



Association of Accounting Technicians of Sri Lanka

AA3 Examination - January 2018

**Questions and Suggested Answers
(AA34)**

**PROCESSES, CONTROLS AND AUDIT
(PCA)**

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THE ASSOCIATION OF ACCOUNTING TECHNICIANS OF SRI LANKA
EDUCATION AND TRAINING DIVISION

AA3 Examination - January 2018
(AA34) Processes, Controls and Audit

SUGGESTED ANSWERS

SECTION – A

Four (04) compulsory questions
(Total 20 marks)

Suggested Answers to Question One:

External environment consist of political, economic, social and cultural, technological, ecological and legal (PESTEL) forces.

• **Political Forces**

Political forces describe how and to what extent a government of a country affects business.

- (a) Government tax policies of Sri Lanka. (b) Taxation policy
(c) Price regulations (d) Unemployment
(e) Global economic factors

• **Economic forces**

The aspects of economy that are affect businesses are inflation, interest rates, taxation etc.

- (a) Rate (b) Interest rate
(c) Government spending (d) Demand and supply

• **Social and cultural forces**

These consists values, beliefs and behaviors of consumers, household and communities.

- (a) Consumers' behaviour (b) Life style of customers
(c) Level of education
(d) Taste and pretences of consumers' segments being served - urban, sub-urban, youth etc.

• **Technological forces**

Businesses are affected by rapid changes in production process, product innovation and technological advancement.

- (a) Online shopping facilities (b) Level of product innovation
(c) Technological advancement
(d) Level of automation manufacturing processes

- **Environmental forces**

This refers to the changes in natural environment.

- (a) Changes in climate

- **Legal forces**

These include the regulatory frame work of a country

- (a) No 07 of 2007 Companies Act.
- (b) Consumer protection level
- (c) Labour laws including EPF & ETF acts
- (d) Accounting and Auditing regulations

(05 marks)

Suggested Answers to Question Two:

- (a) i Overseeing of the preparation, presentation and adequacy disclosures in financial statements of listed entity in accordance with Sri Lanka Accounting Standards.
- ii Overseeing of the Entity's compliance with financial reporting requirements.
- iii Overseeing the process to ensure that the entity's internal control and risk management are adequate to meet the requirements of the SLAUS
- iv Assessment of the independence and performance of the Entity's external auditors.
- v To make recommendations to the Board pertaining to appointment, reappointment and removal of external auditors and to approve the remuneration and terms of engagement of the external auditors.

(03 marks)

- (b) The remuneration committee shall recommend the remuneration payable to the Executive Directors and Chief Executive Officer of the Listed Entity.

(02 marks)

(Total 05 marks)

Suggested Answers to Question Three:

- i Monitoring
- ii Engagement Performance
- iii Human resources
- iv Acceptance and continuance of client relationships
- v Relevant Ethical requirement
- vi Leadership responsibilities for quality within the firm

(05 marks)

Suggested Answers to Question Four:

(a) Annual External Audit.

(02 marks)

(b) Limited Assurance is a lower level of assurance than reasonable assurance. It allows for a lesser amount of testing and evaluations. As a result, there is a greater risk that the auditor gives an incorrect opinion. Since the risk of an incorrect opinion is higher in a limited assurance engagement, the practitioner expresses his opinion in a negative form.

(03 marks)

(Total 05 marks)



End of Section A

Three (03) compulsory questions
(Total 30 marks)

Suggested Answers to Question Five:

(A)

(a) **Sufficiency relates to quantity of evidence.**

Sufficiency means quantity of audit evidence.

The quantity of the audit evidence required is affected by the level of risk in the area being audited. If auditor obtains more quantity of audit evidence, risk is less.

Appropriateness relates to the quality or reliability of evidence.

Appropriateness means quantity of audit evidence.

It includes relevance and reliability (this influenced by the source and nature of the evidence) of audit evidence. If audit evidences are high with quantity, audit risk is less.

(04 marks)

(b) **External confirmation** is the process of obtaining audit evidence directly from a third party in response to a request for information about a particular item affecting assertions in the financial statements or related resources.

- Eg:
- Bank balances and other information from bankers
 - Loans from lenders
 - Account Payable / Receivable balances from creditors / Debtors. Etc...
 - Stock held by third parties
 - Property title deds held by lawyers

(02 marks)

- (B) 01. The relevance and reasonableness of the Actuary's findings or conclusions and their consistency with other audit evidence. Eg: Payments made for termination benefits validated under payroll compared to payments taken account of by Actuary when calculating defined benefits plan liability.
02. Relevance and reasonableness of the assumptions and methods used by the Actuary. Eg: Reasonableness of discount rate used, future salary increase, and rate of employee turnover compared with the understanding of the client and its business environment.
03. If the expert's work involves the use of source data that is significant to that expert's work, the relevance, completeness and accuracy of that source data.

(04 marks)

(Total 10 marks)

Suggested Answers to Question six:

(A) (a) The purpose of engagement letter is to provide written confirmation of the work to be undertaken by auditor for avoiding misunderstanding between auditor and client. When the terms of the engagement are agreed by auditor and the management, those terms should be recorded in an engagement letter. It can confirm the appointment of the auditor and can use as a legal document when necessary.

(03 marks)

- (b) - A significant change in ownership
- A recent change in senior management
- A change in law and regulation
- A change in financial reporting framework
- A significant change in size or nature of the entity
- Any revised or special terms of the audit engagement.
- Any indication that the entity misunderstands the objective and scope of the audit.

(03 marks)

(B) (1) **Self-review threat**

The separate engagement involves review and reporting on the effectiveness of financial controls, including proposing actions to remedy weaknesses identified. These same controls (all or in part) will be tested as part of controls testing during the audit. Therefore, the auditor will review his own work.

(2) **Familiarity Threat**

The threat that is due to a long or close relationship with a client or employer, a professional accountant will be too sympathetic to their interests or too accepting of their work. In this case the audit firm is engaged in the external audit of RK for a long period of time. This will result in familiarity threat.

(3) **Self-interest threat**

The threat that a financial or other interest will inappropriately influence the professional accountants judgment or behavior. The firm depends on the client as it is one of the largest clients of the firm. Therefore, There is a dependency on this client.

(04 marks)

(Total 10 marks)

Suggested Answers to Question seven:

- (a) The auditor should express an unmodified opinion when the auditor conclude that the financial statements are free from material misstatements and it shows true and fair view of the entity's operations.

(03 marks)

- (b) (i) Auditor includes an emphasis of matter paragraph in the audit report when the auditor decides users of the audited financial statements should pay attention to a specific matter appropriately disclosed or presented in the financial statements that in the auditor's judgment, the particular matter is fundamental to users' understanding of the financial statements.

(03 marks)

- (ii)
- i Existence of an uncertainty relating to a future outcome of an exceptional litigation or regulatory action.
 - ii Early application of a new accounting standard that has a pervasive effect on the financial statements.
 - iii A major catastrophe that has had, or continuous to have, a significant effects on the entity's financial position.

(04 marks)

(Total 10 marks)

End of Section B

Two (02) compulsory questions
(Total 50 marks)

Suggested Answers to Question Eight:

(A)

(a)	(b)
Internal control weakness	Recommendation
1. There is no proper process for identifying damaged items	<ul style="list-style-type: none"> - When the items received from suppliers those should be carefully scrutinized to identify any damage items. A responsible person should approve the GRN certifying for no of damaged items. - If any damaged stock is identified it should be returned to the supplier and immediately informed to the finance division with the GRN to prevent the payment to suppliers for damaged items. - Accountant must ensure that he collects adjusted invoices from suppliers for the damaged items or raise debit note for the damaged stock value.
2. Stores clerk raises the GRN. But no responsible person authorizes the GRN	A responsible person should authorize the GRNs after ensuring the correct quantity of goods received as per the order and supplier invoice.
3. Lack of segregation of duties as the person who raises the invoices collect cash (the cashier)	Proper segregation of duties is to be implemented by appointing a person to raise the invoices and cashier will only collect the cash and issue a receipt.
4. No process for approving the invoices	A responsible person shall be appointed to approve the invoices.
5. Based on the dispatch note only the labour staff loading the items to customer vehicles and no one observes and confirm	A responsible person shall observe the loading and ensure the correct quantities are dispatched as per the invoices.
6. No preventive or corrective actions have been taken for the stock shortages	Immediate action to be taken when identifying the stock shortages. It should be inquired from the relevant person for reasons for the shortages and take necessary steps to rectify the issues.

7. Continued stock verifications have not been carried out for the company	Stock verification needs to be carried out on a regular basis for identifying any shortages. Shortages identified must be properly followed up and necessary adjustments to be made.
8. Customers handover manual invoice copy to stores	Copy of the invoice should reach the stores clerk not with the customer. It can be notified to the customer through electronically via IT system.
9. Making of other payments from the cash collected	- For expenses there should be petty cash float and expenses to be incurred with the relevant approval. - Total cash collection to be deposited to the bank accounts.

(10 marks)

- (c) (i) Development of computer applications.
(ii) Prevention and detection of unauthorized chargers to programs.
(iii) Testing and documentation of programme changes.
(iv) Control to prevent unauthorized amendments to data files.
(v) Controls to ensure continuity of operation.

(03 marks)

(d) **Development of computer applications**

- (i) 1. Seek approval by computer users and management.
2. Segregation of duties.
3. Standards over systems design, programming and documentation.
4. Training of staff in new procedures and availability of adequate documentation.

Prevention and detection of unauthorized chargers to programs

- (ii) 1. Password protection.
2. Back-up copies of programs being taken and stored in other location.
3. Segregation of duties.
4. Restricted access to central computer by locked doors, keypads.

Testing and documentation of programme changes

- (iii) 1. Complete testing procedures.
2. Documentation standards.
3. Approval of changes by computer users and management.
4. Training of staff using program.

Control to prevent unauthorized amendments to data files

- (iv)
1. Physical security over remote terminals.
 2. Firewalls.
 3. Limited access to authorized personnel only.
 4. User identification controls such as passwords.

Controls to ensure continuity of operation

- (v)
1. Disaster recovery procedures.
 2. Protection of equipment against fire and other hazards.
 3. Storing extra copies of programmes and data files off site.
 4. Backup power sources.

(06 marks)

(B)

Elements of assurance engagements	Application to the given scenario
Three party relationship	The three parties are; The intended user - TG The practitioner - external auditor Person providing information - TS
Subject matter	The Subject Matter (which is presented as a Statement) can be identified as the KPIs, and the Responsible party (for this subject matter) is Tesco Sri Lanka (TS)
Suitable criteria	The KPIs have been calculated by reference to methods specifically set out in TG's Operating Manual available to TS ("Suitable Criteria")
Evidence	The evidence can be gathered as customers' feedback forms available.
Assurance report / conclusion	The External Auditor is the Practitioner and it is required to express a conclusion on the Statement by issuing a formal report on the amounts reported in the Statement.

(06 marks)

(Total 25 marks)

Suggested Answers to Question Nine:

(a)

Obtain an understanding	Example
Nature of the entity	<ul style="list-style-type: none"> ● Who the owners of Tiara Ltd. are, ● It's financing methods ● Organizational structure of Tiara Ltd., including stores ● Current condition of Tiara Ltd.'s business operations ● Financial reporting framework used to prepare and present financial statements. (Eg: Sri Lanka Accounting Standards, etc...)
Industry, regulatory and other external factors	<ul style="list-style-type: none"> ● Regulatory framework - Companies Act, importation regulations, pricing regulations, etc... ● Government policies and taxation structure ● Cyclical / seasonal activity for high-end fashion clothing available at Tiara Ltd. ● Market and competition in Sri Lanka's fashion industry.
Internal controls	<ul style="list-style-type: none"> ● Control activities ● Monitoring controls ● Control environment ● Risk assessment ● Information systems
Objectives and strategies and related business risks including financial performance	<ul style="list-style-type: none"> ● Short-term and long-term objectives of Tiara Ltd. ● Plans for new investments, clothing lines and expansion ● Plans for changes in business structure (Eg: mergers) ● Tiara Ltd.'s financial performance and how it has been linked to employees' remuneration.
Selection and application of accounting policies	Whether the accounting policies adopted by Tiara Ltd. in preparation and presentation of financial statements are in accordance with Sri Lanka Accounting Standards.

(06 marks)

(b) (i) Tiara Ltd is a company in fashion industry, as a result of that there is a risk, that inventory has a lower Net Realizable Value (NRV) than cost and is therefore overstated. NRV falls due to the client being in an industry where change fashion quickly.

(03 marks)

- (ii) i. Examine the instruction to identify slow moving inventory lines when attending the inventory count.
- ii. Increase the emphasis on reviewing the year end aged inventory analysis for evidence of slow moving inventory.
- iii. Ascertain sales value of maxi dresses sold post year-end that were in inventory at year end to ensure NRV was higher cost recorded as part of the inventory value in the financial statement.

(04 marks)

- (iii) 1) Check accuracy of costs by matching amounts to supplier's invoices.
- 2) Recalculate cost of a sample of items of inventory.

(02 marks)

(c) (i) Inquiry consists of seeking information of knowledgeable persons both financial and non-financial within the entity or outside the entity. Strength of evidence depends on knowledge and integrity of source of information.

Eg: Responses to formal written questions and informal questions.

Observation consists of looking at a procedure or process being performed by others. It is of limited use, as it only confirms the procedure takes place when auditor is watching.

Eg: Observing physical stock count.

Observation provides audit evidence about the performance of a process or procedures. But it is limited to the point in time it which the observation takes place.

- (ii) Recalculation consists of checking the arithmetical accuracy of source documents and accounting records. It is deemed to be a reliable source since work is carried out by the auditor. Eg: Calculation of interest payments, interest income, depreciation etc...

Re-performance means the auditor's independent execution of procedures of controls that were originally performed as part of the entity's internal controls. It is also deemed to be a reliable source because it is carried out by the auditor.

Eg: Re-performance of bank reconciliations, reconciliation of suppliers' statements, etc....

(06 marks)

(d)

- (1) Check mathematical accuracy of reconciliation
- (2) Agree balance as per creditors' control ledger to individual creditors' balances in the creditors' ledger.
- (3) Check the payments made to supplier.

(04 marks)

(Total 25 marks)



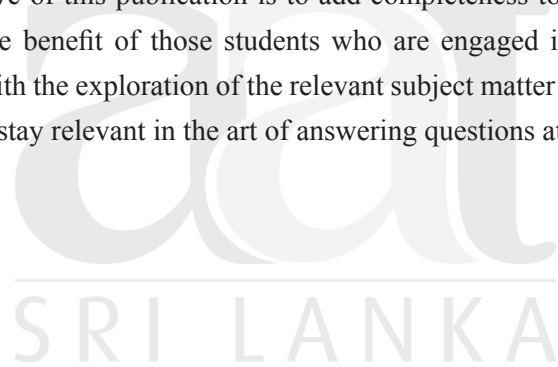
End of Section C

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