



ASSOCIATION OF ACCOUNTING TECHNICIANS OF SRI LANKA

AA3 EXAMINATION - JANUARY 2016

(AA34) PROCESSES, CONTROLS AND AUDIT

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

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

30-01-2016  
Afternoon  
[1.45 – 5.00]

No. of Pages : 08  
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**

**Sajith** is a member of **AAT Sri Lanka** and is presently employed as an accountant of a manufacturing company located in the Katunayake free trade zone.

- (a) **List** three(03) fundamental principles **Sajith** should comply with, as set out in the Code of Ethics for Professional Accountants. (03 marks)
- (b) **State** two(02) types of threats which may affect the compliance with the fundamental principles. (02 marks)
- (Total 05 marks)

**Question 02**

“The auditor’s report provides assurance on the financial statements prepared by the management”.

- (a) **Explain** the importance of “assurance” to the users of financial statements. (02 marks)
- (b) **Identify** three(03) examples for Assurance Engagements, a practitioner may perform other than a statutory audit. (03 marks)
- (Total 05 marks)

### Question 03

**Sunith** is an audit manager of **K & C Associates** a firm of Chartered Accountants. He explains **Namal**, the senior in charge for the audit of **Regent (Pvt) Ltd.** that the auditor's report of this company cannot be finalized without getting the management representation and the receivable confirmations from debtors.

- (a) **State** two(02) instances in which management representations are necessary. (02 marks)
- (b) **Vimal**, an audit junior has informed **Namal** that only 3 responses have been received, out of the 35 receivable balance confirmations called.

**Explain** the instructions to be given to **Vimal** in this regard by **Namal**. (03 marks)  
(Total 05 marks)

### Question 04

**Yamuna** is the senior auditor engaged for the audit of **KM Supermarket (Pvt) Ltd.** According to the initial understanding about the audit and the last year audit working papers, **Yamuna** noted that the company is having a sound internal control system and effective internal controls. She has been assigned to vouch the revenue of **KM Supermarket (Pvt) Ltd.**

- (a) **State** two(02) test of controls that **Yamuna** may perform in evaluating the operating effectiveness of internal controls relating to revenue. (02 marks)
- (b) **State** three(03) substantive procedures that **Yamuna** may perform to vouch the accuracy of revenue. (03 marks)

(Total 05 marks)

---

*End of Section A*

---

## **SECTION B**

Three (03) compulsory questions

(Total 30 marks)

### Question 05

- (a) **List** three(03) matters to be included in the audit planning memorandum. (03 marks)
- (b) The auditor should obtain an understanding of the entity and its environment in order to be able to assess the risks of material misstatements.

**List** three(03) sources of information that an auditor may use to obtain an understanding of the entity and its' environment. (03 marks)

- (c) **Global Phones (Pvt) Ltd.** is engaged in the business of importing and whole selling of mobile phones. You are the audit supervisor of this company's audit. You have observed that substantial amount of old model mobile phones are included in the inventory as at 31<sup>st</sup> March 2015 during the year-end inventory count.

At a discussion with your audit manager, he too agreed that there is a risk that the inventory of the company has a lower Net Realizable Value (NRV) than cost and therefore inventory value included in the financial statements may be overstated.

**Explain** two(02) possible responses for the above identified audit risk as the audit supervisor of **Global Phones (Pvt) Ltd.**

(04 marks)

(Total 10 marks)

### Question 06

**Fast Goods PLC (FG)** is in the business of manufacturing and marketing fast moving consumer goods such as detergent, mosquito coils and health care products. As per the recent financial statements, the financial performance of **FG** was not satisfactory due to drop in sales. The management has identified that the competitors' actions have severely affected the performance of **FG** and considered the need to have a formal process for managing the risks of **FG**.

**Ravin** is the audit manager of the audit of **FG** for the year ended 31<sup>st</sup> December 2015. During the physical inventory verification of **FG**, many significant differences have been noted between the physical inventory balances and those recorded in the bin cards.

**You are required to,**

- (a) **State** the three(03) steps of Risk Management Framework. (03 marks)
- (b) **State** two(02) reasons to prove the importance of performing regular physical inventory verifications at **FG**. (02 marks)
- (c) An audit junior of the team has identified the following balances as unusual, and **Ravin** has instructed him to obtain audit evidence for those balances under the assertions identified in the table below:

Balance	Assertion
Sales	Cut-off
Accounts Receivable	Rights and Obligations
Accounts Payable	Existence
Marketing Expenses	Occurrence
Lands	Existence

**Identify** an audit test that needs to be performed by the audit junior in obtaining audit evidence for each of the above assertions of the above balances. (05 marks)

(Total 10 marks)

## Question 07

**Stylish Dress (Pvt) Ltd. (SDPL)** sells locally manufactured apparels and apparels imported from Thailand in its 5 sales outlets. Purchases are made centrally. The ordered goods are directly delivered to the outlets. Each outlet has its own stock ledger. Purchase requirement is identified based on the sales forecast of each outlet and the stock level of each outlet.

In November 2015, the Purchasing Manager has placed an order from a new supplier identified by the General Manager. However, the shipment had not arrived up to 05<sup>th</sup> January 2016 and as a result **SDPL** could not achieve the sales target for the month of December 2015.

A complaint has been made regarding a shortage of ladies' blouses as even a single order had not been delivered for a period of one month. It was noted that the order placed by Nugegoda outlet had been delivered to the Dehiwala outlet instead of delivering it to the Nugegoda outlet. This has resulted in excess stocks in the Dehiwala outlet.

The finance department of **SDPL** compares the Goods Received Notes (GRNs) with the suppliers' invoices before making payments to suppliers. Every month, supplier statements are reconciled with **SDPL's** records.

**You are required to:**

- (a) **State** three(03) inherent limitations of internal controls. (03 marks)
  - (b) **Identify** a preventive control and a detective control operating in **SDPL**. (02 marks)
  - (c) **Identify** two(02) internal control weaknesses in the internal control system detailed above. (02 marks)
  - (d) **Explain** how the management of **SDPL** would overcome each of those weaknesses identified in (c) above. (03 marks)
- (Total 10 marks)

————— *End of Section B* —————

## **SECTION C**

Two (02) compulsory questions.

(Total 50 marks)

## Question 08

- (a) **Explain** three(03) policies and procedures that need to be considered for quality control on individual engagements. (06 marks)
- (b) **XYZ PLC** has an authorized distribution network in the Western Province. The company imports herbal products and sells to distributors on one month credit basis. Bank guarantee of Rs.500,000/- each has been obtained from all distributors except for recently appointed 4 distributors.

**Mahil Associates** is the external auditor of **XYZ PLC**. You are the audit manager of **Mahil Associates**. You have assigned one of the audit seniors, **Kanishka**, to audit accounts receivable of **XYZ PLC**.

**Mala** is the officer in charge for handling receivables of **XYZ PLC** and has given you the following schedule of "Debtors' Age Analysis":

**XYZ PLC: Age Analysis of Debtors as at 31<sup>st</sup> December 2015:**

Name	Total Outstanding Amount (Rs.)	0-30 days (Rs.)	31-60 days (Rs.)	61-90 days (Rs.)	Over 91 days (Rs.)
Rajapaksa Trading	165,000	100,000	65,000		
Alpha Pharmacy	986,754	870,000	60,000		56,754
Sameera Pharmacy	1,870,320	452,650	320,165	652,800	444,705
Kamil Grocery	356,420	356,420			
Saman Pharmacy	352,960	460,000		(107,040)	
Cash sales	156,800	106,800	50,000		
Palam Stores	278,600				278,600
Suspense Debtors	240,500	240,500			
Other Debtors***	1,156,450	420,300	356,800	115,200	264,150

\*\*\* **Note:** Other debtors comprise of 34 customers where each of the customers is having an outstanding balance of less than Rs.100,000/-.

**You are required to:**

- (i) **Identify** four(04) areas that need special attention in performing audit procedures to audit the accounts receivable of **XYZ PLC**. (04 Marks)
  - (ii) **State** a reason each for considering those areas stated in (i) above, as important when performing audit procedures to audit accounts receivable of **XYZ PLC**. (04 Marks)
  - (iii) **Explain** two(02) matters to be considered when selecting a sample of accounts receivables from the above listing to apply audit procedures. (04 Marks)
  - (iv) **Kanishka** informed you that the General Manager has refused to allow him to call confirmations from Sameera Pharmacy and Alpha Pharmacy.  
**State** two(02) actions that you may take as the auditor in response to the General Manager's behaviour. (02 Marks)
- (c) A junior member of the audit team has prepared a working paper for the tests performed over the fixed assets additions of **XYZ PLC**. This was the only working paper available in the audit file regarding the fixed assets additions and it has been submitted for your review.

<b>XYZ PLC</b>			
<b>Client:</b>		Prepared by:	.....
<b>Description:</b>	.....	Date:	25/06/2015
	.....	Reviewed by:	.....
		Date:	.....
<b><u>Additions to fixed assets</u></b>			
	<b>2015</b>	<b>2014</b>	(Rs. million)
Building	40	0	
Office furniture	35	15	
	<b>75</b>	<b>15</b>	
<b>Work done</b>			
Tested a sample of additions amounting to Rs. 22 million.			

**You are required to:**

**Identify** any five(05) weaknesses noted in the working paper provided above.

(05 marks)  
(Total 25 marks)

## Question 09

- (a) **Lakmal** is employed as an audit senior of **S & S Associates**, a firm of Chartered Accountants. He is in the process of finalizing the audit of **Candy (Pvt) Ltd**, a chocolate manufacturing company. There were no significant issues noted during the audit. The audit manager instructed him to prepare a draft unmodified audit report on the financial statements of **Candy (Pvt) Ltd** for the year ended 31<sup>st</sup> December 2015. The following draft report prepared by him is now ready for the review of the audit manager:

### **Auditor's Report of Candy (Pvt) Ltd.**

#### **Report on the financial statements**

We have audited the accompanying financial statements of **Candy (Pvt) Ltd.**, which comprise the statement of financial position, the statement of comprehensive income, statement of changes in equity and statement of cash flows.

#### **Management's Responsibility for the financial statements**

Management is responsible for the preparation and fair presentation of these financial statements in accordance with Sri Lanka Accounting Standards.

#### **Auditor's Responsibility**

Our responsibility is to express an opinion on these financial statements based on our audit. The standards require that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance about whether the financial statements are free from material misstatements.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depends on the auditor's judgment, including assessment of the risk of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by the management, as well as evaluating the overall presentation of the financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

#### **Opinion**

In our opinion, the financial statements present fairly, in all material respects, the financial position of **Candy (Pvt) Ltd**.

#### **Report on Other Legal and Regulatory Requirements**

In our opinion, these financial statements also comply with the requirements of Section 151 (2) of the Companies Act, No. 07 of 2007.

Colombo

Date : .....

**You are required to:**

- (i) **Explain** the three(03) types of modified audit opinions. (06 marks)
- (ii) **Explain** five(05) errors in the audit report drafted by **Lakmal** given above. (10 marks)
- (b) You are the audit senior responsible for the external audit of **Kamal (Pvt) Ltd.** You have received the below bank reconciliation statement prepared by the assistant accountant of **Kamal (Pvt) Ltd.** as at 30<sup>th</sup> June 2015.

**Bank Reconciliation Statement as at 30<sup>th</sup> June 2015**

			Rs.	Rs.
Balance as per the general ledger bank book				1,875,600
<b>Add: Cheques issued but not presented</b>				
Date	Cheque No.	Supplier Name		
12.10.2014	421356	Sisira (Pvt) Ltd.	125,000	
11.11.2014	421389	Sunil Stores	356,800	
01.10.2015	370122	Kameel	75,800	
22.06.2015	462572	Asoka (Pvt) Ltd.	145,200	
27.06.2015	462581	Mahesh	23,400	
29.06.2015	462584	Ruwan	14,850	
29.06.2015	462594	Malaka	86,880	
22.06.2015	Unidentified Debits		70,000	897,930
<b>Less: Deposits not realised</b>				2,773,530
Date	Cheque No.	Customer Name		
24.06.2015	352161	Nayomi	358,400	
29.06.2015	125630	Sarath	422,120	
04.03.2015	Direct deposits not identified		75,800	
28.06.2015	Cash deposits		100,000	956,320
<b>Balance as per bank statement</b>				<b>1,817,210</b>

**You are required to:**

- (i) **State** two(02) benefits of preparing a bank reconciliation statement to an entity. (01 mark)
- (ii) **Identify** four(04) areas that you need special attention in the above bank reconciliation statement. (04 marks)
- (iii) **State** why these four(04) areas require special attention. (04 marks)
- (Total 25 marks)

*End of Section C*

## **ACTION VERB CHECK LIST**

<b>Knowledge Process</b>	<b>Verb List</b>	<b>Verb Definitions</b>
<b>Level 01 Comprehension</b>  Recall & explain important information	<b>Define</b>	Describe exactly the nature, scope, or meaning.
	<b>Draw</b>	Produce (a picture or diagram).
	<b>Identify</b>	Recognize, establish or select after consideration.
	<b>List</b>	Write the connected items one below the other.
	<b>Relate</b>	To establish logical or causal connections.
	<b>State</b>	Express something definitely or clearly.
	<b>Calculate/Compute</b>	Make a mathematical computation
	<b>Discuss</b>	Examine in detail by argument showing different aspects, for the purpose of arriving at a conclusion.
	<b>Explain</b>	Make a clear description in detail revealing relevant facts.
	<b>Interpret</b>	Present in an understandable terms.
	<b>Recognize</b>	To show validity or otherwise, using knowledge or contextual experience.
	<b>Record</b>	Enter relevant entries in detail.
<b>Summarize</b>	Give a brief statement of the main points (in facts or figures).	

<b>Knowledge Process</b>	<b>Verb List</b>	<b>Verb Definitions</b>
<b>Level 02 Application</b>  Use knowledge in a setting other than the one in which it was learned / Solve closed-ended problems	<b>Apply</b>	Put to practical use.
	<b>Assess</b>	Determine the value, nature, ability, or quality.
	<b>Demonstrate</b>	Prove, especially with examples.
	<b>Graph</b>	Represent by means of a graph.
	<b>Prepare</b>	Make ready for a particular purpose.
	<b>Prioritize</b>	Arrange or do in order of importance.
	<b>Reconcile</b>	Make consistent with another.
	<b>Solve</b>	To find a solution through calculations and/or explanation.

<b>Knowledge Process</b>	<b>Verb List</b>	<b>Verb Definitions</b>
<b>Level 03 Analysis</b>  Draw relations among ideas and compare and contrast / Solve open-ended problems.	<b>Analyze</b>	Examine in detail in order to determine the solution or outcome.
	<b>Compare</b>	Examine for the purpose of discovering similarities.
	<b>Contrast</b>	Examine in order to show unlikeness or differences.
	<b>Differentiate</b>	Constitute a difference that distinguishes something.
	<b>Outline</b>	Make a summary of significant features.