

Examiner's Report
AA3 EXAMINATION - JULY 2018
(AA34) PROCESSES, CONTROLS AND AUDIT

Section A

Four (04) Compulsory Questions

Question No. 01 (Marks Allocated 05)

Part (a)

Candidates were required to **state** two (02) types of business organizations that could be started by Mr. & Mrs. Rupasinghe who have returned to Sri Lanka after working six years in Canada with Rs.10 million of their savings.

Performance of this part of the question was satisfactory. However, there were several irrelevant answers written by candidates such as profit making organizations, non-profit making organizations, buying & selling and Textile Businesses etc.

Part (b)

Candidates were required to **identify** three (03) common objectives of any business organization.

Performance of this part of the question was also satisfactory. However, some candidates had erroneously written discharge social responsibilities, enhance employment satisfaction etc. as common objectives of a business organization.

Question No. 02 (Marks Allocated 05)

Candidates were required to **identify** three (03) differences between Reasonable Assurance Engagement and Limited Assurance Engagement.

Performance of this question was satisfactory. There were significant number of candidates who have obtained full marks for the question. However, some candidates have written examples for Reasonable assurance engagements and Limited assurance engagements instead of their differences.

Question No. 03 (Marks Allocated 05)

Candidates were required to **explain** two (02) financial statement assertions which need to be addressed with an audit procedure for each to be performed when auditing the year-end inventory balance.

Performance of this question was not satisfactory. Considerable number of candidates did not attempt this question. Majority of the candidates did not have any idea regarding the assertions relating to the year-end inventory balance. Some candidates have some knowledge of assertions but they did not know the differences of assertions about account balances at the period end, assertions about classes of transactions and events for the period under audit and assertions about presentation and disclosure. Hence many candidates have written Occurrence, Accuracy, Cut off and Classification and Understandability etc. which are assertions about class of transactions & presentation and disclosure. Hence, obtained no marks for this part of the question.

Many candidates who correctly identified the assertions did not explain them. Due to lack of knowledge about assertions, candidates have written highly irrelevant answers such as, receiving and issuing of stocks, purchase of stocks and theft of stocks, etc.

Question No. 04 (Marks Allocates 05)

Part (a)

Candidates were required to **state** the objective of establishing and maintaining a system of quality control within a firm.

Performance for this part of the question was not satisfactory. Many candidates had misunderstood the question and have written quality control procedures of a manufacturing organization. Some of the irrelevant answers produced by the candidates are listed below:

- Setting quality standards in manufacturing process
- Increase the efficiency of business operation
- Enhancement of human resources effectiveness
- Ensure the quality of the internal controls
- Ensure the effectiveness and efficiency of internal controls

Part (b)

Candidates were required to **identify** two (02) instances where a firm should accept or continue relationship with clients.

Performance for this part of the question was not satisfactory. Majority of the candidates had misunderstood the question and have written client relationship in a manufacturing organization. Instead of writing the instances where a firm should continue client relationship, some candidates have written terms of the engagement letter and components of the assurance engagement etc. which were irrelevant.

Section B

Three (03) Compulsory Questions

Question No. 05 (Marks Allocated 10)

Part (A)

Candidates were required to **state** three (03) components of the entity's internal control system. Performance for this part of the question was satisfactory. Majority of the candidates correctly stated the components and obtained full marks allocated for this part of the question. However there were some candidates, instead of stating three components out of five have produced highly irrelevant answers such as,

- Employees
- Related parties
- Management
- Organization structure
- Financial controls

Part- B (a)

Candidates were required to **explain** what is meant by inherent risk.

Performance for this part of the question was not satisfactory. Majority of the candidates have no clear understanding of the subject matter.

Many candidates have stated that inherent risk is giving an inappropriate audit opinion by the auditor when financial statements are materially misstated, in the absence of internal control or when internal control is not effective.

Instead of explaining Inherent Risk, some candidates have explained either Control Risk or Detection Risk .Only few candidates have correctly stated what the inherent risk is.

Part- B (b)

Candidates were required to **explain** with reasons whether the two scenarios given in the question, give rise to significant risks.

Performance for this part of the question was satisfactory. Majority of the candidates have correctly explained that,

- the proposed merger transaction is an unusual transaction & expected to involve complex accounting principles and have significant management intervention from both the businesses. Hence, the scenario -1 given in the question gives rise to a significant risk. and,
- leasing of office space and making monthly lease payments is a routine non complex transaction which does not give rise to a significant risk.

However, there were some candidates due to lack of understanding of the question and lack of knowledge for the subject matter have stated that the scenario - 1, does not give rise to a significant risk and the lease transaction give rise to a significant risks in scenario - 2, due to monthly lease payment of Rs.450,000/- is paid in cash instead of issuing a cheque.

Question No. 06 (Marks Allocated 10)

Part (a)

Candidates were required to **identify**, in general, a situation where a modified opinion is required with an example.

Performance for this part of the question was not satisfactory. Majority of the candidates did not have a firm knowledge on situations where a modified opinion is required.

Many candidates have written the scenario given in the question paper as the answer for this part. Some candidates have explained the modified opinion and types of modified opinion and gained no marks for this part.

Part (b)

This part for the question was based on the scenario given. Candidates were required to **explain** the type of the audit opinion which will be issued on the financial statements of Somarathne & Sons Ltd. for the year ended 31st December 2017.

Performance of this part of the question was not satisfactory. Majority of the candidates did not have any idea regarding the types of audit opinion. Some candidates did not even know the meaning of modified and unmodified opinion and hence stated that unmodified opinion could be given, displaying their lack of knowledge of the subject matter.

Some candidates have stated that a qualified opinion should be given and some candidates suggested an adverse opinion. It was also noted that there were some instances where all the types of modified opinion (Qualified, Disclaimer and Adverse) have written by the candidates, displaying their inability to decide suitable audit opinion based on the scenario given.

Some candidates have written “a disclaimer of opinion” should be given which is the type of opinion suitable for the given scenario. However, failed to make a clear description in detail revealing relevant facts, as expected by the examiner for this part of the question.

Part (c)

Candidates were required to **explain** how the answer for part (b) above would change if the company has maintained proper back-ups of all the accounting records.

Performance for this part of the question was satisfactory. Many candidates correctly stated that if the company has maintained proper back-ups of all the accounting records, the auditor will be able to carry out their audit procedures and unmodified, qualified or an adverse opinion could be given based on their findings.

However, there were some candidates who did not attempt even this part of the question and some candidates had stated that a disclaimer of opinion should be given, displaying their lack of knowledge of the subject matter.

As in the answer to the part (b) of the question, some candidates had stated “an unmodified opinion” should be given without giving any explanation.

Question No. 07 (Marks Allocated 10)

Part (a)

Candidates were required to explain the “Self-review threat” and “Intimidation threat” to compliance with the fundamental principles.

Performance for this part of the question was not satisfactory. Majority of the candidates have some idea of the threats tested but did not have firm knowledge of the subject matter and have written incomplete answers for this part of the question.

It was observed that some candidates had tried to produce the answer by elaborating the terms “Self-review” and “Intimidation’ without having properly studying the subject matter and obtained no marks for those.

Part (b)

Candidates were required to **explain** the threats to compliance with the fundamental principles applicable to De Silva Associates, based on the scenario given.

Performance for this part of the question was satisfactory. Majority of the candidates have correctly explained the threats given in the scenario and obtained full marks allocated. However, some candidates have written only the “Self-interest threat” and “Intimidation threat” as their answer but did not make a clear description in detail revealing relevant facts. Hence, obtained low marks. Some candidates were unable to correctly identify the threats based on the facts given in the scenario and have written Self-review threat, Advocacy threat and Familiarity threat as their answer and obtained no marks.

Section C

Two (02) compulsory questions only

Question No. 08 (Marks allocated 25)

Part A (a)

Candidates were required to **explain** the importance of Corporate Governance.

Performance for this part of the question was not satisfactory. Majority of the candidates were unable to correctly explain the answer due to lack of knowledge of the subject matter. Only a few candidates were able to obtain full marks for this part of the question.

Many candidates obtained low marks for this part due to number of irrelevant answers such as:

- It encourages the business around the country to do the correct thing.
- It gives guidelines on Integrity, Confidentiality, Professional Competence and Due care.
- It helps to face market challenges.
- To attract more customers.
- It helps to minimize fraud and errors of the client.
- It increases the efficiency and effectiveness of an organization.

Part A - (b)

Candidates were required to **state** three (03) guidelines which have been highlighted by the Code of Best Practice on Corporate Governance.

Performance for this part of the question was not satisfactory. Majority of the candidates did not know the guidelines which have been highlighted by the Code of Best Practice on Corporate Governance and have written highly irrelevant answers such as,

- Implementation of good internal control system.
- Financial statements should be prepared as per the Sri Lanka Accounting Standards.
- Fraudulent activities should not be done.
- The company should be headed by directors.

Part (B) (a)

Candidates were required to **explain** the purchasing process (supported with minimum of 04 steps of an ideal purchasing process) which would be appropriate for the scenario given.

Performance for this part of the question was satisfactory. Majority of the candidates have an adequate knowledge of ideal purchasing process and correctly answered this part of the question. However, some candidates lost marks due to explaining only one or two steps of an ideal purchasing process instead of four steps. Common irrelevant answers produced by candidates are stated below,

- A purchasing manager should be recruited.
- Should purchase on credit basis.
- Accounting the stock receipts.
- Updating the Bin Cards.
- Arranging the stocks properly in the store, etc.

Part- B (b)

Candidates were required to **explain** three (03) risks which will be mitigated by implementing a good purchasing process.

Performance for this part of the question was satisfactory. Majority of the candidates were able to correctly answer and obtained full marks allocated for this part of the question. However, considerable number of candidates have explained the risks associated with Inventory Control System and obtained no marks for this part.

Operational risk, Financial risk, External risk, Risk of fraud, Compliance risk and Reputation risk are some of the common irrelevant answers given by candidates.

Part- B (c)

Candidates were required to **discuss** whether Mrs.Madapatha can have 100% error free situation by having a good internal control system in their organization.

Performance for this part of the question was not that satisfactory. Majority of the candidates did not know the fact that Internal Control System of an organization can provide only a reasonable assurance regarding the effectiveness of achieving their intended objectives due to its inherent limitations.

Some candidates have stated that it can have a 100% error free situation and some candidates stated that it cannot have a 100% error free situation but can have percentages less than 100% such as 70%, 75%, 80% error free situation. Some have only mentioned that it cannot have a 100% error free situation without giving any reasons. Further, considerable number of candidates have explained the risks associated with Inventory Control System as the answer.

Question No. 09 (Marks Allocated 25)

Part (A)

Candidates were required to **assess** whether engagement stated in the scenario given is an assurance engagement or not.

Performance for this part of the question was satisfactory. Majority of the candidates correctly assessed the engagement given as an assurance engagement stating the definition of the assurance engagement and linking it to the facts given in the scenario and obtained full marks allocated. Some candidates have concluded the given engagement as an assurance engagement stating the key elements of an assurance engagement and linking them to the facts given in the scenario which was also considered as a correct answer for this part.

Some candidates obtained low marks or no marks due to following reasons,

- (1) Misunderstanding the question as:
 - objective of an assurance engagement.
 - elements of an assurance engagement.
- (2) Lack of knowledge about the Action Verb (assess) stated in the question
 - They mentioned it is an assurance engagement without stating the definition of the assurance engagement & connecting it to the facts given in the scenario.
 - Limited their answers only to the definition or elements of an assurance engagement

Common irrelevant answers produced by the candidates are stated below:

- The given engagement is not an assurance engagement.
- Assessed the given scenario as an agreed upon procedure.
- Mentioning the wrong definition in assessing of given scenario.
- Re-produce the question as it is without assessing the scenario.

Part (B)

Part B - (a)

Candidates were required to **explain** the term “Audit Evidence” with an example.

Performance for this part of the question was satisfactory. Majority of the candidates have the knowledge on the subject matter tested and have written correct answers. However, considerable number of candidates have not explained the fact that audit evidence includes both information contain in the accounting records underlying the financial statements & other information gathered by the auditor.

Common irrelevant answers produced by the candidates are given below:

- Explained the audit procedures for obtaining audit evidence.
- Explained the audit opinion instead of Audit evidence.
- Discussed regarding Sufficiency & Appropriateness of audit evidence.

Part B - (b)

Candidates were required to **identify** eight (08) areas that need special attention in performing audit procedures for Text connections (Pvt.) Ltd, described in the scenario given.

Performance of this part of the question was satisfactory. Majority of candidates have correctly identified areas that need special attention and obtained full marks allocated for this part.

However, there were some candidates who correctly identified and listed the items in the financial statements, which need special attention, without giving a short explanation why they identified those items, and accordingly failed to earn full marks allocated.

Considerable number of candidates were unable to identify the following important areas which need special attention:

- Depreciation on PPE has not been charged to the Income Statement.
- Unavailability of gratuity expenses or liability recognized in the Financial Statement.
- Unavailability of corresponding interest expense in the Income Statement for the bank loan of Rs. 6.1 Mn. shown in the Statement of Financial Position.

Common irrelevant answers produced by the candidates are given below:

- Types of audit procedures such as inquiry, observation, inspection, recalculation etc.
- Responsibility for preparation of financial statements.
- Sufficiency and appropriateness of audit evidence.
- Events occurring after the balance sheet date.
- Business environment and laws.
- Management representation.
- Whether financial statements are prepared according to accounting standards.
- Whether audit is done according to auditing standards.

Part B - (c)

Candidates were required to list six (06) audit procedures to be performed for the related party payable balance of Rs.697,700/- presented in the statement of the financial position as at 31st March 2018.

Performance for this part of the question was not satisfactory. Majority of the candidates have no proper idea about the Related Party Transactions. As such, they have written verification procedures for purchases and trade payables as follows.

- Checking purchase order with GRN, to ascertain whether what is ordered have been received at agreed prices.
- Checking the invoices with purchase requisitions, purchase orders and GRNs to ascertain whether these documents are matched before payment.
- Checking the agreement of the control account balance in the ledger with the sum total of related party payables.
- Arithmetical accuracy of invoices, ledger balances etc.

There were some candidates who have written only the types of audit procedures such as inquiry, observation, inspection, recalculation, analytical procedures, etc., without describing those procedures and gained no marks for this part.

Part B - (d)

Candidates were required to **state** two (02) actions that an auditor will take if the management of Tex Connections (Pvt.) Ltd has not provided the requested written Representation.

Performance for this part of the question was satisfactory. Majority of the candidates had the knowledge about management representation and have correctly answered this part of the question. However some candidates have produced irrelevant answers such as,

- Take legal action against the client.
- Withdraw from the engagement.
- Obtain external confirmation
- Obtain an assistant from an Expert
- Perform substantive audit procedures

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Suggestions to enhance the Competency Level of Candidates in order to Improve Performance at the Examination:

- Candidates must study the study text and understand its contents.
- Refer articles, magazine in relation to this subject and other reading material related to auditing.
- Understand the definition of action verbs and practice as the candidates have to answer the question based on the action verbs list given at the end of the question paper.
- Study the contents of the past papers and practice at least last five years' examination papers and try to understand the way in which the questions are being set.
- The candidates should understand the relationship between the theory given in the question papers and examiner's expectation of its application at the examination.
- The candidates should study and understand as to what areas in the study text have been tested in the past question paper and make short notes of those areas in the study text.
- The candidate should practice answering the past paper question based on the time given in the question papers and accordingly, it will improve the time management at the examination.
- Write short notes of each study chapter given in the study text and study as and when you get free time to remember the contents of syllabus
- Candidates should write legibly at the examination.
- The candidates should carefully read the instructions given in the examination paper prior to start answering the questions in the paper.
- The candidates should have a clear and balance mind set at the examination in order to understand the question and provide with appropriate and accurate answers required in the question.
- The candidates should allocate time for the questions based on the marks given and accordingly, the candidate should effectively be able to answer all the questions given in the paper.
- Answers should be numbered appropriately and accurately as given in the question paper.
- Very important to understand the relationship between theory and its application in the question, wherever requested, write with examples.
- Check twice whether all required questions were answered and appropriately numbered prior to hand over the answer scripts.