



ASSOCIATION OF ACCOUNTING TECHNICIANS OF SRI LANKA

AA3 EXAMINATION - JULY 2016

(AA34) PROCESSES, CONTROLS AND AUDIT

• **Instructions to candidates** (Please Read Carefully):

- (1) **Time Allowed:** Reading : 15 minutes.
Writing : 03 hours.

16-07-2016
Afternoon
[1.45 – 5.00]

No. of Pages : 09
No. of Questions : 09

- (2) **All questions should be answered.**
- (3) **Answers should be in one language, in the medium applied for, in the booklets provided.**
- (4) **Submit all workings and calculations. State clearly assumptions made by you, if any.**
- (5) **Use of Non-programmable calculators is only permitted.**
- (6) **Action Verb Check List with definitions is attached. Each question will begin with an action verb. Candidates should answer the questions based on the definition of the verb given in the Action Verb Check List.**
- (7) **100 marks.**

SECTION A

Four (04) compulsory questions

(Total 20 marks)

Question 01

“The members of AAT Sri Lanka must comply with the fundamental principles set out in the Code of Ethics for Professional Accountants”.

- (A) “Integrity” is a fundamental principle set out in the Code of Ethics for Professional Accountants.

Explain this principle. (03 marks)

- (B) **State** the two(02) types of assurance engagements a practitioner / an auditor can perform.

(02 marks)

(Total 05 marks)

Question 02

“The Code of Best Practice on Corporate Governance can be divided into two(02) main sections, in which it specifies certain duties for directors as well as for shareholders. Directors act as trustees / agents of the shareholders.”

- (A) **Explain** what the “Agency Conflict” is. (03 marks)
- (B) **State** two(02) guidelines for Board of Directors that have been highlighted by the Code of Best Practice on Corporate Governance. (02 marks)
- (Total 05 marks)

Question 03

- (A) **State** three(03) elements of a system of quality control in an audit firm. (03 marks)
- (B) **Samith** is a member of the audit team auditing the financial statements of **K & P (Pvt) Ltd.** for the year ended 31st March 2016 and he has instructed to audit the additions made to Property, Plant and Equipment (PPE) during the year. Additions to the PPE during the year are considered to be material according to the draft financial statements for the year.
- Explain** an audit procedure **Samith** would perform to verify existence of Property, Plant and Equipment. (02 marks)
- (Total 05 marks)

Question 04

“The auditor obtains third party confirmations regarding certain account balances and transactions”.

- (A) **State** four(04) instances in which the auditor may use external confirmations. (04 marks)
- (B) **Identify** a factor that might indicate doubts about the reliability of the response to an external confirmation request sent by the auditor. (01 mark)
- (Total 05 marks)

End of Section A

SECTION B

Three (03) compulsory questions

(Total 30 marks)

Question 05

Ranmal Lanka (Pvt) Ltd. (RLPL) has constructed a building costing Rs.600 million during the financial year ended 31st March 2016. The auditor of **RLPL** has noted that this building which was used during the year had not been capitalized. The cost of the building is shown as capital work in progress in the financial statements. If the cost of the building has been correctly capitalized, there would have been an additional depreciation charge of Rs.15 million for the year. The profit shown in the financial statements of **RLPL** for the year ended 31st March 2016 was Rs.90 million.

You are required to,

- (A) **Explain** the impact of the above to the Auditor's report of **RLPL**. (04 marks)
 - (B) **Explain** what the "emphasis of matter paragraph" is in an Auditor's report. (03 marks)
 - (C) **State** three(03) important matters stated in the "introductory paragraph" of Auditor's report. (03 marks)
- (Total 10 marks)

Question 06

KK Associates has been appointed as the auditor of **Smile Super (Pvt) Ltd. (SSPL)**. **Kamal**, the partner in charge of the audit of **SSPL** discussed the following matters with the audit team:

- (1) The importance of obtaining an understanding about **SSPL**, its industry and environment prior to commencing the audit work.
- (2) The importance of timely documentation of evidences gathered and work performed of the audit in the current audit file.
- (3) Use of professional skepticism in performing the audit specially in addressing the risk of fraud.
- (4) Significant risk areas of the audit.

Kamal, advised the audit team to perform the following procedures:

- (I) Sales cut-off.
- (II) Select a sample of invoices to verify whether those have been approved.
- (III) Review the accounting policy on depreciation of Property, Plant and Equipment.
- (IV) Call for direct confirmations on the balances outstanding as at 31st March 2016 from selected debtors.

You are required to,

- (A) **List** three(03) documents that contain in the current audit file. (03 marks)
- (B) **State** three(03) ways that the audit team of **SSPL** can gain an understanding about the company, its industry and environment. (03 marks)
- (C) **Identify** the financial statement assertion that will be addressed from each of the procedures listed in **(I)** to **(IV)** of the above scenario. (04 marks)
- (Total 10 marks)

Question 07

- (A) "The internal control system is important for an organization"

You are required to:

- (a) **State** two(02) objectives of an internal control system. (02 marks)
- (b) **List** two(02) components of the Committee of Sponsoring Organizations' (COSO) Internal Control System Framework. (02 marks)
- (B) **Jaya Exports (Pvt) Ltd. (JEPL)** is engaged in the manufacturing of virgin coconut oil. The company exports their main products to Germany and sells certain by-products such as coconut shells and desiccated coconuts to local market.

Customers who buy coconut shells pay mostly by cash. **Amali** who is the accountant of this company, is responsible for collecting cash from customers. She enters these receipts in the petty cash book as cash receipts and uses this cash to make day to day expenses.

Some local customers buy desiccated coconut items from **JEPL** and they make payments by cash cheques. **Amali** encashes these cheques from the bank and enters in the petty cash book as cash receipts.

All foreign buyers settle their dues directly through the USD Bank Account of the company.

You are required to,

- (a) **Identify** three(03) internal control weaknesses in the internal control system detailed above. (03 marks)
- (b) **State** a recommendation each as to how the management of **JEPL** would overcome each of those weaknesses identified in (a) above. (03 marks)
- (Total 10 marks)

End of Section B

SECTION C

Two (02) compulsory questions.

(Total 50 marks)

Question 08

(A) "Appropriateness of audit evidence relates to the quality or reliability of the evidence".

Explain four(04) types of audit procedures for obtaining audit evidence. (08 marks)

(B) (a) **Solid Tyres (Pvt) Ltd. (ST)** manufactures and exports tyres. The following information relates to **ST**:

	As at 31 st March	
	2016 (Rs.)	2015 (Rs.)
Raw material	414,300	364,250
Work-in-progress	154,420	95,610
Finished goods	267,780	275,200
Total	836,500	735,060

Cost of sales for the year ended 31st March 2016 and 31st March 2015 amounted to Rs.8,700,000/- and Rs.9,400,000/- respectively.

You are required to,

Explain two(02) analytical procedures that the auditor could perform on inventories of **ST** as at 31st March 2016 based on the information provided. (04 marks)

(b) **Aravinda** is the senior in charge for the audit of **ST** for the year ended 31st March 2016. The debtors of **ST** are granted 60 days of credit. The board of directors has approved the annual budgets including the capital expenditure budget:

- (1) **Aravinda** selected 10 debtors out of the 60 debtors to request direct confirmations on the balances outstanding as at 31st March 2016. Only 2 debtors replied for the requests and the those balances confirmed were not in agreement with the accounting records of **ST**.
- (2) **Aravinda** reviewed the payroll prepared for the month of March 2016 and he noted that there is a difference of Rs.1 million between the amount of net salary as per the ledger account for the month of March 2016 when compared to the amount of net salary computed by the payroll system, for that month.

- (3) Purchase orders (PO) for acquisition of Property, Plant and Equipment are approved by the Managing Director. However, the approved PO for the purchase of a machinery amounting to Rs. 80 million was not presented to the auditor.
- (4) **ST** has not performed a physical verification of Property, Plant and Equipment during the financial year.

You are required to,

List two(02) additional audit procedures, that the auditors of **ST can perform for each of the matters noted in (1) to (4) above to obtain adequate audit evidence regarding relevant balances.** (08 marks)

- (C) Given below is the only working paper available in the audit file regarding the work performed on Trade Debtors' confirmations of **Solid Tyres (Pvt) Ltd.:**

Client:		Prepared by:	Sarath
Description:	<u>Trade Debtors</u>	Date	25.05.2016
		Reviewed by	
		Date	
<u>Confirmations - Trade Debtors</u>			
		<u>Rs'000</u>	
Trade debtors		<u>12,500</u>	
<i>Work done</i>			
<i>Direct confirmations requested.</i>			
<i>Results</i>			
<i>Two confirmations received.</i>			

- Identify five(05) weaknesses noted in the working paper provided above.** (05 marks)
(Total 25 marks)

Question 09

- (A) **Blue Berry (Pvt) Ltd. (BB)** has appointed **Sidath Associates** (a firm of Chartered Accountants) as the external auditor of the company for the year ended 31st March 2016.

You are required to,

- (a) **Explain** three(03) procedures **Sidath Associates** should follow before accepting the appointment as the external auditor of **BB**. (06 marks)

- (b) After completing the acceptance procedures, a junior auditor of **Sidath Associates** prepared a draft engagement letter to be sent to **BB**. The extract of the draft engagement letter is given below:

Date:

The Board of Directors

Blue Berry (Pvt) Ltd.

Dear Sirs,

LETTER OF ENGAGEMENT

You have requested that we audit the Statement of Financial Position of your company as at 31st March 2016 and the Statement of Comprehensive Income, Statement of Changes in Equity, Statement of Cash Flows for the year then ending and a summary of significant accounting policies and other explanatory information. We are pleased to confirm our acceptance and our understanding of this engagement by means of this letter. Our audit will be conducted with the objective of expressing an opinion on the financial statements.

Management's responsibility:

Our audit will be conducted on the basis that management and those charged with governance acknowledge and understand they have responsibility.

- (a) *For the preparation and fair presentation of the financial statements in accordance with Sri Lanka Accounting Standards and the requirements of the Companies Act, No. 7 of 2007.*
- (b) *For such internal control as management determines is necessary to enable the preparation of financial statements that are free from material misstatements, whether due to fraud or error; and,*
- (c) *To provide us with:*
 - (i) *Access to all information of which you are aware that is relevant to the preparation of the financial statements such as records, documentation and other matters;*
 - (ii) *Additional information that we may request from you for the purpose of the audit; and*
 - (iii) *Unrestricted access to persons within the company from whom we determine it necessary to obtain audit evidence.*

The directors are responsible for safeguarding the company's assets and for the prevention and detection of fraud, error and non-compliance with regulatory requirements.

We look forward to full cooperation from your staff during our audit.

Sidath Associates

Chartered Accountants

Acknowledge on behalf of

Identify six(06) weaknesses noted in the draft engagement letter given above.

(06 marks)

- (B) **Ranhiru (Pvt) Ltd.** has recently computerized its accounting function. There was no parallel run prior to moving to the new system and the balances as at 31st March 2016 were immediately transferred to the new system on 01st April 2016 and continued operations. With the new system which commenced operations on 01st April 2016, the duties were segregated among staff.

The system developer of the company has suggested that application controls such as controls over input completeness and controls over input accuracy be implemented soon after he completes the assignment.

You are required to,

- (a) **List** three(03) examples for controls over input completeness. (03 marks)
- (b) **List** four(04) examples for controls over input accuracy. (04 marks)
- (C) “The financial statements are normally prepared on the assumption that an entity is a going concern and will continue in operation for the foreseeable future. Therefore, the going concern review is a very important part of the audit”.
- (a) **State** three(03) operating indicators that may cast significant doubt about the going concern assumption of an entity. (03 marks)
- (b) **State** three(03) audit procedures that the auditor could apply in performing going concern review. (03 marks)
- (Total 25 marks)

End of Section C

ACTION VERB CHECK LIST

Knowledge Process	Verb List	Verb Definitions
Level 01 Comprehension Recall & explain important information	Define	Describe exactly the nature, scope, or meaning.
	Draw	Produce (a picture or diagram).
	Identify	Recognize, 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.
	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 an understandable terms.
	Recognize	To show validity or otherwise, using knowledge or contextual experience.
	Record	Enter relevant entries in detail.
Summarize	Give a brief statement of the main points (in facts or figures).	

Knowledge Process	Verb List	Verb Definitions
Level 02 Application Use knowledge in a setting other than the one in which it was learned / Solve closed-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.
	Prioritize	Arrange or do in order of importance.
	Reconcile	Make consistent with another.
	Solve	To find a solution through calculations and/or explanation.

Knowledge Process	Verb List	Verb Definitions
Level 03 Analysis Draw relations among ideas and compare and contrast / Solve open-ended problems.	Analyze	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.
	Differentiate	Constitute a difference that distinguishes something.
	Outline	Make a summary of significant features.