UNIVERSITY OF KELANIYA – SRI LANKA

Centre for Distance and Continuing Education

FACULTY OF COMMERCE & MANAGEMENT STUDIES

Bachelor of Commerce (Special) Degree Third Year Examination (External) – 2016

May 2022

BCOM E3072 – Audit & Assurance

No. of Questions: Five (05) **Time: 03 Hours**

Answer FOUR questions including Question No.01.

Question No. 01

You are an audit supervisor of B&S Partners and are planning the audit of Bricks (Pvt.) Ltd for the year ending 31st March 2021. The company has been a client of your audit firm for several years and manufactures car tyres, selling its products to wholesale and retailers. The audit manager attended a planning meeting with the finance director and has provided you with the following notes of the meeting and financial statement extracts:

Planning Meeting Notes

Bricks (Pvt.) Ltd sells approximately 40% of its tyres to wholesale customers. These customers purchase goods on a sale or return basis. Under the terms of the agreement, wholesale customers have 60 days during which any returns can be made without penalty. The finance director has historically assumed a return rate of 10%, however, he now feels that this is excessive and intends to change this to 5%.

In December 2020, the financial controller of Bricks (Pvt.) Ltd was dismissed after it was alleged that she had carried out a number of fraudulent transactions against the company. She has threatened to sue the company for unfair dismissal as she disputes the allegations. The company has only recently started to investigate the extent of the fraud in order to quantify the required adjustment.

A problem occurred in December 2020, during the production of a significant batch of tyres, which affected their quality. The issue was identified prior to any goods being dispatched and management is investigating whether the issues can be rectified, and the tyres can subsequently be sold.

Bricks (Pvt.) Ltd's finance director has informed you that in September 2020 a significant customer was granted a payment break of six months, as it has been experiencing financial difficulties. Bricks (Pvt.) Ltd maintains a provision for trade receivables and it is anticipated that this will remain at the same level as the prior year.

The management letter issued by B & S partners following last year's audit highlighted significant deficiencies relating to Bricks (Pvt.) Ltd.'s purchase cycle.

The finance director has informed you that the company intends to restructure its debt finance after the year-end and will be looking to consolidate its loans to reduce the overall cost of borrowing. As a result of the planned restructuring of debt, Bricks (Pvt.) Ltd has not paid its shareholders a dividend this year, choosing instead to undertake a bonus issue of its Rs. 0.50 equity shares.

You have been asked by the audit manager to complete the preliminary analytical review and she has provided you with the following information:

Financial Statement Extracts for the year ending 31st March

	2021 Rs.000	**2020 Rs.000**
Revenue	23,200	21,900
Cost of Sales	(18,700)	(17,300)
Gross Profit	**4,500**	**4,600**
Finance Costs	290	250
Profit before tax	**450**	**850**
Inventory	2,100	1,600
Long and short-term borrowings	13,000	11,000
Total Equity	10,000	9,500

The audit assistant has already calculated some key ratios for Bricks (Pvt.) Ltd and you have confirmed them as accurate. She has ascertained that the trade receivables collection period has increased from 38 to 51 days.

Required:

(a) Describe the auditor's responsibilities in relation to the prevention and detection of fraud and error.

(03 Marks)

(b) Calculate any three ratios for both years, to assist you in planning the audit of Bricks (Pvt.) Ltd.

(06 Marks)

(c) Using the information provided and the ratios calculated, describe EIGHT audit risks and explain the auditor's response to each risk in planning the audit of Bricks (Pvt.) Ltd.

(16 Marks)

(Total 25 Marks)

Question No. 02

Flex PLC is listed on Colombo Stock Exchange and sells consumer goods to wholesale customers. The company has a large head office and 18 warehouses. You are an audit supervisor of CLP Partners and the final audit for the year ended 31st March 2021 is due to commence shortly. The draft financial statements show total assets of Rs.98.5 million and profit before tax of Rs. 6.1 million. The following three matters have been brought to your attention.

Land and buildings

Flex PLC historically recorded all property, plant, and equipment (PPE) at cost less accumulated depreciation. However, during the year, management decided to change the accounting policy for land and buildings from the cost model to the revaluation model. The finance director hired an external independent valuer to undertake the valuation of all land and buildings, and this took place in July 2020. Depreciation is calculated monthly. Flex PLC's year-end balance for PPE includes land and buildings of Rs.19.2 million (2020 – Rs. 4 million).

Trade receivables

Flex PLC's year-end trade receivables balance of Rs.1.3 million (2020 – Rs.0.7 million) has significantly increased compared to the prior year. Flex PLC's receivables ledger is made up of a large number of customers with balances ranging from Rs.15,000 to Rs.150,000. The majority of responses from customers agreed to the balances as per Flex PLC's receivables ledger on at 31st March 2021, however, the following exceptions were noted.

Customer	Balance per Flex PLC	Response from Customer
Nimz PLC	Rs.141,102	No response
Hemax PLC	Rs.136,321	Rs.122,189

Provision and receivable arising from the sale of defective goods

In December 2020, Flex PLC sold a number of electronic items to a customer, Kidz (Pvt) Ltd. It is alleged by Kidz (Pvt) Ltd that these electronic items are faulty, as there have been a few instances of the toys breaking. As a result, Kidz (Pvt) Ltd is suing Flex PLC for Rs.0.9 million. The court case is due to take place in August 2021 and management believes that Kidz (Pvt) Ltd.'s claim is likely to be successful. No electric items remain in Flex PLC's inventory at the year-end.

Flex PLC purchased the electronic items from a supplier, Thomas (Pvt) Ltd. In February 2021 Flex PLC contacted Thomas (Pvt) Ltd and requested that they reimburse Flex PLC for damages that may become payables as a result of the sale of defective electronic items. Flex PLC is requesting a sum of Rs. 0.9 million from Thomas (Pvt) Ltd. The draft financial statements contain a provision of Rs. 0.9 million in respect of the customer's claim and a receivable of Rs.0.9 million in respect of Flex PLC's counterclaim against its supplier.

Required:

(a) Describe substantive procedures the auditor should perform to obtain sufficient and appropriate audit evidence in relation to Flex PLC's land and buildings.

(07 Marks)

(b) Describe the procedures the auditor should perform in relation to the exceptions noted in respect of Nimz PLC and Hemax PLC.

(08 Marks)

(c) Describe substantive procedures the auditor should perform to obtain sufficient and appropriate audit evidence in relation to the Provision and the Receivable arising from the sale of defective goods.

(10 Marks)

(Total 25 Marks)

Question No. 03

(a) Identify and explain TWO factors that would indicate that an engagement letter for an existing audit client should be revised.

(05 Marks)

(b) Explain the auditor's responsibility with regard to laws and regulations directly effect on the financial statements and do not have a direct effect on laws and regulations.

(10 Marks)

(c) An audit manager of James Chartered Accountants drew up his audit programme without evaluating internal controls of Felena (Pvt.) Ltd. When the partner asked the audit manager for the reason, he stated that the controls were developed by the General Manager (Finance) of Felena (Pvt.) Ltd., who is a Chartered Accountant and had written a few books on "Internal Control" and, therefore there was no need to review the said area. Comment in this regard.

(10 Marks)

(Total 25 Marks)

Question No. 04

You are an audit manager of Nilkam Partners and are planning the audit of Fitz Finance PLC, a banking institution that provides a range of financial services including loans. Your firm has audited Fitz Finance PLC for four years and the company's year-end is 31st March 2021. At the end of February 2021, Fitz Finance PLC's financial controller left, and the new replacement is not due to start until approximately two months after the year-end. The finance director, who is the sister of the audit engagement partner, has asked if a member of the audit team can be seconded to Fitz Finance PLC for three months to act as the temporary financial controller. You are aware that a number of the audit team members currently bank with Fitz Finance PLC, and two team members have significant loans owing to the company. Nilkam Partner's taxation section also provides services to Fitz Finance PLC. They have been approached by Fitz Finance PLC Ltd to represent them in negotiations to resolve some outstanding issues with the taxation authorities, for which the fees quoted are substantial. The finance director has informed the audit engagement partner that when the audit is complete, she would like the whole team to attend an evening a luxury meal.

Required:

(a) Identify and explain FIVE ethical threats which may affect the independence of Nilkam Partner's audit of Fitz Finance PLC: and

(10 Marks)

(b) for each threat, explain how it might be reduced to an acceptable level.

(15 Marks)

(Total 25 Marks)

Question No. 05

Briefly explain the following terms.

(a) Intended Users

(b) Control Risk

(c) Qualified Opinion

(d) Engagement Quality Control Reviewer

(e) Limited Assurance Engagement

(05 Marks x 5 = Total 25 Marks)