



ASSOCIATION OF ACCOUNTING TECHNICIANS OF SRI LANKA

AA3 EXAMINATION - JANUARY 2017

(AA34) PROCESSES, CONTROLS AND AUDIT

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

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

21-01-2017  
Afternoon  
[1.45 – 5.00]

No. of Pages : 07  
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**

**Uniweb Lanka (Pvt) Ltd.** is a subsidiary of **Uniweb International** which is an Australian based company. **Uniweb Lanka (Pvt) Ltd.** is engaged in developing software programs for corporate customers of **Uniweb International**. The company receives income in foreign currency.

**State** three(03) economic factors and two(02) technological factors affecting the business of **Uniweb Lanka (Pvt) Ltd.** (05 marks)

**Question 02**

**EMobile (Pvt) Ltd.** is engaged in the business of selling mobile phones. The business is affected by both internal and external risks and the company cannot completely avoid the risks.”

(A) **State** three(03) internal risks that may be affect **EMobile (Pvt) Ltd.** (03 marks)

(B) **List** two(02) types of techniques that may be used to mitigate the risks of **EMobile (Pvt) Ltd.** (02 marks)  
(Total 05 marks)

### Question 03

Direction, supervision and review are the policies and procedures that need to be considered for quality control on an individual audit. The engagement partner is ultimately responsible for quality control on an individual audit.

- (A) **State** three(03) matters which audit partner should communicate to the members of the audit team under the direction. (03 marks)
- (B) **State** two(02) functions included under the supervision when conducting an audit. (02 marks)  
(Total 05 marks)

### Question 04

An internal control system refers to processes introduced by management to help the organization to accomplish its objectives and goals. There are five components in an internal control system according to COSO (Committee of Sponsoring Organizations). Control environment and control activities are two of the five components of the COSO.

- (A) **Explain** what is meant by the “Control Environment”. (02 marks)
- (B) **State** three(03) types of internal control included in the control activities. (03 marks)  
(Total 05 marks)

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*End of Section A*

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## **SECTION B**

Three (03) compulsory questions  
(Total 30 marks)

### Question 05

AAT members are required to comply with the requirements of the Code of Ethics issued by the Association of Accounting Technicians of Sri Lanka.

**You are required to,**

- (A) **State** four(04) fundamental principles applicable for the members of AAT Sri Lanka. (04 marks)
- (B) **Explain** the following threats to compliance with the fundamental principles:
- (a) Self-interest threat.
  - (b) Advocacy threat.
  - (c) Familiarity threat.
- (06 marks)  
(Total 10 marks)

## Question 06

**Latest Fashions (Pvt) Ltd.** is engaged in retail business of ladies' wear. The customers of the company are mainly from high income generating category. In every 6 months new designs are added by the company. Thereafter the apparels of old designs are sold at discounted prices. **Latest Fashions (Pvt) Ltd.** is managed by the two key shareholders of the company. **SP Associates**, the auditors of the company for the year ended 31<sup>st</sup> December 2016 noted the following:

- (1) The apparels worth Rs.50 million had remained as non-moving items since last year. However, no provision had been made in the financial statements. The inventories are valued at cost. The net realizable value of non-moving items were estimated by the accountant and it was estimated to be Rs.20 million. The auditor has tested the reasonableness of this calculation independently and no issues have been noted.
- (2) The overall materiality level applicable for the audit of **Latest Fashions (Pvt) Ltd.** for the year ended 31<sup>st</sup> December 2016 is estimated at Rs.18 million and it is appropriately computed.
- (3) The shareholders' expectation is to receive constant dividends from this business.

**You are required to:**

- (A) **Assess** the impact of the issue described above to the auditor's report of **Latest Fashions (Pvt) Ltd.** for the year ended 31<sup>st</sup> December 2016. (04 marks)
  - (B) **Differentiate** "a modified audit report" from "an audit report with emphasis of matter paragraph" with an appropriate example for each. (06 marks)
- (Total 10 marks)

## Question 07

**Monarch (Pvt) Ltd (Monarch)** is in the retail business. **Monarch** entered into a contract with a leading bank to obtain funds for a project. As per this contract, **Monarch** should submit financial statements to the bank bi-annually, prepared as per the provisions of the contract. The financial statements should be prepared as per the criteria set in the contract. These financial statements are subject to the audit.

Therefore, management of **Monarch** requested **S&S Co.**, to conduct an assurance engagement and issue a report on the special purpose financial statements.

**You are required to:**

**Explain** the key elements of the assurance engagement. (10 marks)

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*End of Section B*

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## SECTION C

Two (02) compulsory questions.

(Total 50 marks)

### Question 08

- (A) **SSI (Pvt) Ltd. (SSI)** is a company engaged in manufacturing of foot wear for the export market. It currently employs 300 factory employees. Each employee has been issued a punch card to record the attendance. Punch card should be swiped at the start and at the end of each shift. However, swiping process is not supervised by any officer since it is fully automated and no one can alter the time.

All new appointments of the company are done by the HR department and new employees are entered into the payroll by HR Executive.

Overtime (OT) payments are also calculated by the payroll system and payments are made twice a month. Once the OT payments are made, OT reports are sent to production supervisors to check the accuracy.

Attendance bonus is paid to employees based on the attendance records. Amounts to be paid are decided by the production supervisors and payroll clerk enters those amounts to the payroll system.

Salaries are paid in cash for all the factory employees, and payroll clerk distributes pay packets among employees. As he knows all the factory employees personally, he does not obtain salary acknowledgements for the payments made by him.

**You are required to:**

- (a) **Identify** four(04) internal control weaknesses in the payroll system detailed above. (04 marks)
- (b) **State** a recommendation each as to how the management of **SSI** would overcome each of those weaknesses identified in (a) above. (04 marks)
- (c) **State** two(02) main risks associated with the use of a computerized payroll system. (02 marks)
- (d) (i) **Identify** three(03) general controls that could be established by the management of **SSI** to strengthen and protect the information included and entered to the payroll system. (03 marks)
- (ii) **Identify** two(02) application controls that could be established by the management of **SSI** to strengthen and protect the information included and entered to the payroll system. (02 marks)

- (B) **Sameera** is the senior in charge of the audit of **Perera Trading (Pvt) Ltd.** for the year ended 31<sup>st</sup> March 2016 and the following balances were extracted from the financial statements of **Perera Trading (Pvt) Ltd.** for the years ended 31<sup>st</sup> March 2016 and 31<sup>st</sup> March 2015:

	<b>2016 (Rs.)</b>	<b>2015 (Rs.)</b>
Sales	1,005,630	700,250
Cost of sales	(553,000)	(357,120)
<b>Gross Profit</b>	<b>452,630</b>	<b>343,130</b>
Property, Plant and Equipment - at cost	8,000,000	500,000
Trade Debtors	209,500	116,700
Bank Loan	350,000	500,000

- (1) The company has only 5 debtors. Balance receivable from one debtor has been written off as bad debt. **Sameera** has selected 3 debtors to check subsequent settlements and all 03 debtors have not settled the balances subsequently.
- (2) **Sameera** has noted in his preliminary analytical review of Property, Plant and Equipment that there has been a significant increase in machinery.
- (3) **Sameera** has checked the loan agreement of the bank loan.

**You are required to:**

- (a) **Identify** two(02) additional audit procedures each that **Sameera** should perform for the items stated in (1) to (3) above to obtain sufficient and appropriate audit evidence. (06 marks)
  - (b) **Identify** an analytical procedure each for trade debtors and gross profit, based on the given information in the extract of the financial statements. (02 marks)
  - (c) **State** two(02) assertions about account balances at the period end financial statements. (02 marks)
- (Total 25 marks)

### Question 09

- (A) You have been assigned as the senior in charge of the audit of **Ambathale Dairy Products (Pvt) Ltd. (ADP)**, a company with 3 subsidiaries which is engaged in manufacturing and selling of dairy products. **ADP** is a new audit client for your firm.

Accountant of the company has been recruited 2 months before the year end. Current accountant is the third person recruited to the post of accountant during the year. Further, he is not a professionally qualified person.

Marketing Manager has stated that a new competitor called “**Treemo**” has emerged in the industry of **ADP**. **Treemo** has made a large investment in advertising and promotions and captured a significant market share. Therefore the demand for the products of **ADP** is declining drastically.

When the related party transactions were validated, you have identified that significant amount of inter-company sales have been made closer to the year end. Direct confirmations have been received from the relevant related parties and those agree with the ledger balance.

When reviewing the payments, you have found that several significant amounts have been paid to a lawyer. However, supporting documents are available for those payments.

There is an Accounts Executive in the Accounts Department. He is responsible for collecting milk from farmers in the area and making payments to those farmers.

**You are required to:**

- (a) **Explain** what is meant by audit risk. (02 marks)
  - (b) **List** three(03) areas that you need to obtain an understanding about **ADP** and its environment. (03 marks)
  - (c) **Explain** four(04) areas that indicate significant risk to be addressed when performing the audit of **ADP**. (08 marks)
  - (d) **List** two(02) types of information that you might include in the permanent audit file of **ADP**. (02 marks)
- (B) You are the senior in charge of the audit of **MN (Pvt) Ltd**. **MN (Pvt) Ltd** uses revaluation model to measure its lands. After 5 years of the revaluation, the management has identified that market values of lands have been increased significantly. Therefore the management has carried out another revaluation in the current year. Land valuation has been done by **AB Valuers**. A copy of the valuation report has been provided to you.

The company uses cost model to measure its buildings. One of the buildings is partly damaged due to flood. Therefore the company has made a provision for impairment. You have obtained a representation from the management regarding the impairment provision.

**You are required to:**

- (a) **List** two(02) audit procedures to be performed in reviewing the land valuation. (04 marks)
- (b) **State** what is meant by “a written representation by management”. (02 marks)
- (c) **Discuss** the quality and reliability of the management representation as an audit evidence. (04 marks)

(Total 25 marks)

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*End of Section C*

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## ACTION VERB CHECK LIST

Knowledge Process	Verb List	Verb Definitions
<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).	

Knowledge Process	Verb List	Verb Definitions
<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.

Knowledge Process	Verb List	Verb Definitions
<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.