Shehan is interested in starting up his own business. He decided to start a small snack bar near a leading tuition class. His initial investment is Rs. 50,000/-. There are other several shops in the vicinity that are engaged in similar businesses.

(A) Identify the most likely business objectives of Shehan at each of the following stages:
   (a) At the initial stage of his business. (02 marks)
   (b) After the lapse of about one year if he succeeds in his business. (02 marks)

(B) State three (03) social and cultural factors affecting the business of Shehan. (03 marks)

Question 02

“A framework of risk management consists of risk assessment, risk mitigation, monitor and review of controls”.

(A) Identify two (02) methods of mitigating risks. (02 marks)

(B) State three (03) examples for risk reduction methods. (03 marks)
"The auditor plans and performs an assurance engagement with an attitude of professional skepticism to obtain sufficient appropriate evidences and he shall exercise professional judgments in planning and performing an audit of financial statements."

(A) **Explain** the term “Professional Skepticism”.

(B) **Identify** three(03) areas of an audit, where auditors should apply professional judgment.

(02 marks) (03 marks) (Total 05 marks)

Quality control policies and procedures should be implemented both at the levels of audit firm and on individual audits. The work performed by each assistant of an individual audit should be reviewed by personnel with competence and experience.

(A) **State** two(02) objectives of the quality control policies and procedures to be adopted by an audit firm.

(B) **State** three(03) matters to be ensured by a senior team member when reviewing the work of a more junior team member.

(02 marks) (03 marks) (Total 05 marks)

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**SECTION B**

Three (03) compulsory questions

(Total 30 marks)

**Question 05**

Swarna Ceramic (Pvt) Ltd. is engaged in retail and wholesale trade of floor tiles, wall tiles and bath ware items. Your audit firm was appointed as an external auditor of the Swarna Ceramic (Pvt) Ltd. and you are the senior in charge of the team auditing the financial statements of the company for the year ended 31st March 2017.

Directors of the company have requested a bank loan of Rs.150 million and bank manager has requested a financial forecast for five(05) years to grant this loan. Your audit firm has been requested to conduct an assurance engagement on 5 years’ financial forecast. The directors have also requested to evaluate their key performance indicators reported by them about the non-financial aspects of the company.

You are required to:

(A) **Explain** what an “assurance engagement” is.

(B) **Recognize** the appropriate type of engagement that your audit firm can undertake for each of the above requested services by Swarna Ceramic (Pvt) Ltd.

(04 marks) (06 marks) (Total 10 marks)
The engagement team of AB (Pvt) Ltd. was briefed by the engagement partner of the audit for the year ended 31st March 2017 regarding the areas that they need to devote special attention. The engagement partner emphasized the importance of obtaining sufficient and appropriate audit evidence. He also emphasized that the audit evidence shall be reliable and relevant for the audit. The engagement team determined certain procedures for obtaining audit evidence.

The office building of AB (Pvt) Ltd. has been obtained under an operating lease. The auditor noted that the lease rental expenses have increased by 20% compared to previous year. The auditor documented this in the working paper.

**You are required to:**

(A) **Identify** four(04) ways that increase in the reliability of audit evidence when gathering audit evidence. (04 marks)

(B) **Explain** three(03) audit procedures for obtaining audit evidence which could be used to check increase of the lease rental expenses. (06 marks)

---

Crown Holdings Ltd. is a group of company which has 12 subsidiaries islandwide. The group is engaged in the business of agriculture and livestock. The group have a significant volume of intra-group sales and purchase transactions between its subsidiaries. You are the external auditor for one of its subsidiaries - Green (Pvt) Ltd.

**You are required to:**

(A) **Explain** the responsibilities of the Green (Pvt) Ltd.’s management with respect to related party transactions. (03 marks)

(B) **State** five(05) audit procedures you would perform to identify possible related party transactions of Green (Pvt) Ltd. (05 marks)

(C) **State** a matter of the written representation that would be obtained from the management of Green (Pvt) Ltd. on related party transactions and balances. (02 marks)

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End of Section B
SECTION C
Two (02) compulsory questions.
(Total 50 marks)

Question 08

(A) You are a team member of the audit of **Taste Ltd.** for the year ended 31\textsuperscript{st} March 2017. **Taste Ltd.** is a company engaged in the business of manufacturing and selling packets of marshmallows. Marshmallows are produced only when an order is received from a customer.

Based on the customer order, a production order is generated by the production controller, which is sent to the kitchen executive. Based on the production order, the kitchen executive requests raw material from raw material stores and the stores will release raw material. These are issued only upon receiving a material requisition note (MRN) which is duly signed by the kitchen executive. Based on the MRN, the stores issues the relevant quantities of raw material together with material issue note signed by the stores executive. At the end of each day, MRNs are matched with material issue notes by both the kitchen and the stores.

Marshmallows are produced and packed in the factory kitchen. Standard pack size is 20 marshmallows per pack and should weigh 50 grams per pack. The production assistants check the accuracy of the weight and number of marshmallows produced with the relevant production order and sign-off on the kitchen transfer note, authorizing transfer of packs to finished goods (FG) stores. FG stores will not accept marshmallow packs without kitchen transfer note. FG stores executive checks copy of customer order with goods dispatch note and sales invoice and signs-off as evidence of such checking prior to releasing of FG from the factory premises to be delivered to customer (three-way matching).

At the end of each day, the sales department generates a goods dispatch report and compares with volume of sales recorded for the day. They further cross check a sample of goods dispatches to relevant customer orders, production orders, material requisition and issue notes, kitchen transfer notes, goods dispatch notes and sales invoices and follows up on any exceptions, if any.

**You are required to:**

(a) **Identify** three(03) important matters to be included in the Material Requisition Note (MRN). (03 marks)

(b) **Identify** an audit procedure to evaluate the operating effectiveness of each of the following controls:

(i) Production orders are issued based on the customer orders.
(ii) Material requisition note is issued only if valid production order is available.
(iii) Matching of material issues with material requisitions.
(iv) Three way matching performed by FG stores Executive.
(v) Controls performed by sales department. (05 marks)
(c) **State** three(03) audit procedures the auditor should perform to obtain an understanding of the entity and its environment.  

(03 marks)

(d) **Explain** three(03) financial statement assertions that need to be addressed in testing sales of **Taste Ltd.**

(06 marks)

(B) “Most businesses presently use information technology extensively for business operations. Therefore, information technology (IT) general controls are important in such an environment”

**You are required to:**

List two(02) examples each for the following IT general controls:

(a) Development of computer application.

(b) Controls to prevent unauthorized amendments to data files.

(c) Controls to ensure continuity of operations.

(d) Prevention or detection of unauthorized changes to programme.  

(08 marks)

(Total 25 marks)

**Question 09**

(A) You have been assigned to perform audit procedures on the existence of the year-end balance of your audit client’s Property, Plant and Equipment (PPE). You have been provided with the PPE register for the purpose of your audit work. Balances stated in the PPE register agree to the balances stated in the general ledger.

**You are required to:**

(a) **State** three(03) audit procedures that the auditor would perform to verify Property, Plant and Equipment.  

(03 marks)

(b) **State** the difference between test of controls and substantive procedures.  

(03 marks)

(B) The schedule of movement of buildings of your audit client as at 31\textsuperscript{st} March 2017 is as follows:

<table>
<thead>
<tr>
<th>Description</th>
<th>Rs.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Balance as at 01\textsuperscript{st} April 2016</td>
<td>15,000,000</td>
</tr>
<tr>
<td>Add: Additions during the year</td>
<td>7,000,000</td>
</tr>
<tr>
<td>Less: Disposals during the year</td>
<td>-</td>
</tr>
<tr>
<td>Balance as at 31\textsuperscript{st} March 2017</td>
<td>22,000,000</td>
</tr>
</tbody>
</table>
The audit procedures you performed on the above indicated that additions amounting to Rs.2,500,000/- related to the renovations made to the right wing of the corporate building. This has been incurred close to the financial year end. The remainder of additions relates to a new wing built to the corporate office. The management of the audit client has not adjusted its books of accounts for the proposed audit adjustments. You have determined the materiality for this audit client to be Rs.800,000/-. 

You are required to:

(a) Discuss the effect of the above on the audit opinion on the financial statements of your audit client (assume there are no other misstatements noted). (06 marks)

(b) State three(03) elements of the Auditor’s Report other than auditor’s opinion paragraph. (03 marks)

(C) You are the auditor of Shiran Garments (Pvt) Ltd. Its showroom is located near Kottawa junction. As the auditor of Shiran Garments (Pvt) Ltd., you have built up a good relationship with the managing director. As a result, you have been given the opportunity to set up a branch office of your audit firm at this showroom building. The managing director has agreed with you a monthly rent which is extremely low amount compared to the market rates in the area. You have allocated a senior person to conduct the interim audit. This senior person has been handling the audit of Shiran Garments (Pvt) Ltd. for last 12 years.

You are required to:

(a) Explain two(02) threats to compliance with the fundamental principles in the above circumstances. (04 marks)

(b) Explain the following fundamental principles which members of AAT Sri Lanka must comply:

(i) Objectivity.

(ii) Professional Competence.

(iii) Professional Behaviour. (06 marks)

(Total 25 marks)

End of Section C
### ACTION VERB CHECK LIST

<table>
<thead>
<tr>
<th>Knowledge Process</th>
<th>Verb List</th>
<th>Verb Definitions</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Level 01</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Comprehension</strong></td>
<td>Define</td>
<td>Describe exactly the nature, scope, or meaning.</td>
</tr>
<tr>
<td></td>
<td>Draw</td>
<td>Produce (a picture or diagram).</td>
</tr>
<tr>
<td></td>
<td>Identify</td>
<td>Recognize, establish or select after consideration.</td>
</tr>
<tr>
<td></td>
<td>List</td>
<td>Write the connected items one below the other.</td>
</tr>
<tr>
<td></td>
<td>Relate</td>
<td>To establish logical or causal connections.</td>
</tr>
<tr>
<td></td>
<td>State</td>
<td>Express something definitely or clearly.</td>
</tr>
<tr>
<td></td>
<td>Calculate/Compute</td>
<td>Make a mathematical computation</td>
</tr>
<tr>
<td></td>
<td>Discuss</td>
<td>Examine in detail by argument showing different aspects, for the purpose of arriving at a conclusion.</td>
</tr>
<tr>
<td></td>
<td>Explain</td>
<td>Make a clear description in detail revealing relevant facts.</td>
</tr>
<tr>
<td></td>
<td>Interpret</td>
<td>Present in an understandable terms.</td>
</tr>
<tr>
<td></td>
<td>Recognize</td>
<td>To show validity or otherwise, using knowledge or contextual experience.</td>
</tr>
<tr>
<td></td>
<td>Record</td>
<td>Enter relevant entries in detail.</td>
</tr>
<tr>
<td></td>
<td>Summarize</td>
<td>Give a brief statement of the main points (in facts or figures).</td>
</tr>
<tr>
<td><strong>Level 02</strong></td>
<td>Apply</td>
<td>Put to practical use.</td>
</tr>
<tr>
<td><strong>Application</strong></td>
<td>Assess</td>
<td>Determine the value, nature, ability, or quality.</td>
</tr>
<tr>
<td></td>
<td>Demonstrate</td>
<td>Prove, especially with examples.</td>
</tr>
<tr>
<td></td>
<td>Graph</td>
<td>Represent by means of a graph.</td>
</tr>
<tr>
<td></td>
<td>Prepare</td>
<td>Make ready for a particular purpose.</td>
</tr>
<tr>
<td></td>
<td>Prioritize</td>
<td>Arrange or do in order of importance.</td>
</tr>
<tr>
<td></td>
<td>Reconcile</td>
<td>Make consistent with another.</td>
</tr>
<tr>
<td></td>
<td>Solve</td>
<td>To find a solution through calculations and/or explanation.</td>
</tr>
<tr>
<td><strong>Level 03</strong></td>
<td>Analyze</td>
<td>Examine in detail in order to determine the solution or outcome.</td>
</tr>
<tr>
<td><strong>Analysis</strong></td>
<td>Compare</td>
<td>Examine for the purpose of discovering similarities.</td>
</tr>
<tr>
<td></td>
<td>Contrast</td>
<td>Examine in order to show unlikeness or differences.</td>
</tr>
<tr>
<td></td>
<td>Differentiate</td>
<td>Constitute a difference that distinguishes something.</td>
</tr>
<tr>
<td></td>
<td>Outline</td>
<td>Make a summary of significant features.</td>
</tr>
</tbody>
</table>