



ASSOCIATION OF ACCOUNTING TECHNICIANS OF SRI LANKA

AA3 EXAMINATION - JULY 2018

(AA34) PROCESSES, CONTROLS AND AUDIT

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

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

21-07-2018
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

Mr. & Mrs. Rupasinghe returned to Sri Lanka after working six years in Canada. They have saved approximately Rs.10 million and are planning to start up their own business organization.

You are required to:

- (a) **State** two(02) types of business organizations that could be started by **Mr. & Mrs. Rupasinghe**. (02 marks)
- (b) **Identify** three(03) common objectives of any business organization. (03 marks)
- (Total 05 marks)

Question 02

When a practitioner undertakes an assurance engagement, he shall clearly understand from the outset whether it is a reasonable assurance engagement or limited assurance engagement, as this will have an impact on the work that he will carry out.

You are required to:

Identify three(03) differences between the reasonable assurance engagement and the limited assurance engagement. (05 marks)

Question 03

Sanath is a member of the team auditing the financial statements for the year ended 31st March 2018 of **Regent Ltd.**, a leading retailer of Sri Lankan gemstones. He has been assigned to perform the audit procedures for the year-end inventory balance of **Regent Ltd.**

You are required to:

Explain two(02) financial statement assertions that need to be addressed with an audit procedure for each to be performed when auditing the year-end inventory balance of **Regent Ltd.** (05 marks)

Question 04

The firm should establish and maintain a system of quality control to address elements such as leadership responsibilities for quality within the firm, relevant ethical requirements, acceptance and continuance of client relationships, human resources, engagement performance and monitoring.

You are required to:

- (a) **State** the objective of establishing and maintaining a system of quality control within a firm. (03 marks)
- (b) **Identify** two(02) instances where a firm should accept or continue relationships with clients. (02 marks)
- (Total 05 marks)

End of Section A

SECTION B

Three (03) compulsory questions

(Total 30 marks)

Question 05

- (A) When understanding an entity and its environment, the entity's internal control is one of the general areas considered by the auditor.

You are required to:

State three(03) components of the entity's internal control system. (03 marks)

- (B) (a) Audit risk is the risk that the auditor expresses an inappropriate audit opinion when the financial statements are materially misstated.

You are required to:

Explain what is meant by inherent risk. (03marks)

(b) The following transactions are related to different entities:

- (i) **Cups Ltd.** is a business engaged in manufacturing paper cups and **Butter Cakes Ltd.** is in the business of running a bakery that sells butter cakes. **Cups Ltd.** and **Butter Cakes Ltd.** decided to merge their businesses into a single business known as **Cupcakes Ltd.** The proposed merger transaction is expected to involve complex accounting principles and have significant management intervention from the both businesses.
- (ii) **Tapro Lanka Ltd. (TL)** has leased an office space from the East Tower Block of World Trade Centre (WTC) on an operating lease. At the commencement of every month, **TL** pays a lease payment of Rs.450,000/- in cash to the owners of WTC. Once payment is made, the accounting records are updated.

You are required to:

Explain with reasons, whether each of the above scenarios give rise to significant risks.

(04 marks)

(Total 10 marks)

Question 06

Somarathne & Sons Ltd. is a company engaged in the retail trade of groceries. Both the company's headquarters and the shop it owns are located in Kandy. The flash floods that took place in May 2017 caused extensive damages to the shop and its headquarters. The company personnel was not able to evacuate in time and consequently, 95% of all records of the company including supporting documents were completely destroyed. The company does not have any backup procedures.

Assume that your audit firm has been assigned to audit the financial statements of **Somarathne & Sons Ltd.** for the year ended 31st December 2017.

You are required to:

- (a) **Identify**, in general, a situation where a modified opinion is required with an example. (04 marks)
 - (b) **Explain** the type of the audit opinion that will be issued on the financial statements of **Somarathne & Sons Ltd.** for the year ended 31st December 2017. (03 marks)
 - (c) **Explain** how the answer for part (b) above would change if the company has maintained proper back-ups of all the accounting records. (03 marks)
- (Total 10 marks)

Question 07

- (a) Compliance with the fundamental principles may potentially be threatened by a broad range of circumstances and relationships. Threats to compliance with the fundamental principles fall into several categories.

You are required to:

Explain the following categories of threats to compliance with the fundamental principles.

- (i) Self-review threat.
(ii) Intimidation threat. (04 marks)

- (b) **Ann PLC** is one of the three major clients of your audit firm, **De Silva & Associates**. **Ann PLC** pays a fee of Rs.4 million per annum and the total fee income of **De Silva & Associates** per annum is Rs.12 million. During the year ended 31st December 2017, **Ann PLC** has incurred a significant market development expenditure, which they have capitalized as a non-current asset. However, this expenditure does not satisfy the criteria to be capitalized and the correct accounting treatment would have been to charge this expenditure to the Income Statement as an expenditure. The management of **Ann PLC** has indicated that they will not re-appoint **De Silva & Associates** if they disagree with the accounting treatment adopted by **Ann PLC**.

You are required to:

Explain the threats to compliance with the fundamental principles applicable to **De Silva & Associates** as provided in the above scenario. (06 marks)

(Total 10 marks)

End of Section B

SECTION C

Two (02) compulsory questions.

(Total 50 marks)

Question 08

- (A) Corporate governance guidance in Sri Lanka is provided in the Code of Best Practice on Corporate Governance 2013 issued jointly by the Securities and Exchange Commission of Sri Lanka and the Institute of Chartered Accountants of Sri Lanka.

You are required to:

- (a) **Explain** the importance of Corporate Governance. (04 marks)
(b) **State** three(03) guidelines that have been highlighted by the Code of Best Practice on Corporate Governance. (03 marks)

(B) **Mrs. Madapatha** who is a master of designing fashion items received an award in 2016 for designing of fashion items. Since she is getting many orders for designing of fashion items after the award was received, she started a small garment manufacturing entity with a Rs.30 million bank loan facility. She does not have any accounting background but the bank manager insisted her several times to recruit an accountant to manage her finance activities. Assume that she has recruited you as the accountant of her business. This is your first week in the office and you have gathered the information below:

- (1) Factory building construction is almost over now. **Mrs. Madapatha** has already completed and supplied six orders to retail outlets.
- (2) Forty five (45) employees are working in this factory.
- (3) **Mrs. Madapatha** purchased fabrics from the local market by her own on several occasions but now the supervisor is attending for purchasing activities.
- (4) Purchases are made on one month credit basis.
- (5) Last week, one purchase order was returned back to the supplier since it was not up to the required quality specifications.
- (6) Further, at most of the instances suppliers submit invoices for incorrect amounts or for goods that have not been delivered.
- (7) Supervisor has purchased some items at higher price than **Mrs. Madapatha** purchased before.
- (8) Due to the unique designs, the demand has increased and a rapid growth of the business is expected.

During the last discussion, she requested you to overlook the purchasing process and report her your concerns. At the discussion you have stated the importance of having a good internal control system in the entity. **Mrs. Madapatha** wants to know whether by implementing a good internal control system she can have 100% assurance that there will be no errors, mistakes and frauds within the organization.

You are required to:

- (a) **Explain** the purchasing process (procurement process) which would be appropriate for **Mrs. Madapatha's** organization (your answer should be supported with minimum of 4 steps of an ideal purchasing process). (08 marks)
 - (b) **Explain** three(03) risks that will be mitigated by implementing a good purchasing process. (06 marks)
 - (c) **Discuss** whether **Mrs. Madapatha** can have 100% error free situation by having a good internal control system in the organization. (04 marks)
- (Total 25 marks)

Question 09

- (A) Your audit firm has been approached by one of your clients, **Zonto Lanka PLC** for a special assignment. Its parent, **Zonto UK Org.**, which is a UK company has specially requested **Zonto Lanka PLC** to prepare a statement of related party transactions and relationships to be submitted to the regulator.

The directors of **Zonto Lanka PLC** have prepared this statement for the six months period ended 30th June 2018. The statement has been prepared in accordance with the principles of LKAS 24, Related Party Disclosures. The parent company requires this statement to be tested by the **Zonto Lanka PLC's** auditor and an opinion should be issued whether the content is in accordance with the principles of LKAS 24.

You are required to:

Assess whether the above engagement is an assurance engagement. (05 marks)

- (B) Your firm has been appointed as the auditors of **Tex Connections (Pvt) Ltd. (TC)** which is a software solution company. This is a new audit and the engagement partner has appointed you as the senior in charge for the audit. The Draft Comprehensive Income Statements and the Statements of Financial Position are provided to you as follows:

Draft Comprehensive Income Statements (Rs.'000)

For the year ended	31 st March 2018	31 st March 2017
Revenue:		
Software Developments	18,750	45,320
Fees on Annual Maintenance agreements	1,120	6,512
Hardware sales	1,552	322
	21,422	52,154
Expenses:		
Salaries	16,564	21,462
EPF and ETF	23	1,719
Travelling	565	3,765
Office Maintenance	3,265	340
Telephone and Electricity	1,654	1,265
Computer maintenance	765	915
	22,836	29,466
Profit / (loss)	(1,414)	22,688

Draft Statements of Financial Position

(Rs.'000)

As at	31 st March 2018	31 st March 2017
Non-Current Assets:		
Land and Building	2,550	5,720
Motor Vehicle - Van	4,300	4,300
Furniture and Fittings	656	652
	7,506	10,672
Current Assets:		
Trade Receivables	8,565	750
Cash and Cash Equivalents	1	8
	8,566	758
Total Assets	16,072	11,430
Equity:		
Stated Capital – Ordinary Shares	1,500	1,500
Retained Earnings	675	2,089
	2,175	3,589
Current Liabilities:		
Bank Loan	6,100	-
Trade Payables	4,100	2,730
Related Party Payables	3,697	5,111
	13,897	7,841
Total Equity and Liabilities	16,072	11,430

You are required to:

- (a) **Explain** the term “Audit Evidence” with an example. (04 marks)

- (b) **Identify** eight(08) areas that you need special attention in performing audit procedures of **Tex Connections (Pvt) Ltd.** (08 marks)

- (c) **List** six(06) audit procedures that you would perform for the related party payable balance of Rs.3,697,000/- presented in the Statement of Financial Position as at 31st March 2018. (06 marks)

You have requested a management representation letter from the management of **TC** to confirm the areas that you have mentioned under part (b) above. However, the management has not provided you the requested written representation.

- (d) **State** two (02) actions that you will take on such situation. (02 marks)
- (Total 25 marks)

End of Section C

ACTION VERB CHECK LIST

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

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

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