to Rs. 100,000. (3 marks)

(iii) One credit customer, AJ Plc, owes Rs. 4,500,000 at 31 December 20X1 and this amount is included in the statement of financial position. At the year end a receivables confirmation was conducted and a reply received from AJ Plc confirming the balance owed. To date, no amounts have been received in relation to the outstanding debt. The audit senior has read the minutes of board meetings up to the current date and has noted that in February 20X2 AJ Plc contacted New Visions to explain that its business was in extremely serious financial difficulty. (3 marks)

Required

Analyse each of these issues and outline the impact on the audit report if they remain unresolved.

(Note: The mark allocation is shown against each of the three issues above.)

(LO 5.1.1) (Total = 10 marks)

SECTION 3

Both questions are compulsory.
Total marks for section 3 is 40 marks.
Recommended time for the section is 72 minutes.

15 Kangaroo Construction Plc

You are the audit senior of Rhino & Co and you are planning the audit of Kangaroo Construction Plc (Kangaroo) for the year ended 31 March 20X3. Kangaroo specialises in building houses and provides a five-year building warranty to its customers. Your audit manager has held a planning meeting with the finance director. He has provided you with the following notes of his meeting and financial statement extracts:

Kangaroo has had a difficult year; house prices have fallen and, as a result, revenue has dropped. In order to address this, management has offered significantly extended credit terms to their customers. However, demand has fallen such that there are still some completed houses in inventory where the selling price may be below cost. During the year, whilst calculating depreciation, the directors extended the useful lives of plant and machinery from three years to five years. This reduced the annual depreciation charge.

The directors need to meet a target profit before interest and taxation of Rs. 0.5 million in order to be paid their annual bonus. In addition, to try and improve profits, Kangaroo changed their main material supplier to a cheaper alternative. This has resulted in some customers claiming on their building warranties for extensive repairs. To help with operating cash flow, the directors borrowed Rs. 1 million from the bank during the year. This is due for repayment in December 20X3.

Financial statement extracts for year ended 31 March

	DRAFT 20X3 Rs. Mn	ACTUAL 20X2 Rs. Mn
Revenue	12.5	15.0
Cost of sales	(7.0)	(8.0)
Gross profit	5.5	7.0
Operating expenses	(5.0)	(5.1)
Profit before interest and taxation	0.5	1.9
Inventory	1.9	1.4
Receivables	3.1	2.0
Cash	0.8	1.9
Trade payables	1.6	1.2
Loan	1.0	–

Required

(1) State the meaning of the concepts of materiality and performance materiality in accordance with SLAuS 320 Materiality in Planning and Performing an Audit. (5 marks)

(2) Identify the factors to consider when using analytical procedures at the planning stage of the audit. (5 marks)

(3) Analyse the information above to identify FIVE audit risks. You may calculate ratios to help you in your analysis. (5 marks)

(4) Outline the auditor's response to each risk in planning the audit of Kangaroo Construction Plc. (5 marks)

(LO 2.4.1, 3.5.1 & 2.5.1) (Total = 20 marks)

16 Heanor Wholesale Plc

You have been asked by the manager in charge of the audit of Heanor Wholesale Plc (Heanor) to verify trade payables and accruals at the company's year-end of 30 April 20X2. The company maintains its purchase ledger, using a standard purchase ledger accounting package. Purchase invoices are posted to the purchase ledger after they have been checked to the delivery note and the purchase order and have been authorised by either the financial director or the managing director.

The purchase ledger can show for each purchase ledger account:

(a) The unpaid invoices and credit notes

(b) An ageing of the balance into current month, one month, two months and three or more months

(c) The total balance on the account

Also, the system is able to provide the total of the balances of all the accounts on the purchase ledger.

Your audit of the purchases system has revealed that the system for recording receipt of goods is relatively weak. The company does not use goods received notes, but the supplier's delivery note should be dated by the goods received department when the goods are received. Your audit tests have revealed that some delivery notes are not dated by the goods received department. The delivery note is filed with the purchase invoice in alphabetical order (by supplier).

A full inventory count was carried out at the company's year-end and you are satisfied that it was counted accurately.

In the company's draft financial statements the value of trade payables and accruals at 30 April 20X2 are as follows.

	Rs.
Trade payables	509,200
Purchase accruals	27,050
	536,250
Sundry payables and accruals	59,480
Current liabilities	595,730

Heanor's annual revenue figure is about Rs. 3.5 million and its profit before tax is Rs. 190,000. The age of payables at 30 April 20X2 is 3.4 months, which is similar to the previous year. Sundry payables and accruals comprise mainly wages accruals (including income tax and other deductions) and a sales tax liability of Rs. 20,000.

Required

(1) Explain the purpose of five application controls which you would expect to see over Heanor's purchase ledger system. (5 marks)

(2) Outline the audit work you will perform to verify trade payables and purchase accruals. (8 marks)

(3) Outline the audit procedures you will perform to verify sundry payables and accruals, including the sales tax liability. (7 marks)

(LO 1.3.1, 3.1.1) (Total = 20 marks)

Mock Exam Answers

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SECTION 1

All 10 questions are compulsory. Each question is worth 2 marks. Total marks for section 1 is 20 marks. Recommended time for the section is 36 minutes.

1

Suppliers with material balances at the year end	Include	
Suppliers which have a high volume of business with Poppy Co	Include	
Major suppliers with nil balances at the year end	Include	
Major suppliers where the statement agrees to the ledger		Exclude

Where completeness is the key assertion, the sample should be selected to verify where the balance may be understated and therefore should include suppliers with material balances, suppliers with a high volume of business with Poppy Co and major suppliers with no outstanding balance at the year end.

2 The correct answer is: Inspect the goods received note to determine when the goods were received.

In order to determine if the balance with Lily Co is understated, the auditor should determine if the goods should be included in payables at the year end by inspecting the goods received note.

3 The correct answer is: 1 and 2 only

To confirm the balance with Carnation Co, the auditor must determine if the liability exists for the disputed items at the year end by reviewing pre year end goods returned notes and post year end credit notes to verify that the goods have been returned and the order cancelled by the supplier.

4 The correct answer is: The effect of the control error should be projected across the whole population.

Although the error is immaterial, the auditor must reach a conclusion on the sample selected and in order to do so the effect of the error must be considered in relation to the whole population.

5 The correct answer is: Inputting dummy purchase invoices into the client system to see if processed correctly

Test data involves inputting fake transactions into the client's system to test how the transactions are processed. The other options are examples of audit software.

6

The date the subsequent events review is performed	The date of approval of the financial statement	The date of the auditor's report	The date the financial statements are issued
☐	☐	☑	☐

As per SLAuS 560 Subsequent Events, the auditor has an active responsibility to carry out subsequent events procedures between the date of the financial statements and the date of the auditor's report.

7 The correct answers are:

Discuss the matter with management and, where appropriate, those charged with governance

Enquire how management intends to address the matter in the financial statements where appropriate

As per SLAuS 560 paragraph 15, in the circumstances described the auditor should initially discuss the matter with management and understand how management intends to address the matter in the financial statements.

8 The correct answer is: 1, 3 and 4

The auditor is unlikely to ask the finance director, who is no longer an officer of the company and the party involved in the claim, to confirm the level of damages payable. All other procedures would be appropriate.

9 The correct answer is: Matters which required significant auditor attention

As per paragraph 9 of SLAuS 701 Communicating Key Audit matters in the Independent Auditor's Report, in determining key audit matters, the auditor shall determine, from the matters communicated to those charged with governance, those which required significant auditor attention.

10 The correct answer is: An unmodified audit opinion

The maximum damages of Rs150,000 is not material to the financial statements at 2.3% of profit before tax and 0.2% of revenue. Therefore no modification to the audit opinion is required.

SECTION 2

All four questions are compulsory.
Total marks for section 2 is 40 marks.
Recommended time for the section is 72 minutes.

11 Zen (Pvt) Ltd

(1) Ethical threat	(2) Managing threat
Staff membership rates at Zen – self-interest threat Such a benefit could cause a self-interest threat to the audit, because the recipients may not want to lose their benefit, and therefore be biased in their audit work or not seek adjustments where there are material issues in the financial statements.	Auditors are not allowed to accept such benefits unless their value is clearly insignificant. In this case, the value of a reduced membership of a spa is unlikely to be insignificant to audit staff members and therefore Adams and Co should reject this offer.
Partner invited to sit on the board – familiarity/ managerial threat If the partner were to sit on the board of directors, there is a risk that the partner could lose her audit objectivity as she may start identifying too closely with the company and its other directors. There is also a risk that the audit partner may start making management decisions at Zen.	Auditors are prohibited by the CA Sri Lanka Code of Ethics for Professional Accountants from sitting on the boards of their clients. Carol Gamage should explain this to Li Smith and politely decline the invitation.
Finance controller married to audit manager – familiarity threat The finance controller at Zen is married to an audit manager at Adams and Co. There is no indication that Chamani Warnapura has any connection to the audit of Zen. Clearly, the personal relationship between Elizabeth and Chamani Warnapura means that Chamani could not carry out this audit objectively.	Chamani must not be involved in the audit of Zen whilst Elizabeth is finance controller. However, it is acceptable for the firm to carry out the audit under these conditions.

(1) Ethical threat	(2) Managing threat
Assurance re insurance claim – advocacy threat Audit firms must always ensure that accepting other services does not impact on audit objectivity, whether due to the amount of fees relating to the service or as a result of the nature of the service itself.	The partners should discover more about the size and nature of this engagement to determine whether it will affect independence. In particular they should determine whether such an engagement would put the firm in the position of advocating Zen's position to the insurance firm, as this could cause an insurmountable barrier to independence. They should also monitor the level of fee income this would earn Adams and Co from all work performed for Zen. Where a substantial level of fees is derived from one client a self-interest threat arises.
Conflict of interest Adams and Co has been invited to tender for an audit which will involve Zen's major competitor, Revitalise. It is appropriate for audit firms to audit competitors, but the clients involved might feel that there is a threat to client confidentiality and may prefer to seek other auditors in such a situation.	Adams and Co should disclose to Zen that they are in the process of tendering for the audit of a competitor. If either Zen Co or Revitalise is unhappy with this situation then Adams and Co will need to decide which audit they want to secure. If Adams and Co performs both audits, they must ensure that they use separate audit partners and teams and set up information barriers to maintain confidentiality.

12 Chuck Industries (Pvt) Ltd

Chuck Industries – payroll system implications and recommendations

(i) Implication	(ii) Recommendation
Lack of monitoring of clocking in:	
The lack of monitoring of the clocking in/out process allows other employees to clock in colleagues resulting in a payroll cost in excess of that expected for the actual hours worked.	Clocking in and out should be monitored by a supervisor of an appropriate level.
The lack of supervision over clocking in and out also gives employees the opportunity to delay clocking out (or to clock in before starting work) to increase their overtime, leading to invalid payroll costs being incurred.	Payment of overtime hours should only be made on authorisation by a supervisor who has reviewed the overtime hours for reasonableness and compared them to production volumes and observed working patterns.
The absence of clocking in/out monitoring may result in a weak control environment as it promotes an attitude where it is acceptable to override controls.	Formal communications should be made on the importance and purpose of the company's policies and procedures in relation to clocking in and out, and the importance of adhering to company controls in general.
Payroll calculations not reviewed:	
Since payroll calculations are not checked and the system is entirely trusted, any errors made as a result of standing or underlying data being incorrect or occurring during payroll processing would not be discovered. Overpayments or underpayments (and incorrect payroll costs) may result and lead to losses or disgruntled employees.	A payroll supervisor should periodically recalculate the net pay based on the gross pay and expected deductions, then compare the result with the computer generated figures for a sample of employees. The review should be evidenced by a signature and wages should not be paid until this signed review is completed.

(i) Implication	(ii) Recommendation
Factory supervisor distribution of wages:	
The factory supervisor is trusted with substantial cash sums in advance of distribution of wages to the night shift. This cash is susceptible to theft and loss while not with employees or securely stored.	Payroll officials should be available for certain hours during the night shift to distribute wages.
The factory supervisor keeps absent employee's wages over the weekend before handing back to payroll and this further increases the risk of loss or theft of cash wages.	Any amounts not paid out on Fridays should be kept by payroll in a safe or other secure means until Monday when the employee can collect from the payroll department.
The supervisor entrusted with the wages is not independent and may take it upon him/herself to reallocate the wages as he/she deems necessary.	The supervisor should not be responsible for distribution of cash wages. Payroll should distribute these and should consider the proposal of operating for at least part of the night shift.
Poor communication of joiners/leavers:	
The lack of procedures in place to ensure timely notification of joiners/leavers means leavers may still be paid in error and joiners may not be paid on time. The payroll records will not reflect accurate wages costs at least temporarily.	HR staff duties and responsibilities should be reallocated when staff are ill or on holiday, including the responsibility of immediate communication of new joiners/leavers to payroll. In addition new joiner forms showing start date should be completed and authorised and passed to payroll so they are aware of the need to update the payroll records.

(Note: Only five well explained implications and five related recommendations were needed to gain full marks.)

13 Balotelli Beach Hotel Plc

(1) Tests of controls aim to obtain sufficient appropriate evidence that controls have been operating effectively during the period under audit.

Substantive procedures provide evidence as to whether transactions, account balances or disclosures are materially misstated. Substantive procedures include analytical procedures and tests of details.

(2) Substantive procedures

Depreciation

- Review the reasonableness of the depreciation rates applied to the new leisure equipment by comparing them to industry averages.
- For a sample of leisure equipment in the non-current asset register, recalculate the depreciation charge to ascertain its arithmetical accuracy.
- Make enquiries of management and review the capital expenditure forecasts to determine whether there are any plans to replace any of the new leisure equipment. Any plans to replace the equipment within 10 years would indicate a shorter useful life than has been assumed.
- Perform a proof in total calculation for the depreciation charged on the equipment and discuss any significant fluctuations with management.
- Review gains and losses on the disposal of assets during the year, to assess the reasonableness of the depreciation policies.
- Review the disclosure of the depreciation charges and policies in the draft financial statements.

Food poisoning

- Assess whether Balotelli has a present obligation as a result of a past event by reviewing correspondence from the customers.
- With the client's permission, contact the company's lawyers to obtain their written opinion on the probability of a successful lawsuit.
- Make enquiries of Balotelli's management and review board minutes to determine whether the directors believe that the claim will be successful.
- Review the post year-end payments for evidence of any payments made to the claimants.
- Inquire of management as to whether a contingent liability will be disclosed in the financial statements; consider the reasonableness of this.
- Obtain a written representation confirming management's assessment of the likely outcome of the lawsuit, and the appropriateness of accounting treatment adopted for the damages.
- Review the adequacy of any disclosures made in the financial statements.

14 New Visions

(i) Development costs

The capitalisation of the development costs appears to be appropriate and in accordance with LKAS 38. However LKAS 38 also states that once the asset is ready for commercial production/ use, it should be amortised over its useful life.

To date no amortisation has been charged which is contrary to LKAS 38.

The asset is deemed to have a useful life of 3 years being consumed 60% in year 1 and 20% in years 2 and 3 and so the financial statements should therefore show an amortisation charge of:

Rs. 2,000,000 × 60% × $^{3}/_{12}$ = Rs. 300,000.

The amortisation charge would reduce both profit before tax and the carrying value of the asset by Rs. 300,000.

This error amounts to 5% of profit before tax (Rs. 300,000 / Rs. 6,000,000) and so is likely to be material, hence management should charge the amortisation in the financial statements.

If management refuse to amend this error then the auditor's report would be modified. As management has not complied with LKAS 38 and the error is material but not pervasive then a qualified opinion would be necessary.

The opinion paragraph would be qualified on the grounds that the financial statements are materially misstated.

A basis for qualified opinion section would need to be included, explaining the material misstatement in relation to the non-amortisation of development costs and the effect on the financial statements.

(ii) Cash sales

The auditor is unable to verify the cash sales figure of Rs. 100,000 because audit evidence is not available.

The balance of cash sales at Rs. 100,000 amounts to 1.7% of profit before tax (Rs. 100,000 / Rs. 6,000,000) and is therefore not material.

The auditor should include this matter in their 'report to those charged with governance' and will also need to consider whether the company has, in general, kept proper accounting records.

Provided that the auditor is confident that proper accounting records have been maintained, then the auditor should issue an unmodified audit report.

(iii) AJ Plc – receivable

The balance of Rs. 4,500,000 has been confirmed in the year end confirmation and so audit evidence has been gained in relation to the existence of and rights and obligations to the debt.

However no monies have been received post year end and so the valuation of the amount has not been verified.

Given that the customer is suffering extremely serious financial difficulties, it is unlikely that much of the debt can be recovered.

At 75% of profit before tax (Rs. 4,500,000 / Rs. 6,000,000), the misstatement is certainly material and is likely to be material and pervasive.

If management refuse to amend this misstatement then the auditor's opinion would be modified. As management has not written down the debt to its recoverable amount, and the misstatement is likely to be both material and pervasive, then an adverse opinion would be necessary.

The adverse opinion section would state that the financial statements 'do not present fairly' as a result of a material misstatement.

A 'basis for adverse opinion' section would need to be included, explaining the material misstatement in relation to the overstatement of receivables and the effect on the financial statements.

SECTION 3

Both questions are compulsory.
Total marks for section 2 is 40 marks.
Recommended time for the section is 72 minutes.

15 Kangaroo Construction Plc

(1) Materiality and performance materiality

Materiality is not specifically defined in SLAuS 320 Materiality in planning and performing an audit but it does state that misstatements are material if they could reasonably be expected to influence the economic decisions of users (either individually or in aggregate).

SLAuS 320 also states that judgements about materiality are affected by the size and/or nature of a misstatement.

Auditors set their own materiality levels, based on their judgement of risk. During audit planning, the auditor will set materiality for the financial statements as a whole and this involves the exercise of professional judgement.

Benchmarks and percentages are often used to calculate a materiality level for the financial statements as a whole, eg 5% of profit before tax or 1-2% of total assets, but ultimately, the level of materiality set is down to the auditor's professional judgement, and may be revised during the course of the audit.

The auditor also has to set performance materiality, which is lower than materiality for the financial statements as a whole. Performance materiality is defined in SLAuS 320 as the amount or amounts set by the auditor at less than materiality for the financial statements as a whole to reduce to an appropriately low level the probability that the aggregate of uncorrected and undetected misstatements exceeds materiality for the financial statements as a whole.

(2) Factors to consider when using analytical procedures at the planning stage of the audit

- The objectives of the analytical procedures and the extent to which their results are reliable
- The degree to which information can be analysed
- The availability of information
- The reliability of the information available
- The relevance of the information available

- The source of the information available
- The comparability of the information available
- Knowledge gained from previous audits

(3) Audit risk and responses

(3) Audit risk	(4) Auditor's response
The company offers a five year building warranty on its houses. During the year, as a result of switching to a cheaper supplier, some customers have claimed on their guarantees. There is a risk that the warranty provision is understated in the financial statements.	As this is a judgemental area, the auditors need to discuss the basis of calculating the provision with the directors and assess the reasonableness of any assumptions made. They should also review a sample of guarantees claimed during the year and vouch amounts to repairs invoices. They should review the level of claims made in the year and assess whether the provision needs revising in light of this.
The company has had a difficult year due to a fall in house prices. Gross profit margin has fallen by 3% (47% (7/15 × 100) in 20X2, 44% (5.5/12.5 × 100) in 20X3 and operating margin has fallen significantly from 13% (1.9/15 × 100) to 4% (0.5/12.5 × 100). In addition, the company has had to take out a loan of Rs. 1m during the year to help with operating cash flow. Payables days have also increased from 55 days (1.2/8 × 365) to 83 days (1.6/7 × 365), indicating that the company is having problems paying suppliers. There is therefore a risk that the company may not be a going concern.	The auditors must discuss with directors whether they believe that the company is still a going concern in light of the results of the ratio analysis, and review cash flow forecasts and budgets for the forthcoming year.
Receivables days have increased from 49 days (2/15 × 365) to 91 days (3.1/12.5 × 365) as a result of the directors increasing the credit terms offered to customers. There is a risk that the receivables' balance at year-end is materially overstated as customers may not be able to pay.	The auditors should carry out post year-end testing and cut-off testing on receivables' balances to verify the accuracy of the year-end balance. The auditors should also review the aged receivables listing to identify any balances that need writing off.

(3) Audit risk	(4) Auditor's response
There is a risk that inventory is overstated in the financial statements as there may be some houses whose selling price is less than cost. Inventory days have also increased from 64 days (1.4/8 × 365) to 99 days (1.9/7 × 365).	Detailed audit work on inventory should be carried out as this is likely to be a material balance. An auditor's expert may need to be used to independently verify the value of inventory at the year-end.
There is a risk that revenue and costs have been deliberately misstated in the financial statements in order for the directors to meet the target profit before interest and taxation figure of Rs. 0.5m so as to get their bonuses (window dressing). This is also indicated by the fact that the directors have changed the useful economic life of plant and machinery from three to five years to reduce the depreciation charge for the year and hence inflate the profit figure to attain the minimum target figure.	The auditors need to maintain professional scepticism throughout the audit and carry out detailed cut-off testing on revenue and expenses to confirm that the figures are correctly stated.
There is a risk that the depreciation charge for the year is understated and non-current assets on the statement of financial position are overstated as the directors have amended the useful economic life of plant and machinery from three to five years.	The auditors should discuss the change and the reasons for it with the directors and assess whether it is reasonable or not. They should also examine a sample of plant and machinery assets to assess whether the change is appropriate.
The company has taken out a loan of Rs. 1m from the bank which is repayable within a year. There is a risk that this loan has been incorrectly disclosed in the financial statements. It should be disclosed as a current liability as it is repayable within a year.	The auditors should review the terms of the loan agreement to verify the repayment date and the amount borrowed. They should review the draft financial statements to confirm the correct disclosure of the loan.

(Note: only five audit risks were required.)

16 Heanor Wholesale Plc

(1) Application controls the auditor would expect to see include the following:

- The use of manual or programmed agreement of control totals to ensure that input of purchase invoices is complete
- Document counts to confirm that all purchase invoices for the relevant period have been processed. This helps to ensure completeness.
- Programmed data filed checks to ensure the accuracy of input of data contained on the purchase invoice, for example existence checks on the company name, the use of permitted ranges.
- Batch reconciliations after processing to ensure that processing of purchase invoices is complete.
- Cyclical review of standing data and master files to ensure that the data relating to suppliers is accurate.

(2) Audit work to verify trade payables and purchase accruals would be as follows.

(i) Purchases cut-off

As goods received notes are not used the normal procedures for auditing cut-off will need to be adapted.

(1) Examine purchase invoices on either side of the year-end to dated suppliers delivery note to ensure invoices have been correctly accrued. (Where the goods received department have not date-stamped the delivery date it will be necessary to use the suppliers despatch date.)

(2) Enquire if the goods received department or bought ledger department are holding any unmatched delivery notes (those without an invoice) relating to the period before the year-end.

(ii) Completeness, existence and ownership

(1) Select invoices from the trade payables listing and trace to supporting documentation to ensure that the purchase was for the purpose of the business.

(2) Reconcile a sample of suppliers' statements with purchase ledger balances. This will highlight any purchases that have been omitted. Where there are major accruals for which statements are not available it may be necessary to carry out a payables' circularisation. (A circularisation is not normally the primary procedure to be selected as the supplier's statement provides more effective evidence and a reconciliation is simpler to carry out than a circularisation.)

(3) Review balances for unusually low balances with major suppliers.

(4) Compare the ratio of trade payables to purchases and inventory with the previous year's figures.

(5) Match cash payments posted in purchase ledger accounts before and after the year-end to cash records to ensure they were posted in the right period.

(iii) Trade payables listing

(1) Agree the total unpaid invoices and credit notes to balances on the aged payables listing.

(2) Agree the total of balances on the aged payables listing to the purchase ledger control account.

(3) Agree the list of balances to individual ledger accounts and vice versa.

(4) Review the listing for large payable balances and enquire into reasons for them and action being taken.

(5) Review the control account around the year-end for unusual items.

(3) Sundry payables and accruals is an area that lends itself to analytical review and reconciliation techniques, except for liabilities such as income tax and sales tax which should be checked in detail.

(i) From the sundry payables and accruals listing confirm that the calculation of accruals is reasonable and verify to subsequent payments. Income tax and related deductions liabilities should also be verified to payroll.

(ii) Scrutinise post year-end payments/invoices received to check for understatement of sundry payables and accruals.

(iii) Ascertain whether any expenditure is likely to be invoiced a long time after the goods or services are received.

(iv) Compare sundry payable and accruals with prior year balances and inquire into significant variations.

(v) Check that the sales tax accrual is disclosed at correct amount by vouching to returns and accounting records.

(vi) Ensure that no non-deductible tax is reclaimed on the return, by scrutinising it.

(vii) Vouch payments or refunds of sales tax to cash book from sales tax returns.

(viii) Obtain sales tax returns for the period and check that they have been properly prepared and filed promptly.

(ix) Test sales tax totals from prime records to monthly/quarterly summaries and test cast summaries and scrutinise for unusual items.

(x) Review correspondence with taxation authority and results of any recent control visits.