



ASSOCIATION OF ACCOUNTING TECHNICIANS OF SRI LANKA

AA3 EXAMINATION - JANUARY 2019

(AA34) PROCESSES, CONTROLS AND AUDIT

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

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

26-01-2019
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

Assume you are a business analyst of a leading software (IT applications) development company.

You are required to:

- (a) **Identify** two(02) key forces of the external environment that are expected to have a significant impact on this business. (02 marks)
- (b) **Explain** the impact of the above identified key forces on the given business. (03 marks)
- (Total 05 marks)

Question 02

Samanthi is a member of the team auditing the financial statements of **Success Engineering Ltd.**, a company engaged in construction activities. She has been assigned to perform the audit procedures on the Property, Plant and Equipment (PPE) balance of **Success Engineering Ltd.**

You are required to:

Explain any three(03) financial statement assertions that **Samanthi** needs to identify that are relevant for Property, Plant and Equipment of **Success Engineering Ltd.** (05 marks)

Question 03

The Board of Directors of **ABC PLC** is considering to appoint **SW & Co.**, a firm of Chartered Accountants as their statutory auditor.

You are required to:

- (a) **Identify** two(02) persons who may not be appointed or act as an auditor of a company. (02 marks)
- (b) **Explain** two(02) procedures to be carried out by **SW & Co.**, before accepting the appointment as the first auditor of **ABC PLC**. (03 marks)
- (Total 05 marks)

Question 04

Roma Ltd. is a company engaged in the business of selling readymade garments. The management of **Roma Ltd.** comprises two (02) persons, the Managing Director and Finance & Administration Manager. Managing Director who is a middle-aged person with a dominant personality has been with **Roma Ltd.** for nearly 15 years and he is one of its most trusted employees. The Board of Directors neither meets regularly nor takes an active interest in overseeing company's management as they have complete faith in the Managing Director's capabilities. Further, management has shown a very little interest in responding to the statutory auditor regarding the points of the management letter that highlight key weaknesses in internal financial controls.

You are required to:

- (a) **Explain** what is meant by misappropriation of assets. (02 marks)
- (b) **Identify** two(02) conditions / events that increase the risk of fraud in **Roma Ltd.** (03 marks)
- (Total 05 marks)

End of Section A

SECTION B

Three (03) compulsory questions

(Total 30 marks)

Question 05

Sectos Ltd. wishes to invest in a project to introduce a new product. This project is to be financed through a bank loan and the bank has instructed to prepare a financial forecast detailing the cash inflows and outflows from this project. The bank requires this financial forecast to be tested by **Sectos Ltd.’s** auditor and an opinion should be issued on the financial forecast by the auditor.

You are required to:

- (a) **Explain** what is meant by “Assurance Engagement”. (03 marks)
- (b) **List** three(03) examples for assurance engagements. (03 marks)
- (c) **Assess** the type of assurance engagement that would be performed on **Sectos Ltd.’s** financial forecast. (04 marks)

(Total 10 marks)

Question 06

(A) **Randula** is a junior audit team member who is testing the bank reconciliation statements prepared by the Assistant Accountant of the audit client as at 31st March 2018. The audit client has only one (01) current account and **Randula** does not expect to re-perform the bank reconciliation statements.

You are required to:

- (a) **Differentiate** “inspection” from “observation” as types of audit procedures. (04 marks)
 - (b) **Identify** three(03) possible audit procedures that **Randula** would perform on the bank reconciliation statements as at 31st March 2018. (03 marks)
- (B) **Ameen** is a member of the audit team auditing the financial statements for the year ended 31st December 2018 of **Local Retailers Ltd.** Its head office is in a leased out building in Colombo and rent is payable quarterly in advance. Rent per quarter is Rs.30,000/- and Rs.150,000/- was paid in 2018 as rent. Prepaid rent balance brought forward as at 01st January 2018 was Rs.30,000/-.

You are required to:

Identify three(03) audit procedures that **Ameen** would perform when auditing the rent expenses for the year ended 31st December 2018 and prepaid rent expenses as at 31st December 2018. (03 marks)

(Total 10 marks)

Question 07

- (a) The objective of using external confirmation procedures by the auditor is to design and perform such procedures to obtain relevant and reliable audit evidence.

You are required to:

- (i) **State** three(03) instances in which external confirmations may be used. (03 marks)
- (ii) **Identify** two(02) actions that could be taken by the auditor, if the management refuses to allow the auditor to send confirmation requests. (04 marks)
- (b) The roles of management and those charged with governance in agreeing with the terms of the audit engagement for the entity depend on the governance structure of the entity and relevant law or regulation.

You are required to:

State three(03) points that should be included in an audit engagement letter. (03 marks)
(Total 10 marks)

End of Section B

SECTION C

Two (02) compulsory questions.

(Total 50 marks)

Question 08

- (A) Organizations should manage their risks. Risk Management Framework consists of several steps.

You are required to:

Explain the steps of the Risk Management Framework. (06 marks)

- (B) **Janadi Export Ltd. (JEL)** is engaged in manufacturing and exporting of coconut oil. **JEL** has employed over 500 employees and the employees are distributed in different divisions of **JEL** as follows:

| Division | No. of employees |
|----------------------|-------------------------|
| Manufacturing | 440 + |
| Quality control | 16 |
| Packing | 24 |
| Transport | 12 |
| Finance | 10 |
| Human Resources (HR) | 3 |
| Marketing | 4 |

When a need for a new employee arises, a recruitment requisition form should be filled by the relevant head of department and sent to the General Manager (GM) for approval. GM approves it at the weekly HR meetings by deciding the salary, allowances, required qualifications etc. The company has a formal recruitment process comprising of advertising and conducting interviews. As soon as the employee is recruited by the HR department with the relevant head of department, appointment letter is issued and it is notified to the payroll officer and the confidential secretary, who keeps personal files in the HR department.

Finger print machines are available in each department to record the employees' respective in and out time. Non-executive employees of the manufacturing department are paid based on the number of hours worked. Department supervisors and the relevant head of department approve the overtime work requirements.

If necessary, non-executive employees can apply for salary advances before the 15th day of the relevant month. Non-executive employees are allowed to obtain salary advances on every 20th day of the month and salaries are paid on the 10th day of the following month. Fixed amount of advance is paid as the salary advance. All the payments related to employees are paid through bank transfers including the salary advances. Payroll officer ensures that all statutory deductions are made and paid to the relevant regulatory authorities on time.

Once the payroll is ready, the accountant and head of finance approve it. A firm of chartered accountants engages in conducting the internal audit and regularly checks the payroll calculations and the staff records as part of their internal control testing.

You are required to:

- (a) **Explain** "Monitoring", a component in the internal control system according to the Committee of Sponsoring Organization (COSO). (03 marks)
 - (b) **Identify** five(05) strengths of internal controls related to the payroll system of **Janadi Export Ltd.** (05 marks)
 - (c) **State** an objective for each of those strengths identified in (b) above. (05 marks)
- (C) Information Technology (IT) controls comprise general controls and application controls. IT general controls establish a framework of overall control over the system's activities whereas application controls are specific controls over the applications maintained by the system.

You are required to:

- (a) **List** three(03) examples for IT general controls. (03 marks)
 - (b) **List** three(03) examples for application controls. (03 marks)
- (Total 25 marks)

Question 09

- (A) **Mr. Mendis** operated a shoe shop “**Beta Shoes**” in a two-storey building owned by him, at No. 69, Galle Road, Colombo 03. The shop was destroyed by a fire on 21st August 2018 and all the items in the shoe shop were destroyed. **Mr. Mendis** is confident of re-commencing his business by using an inventory of shoes stored at an off-site location and completing the restoration of the destroyed building by September 2019. An insurance claim has been initiated and is being processed by the insurance company. The Accountant of “**Beta Shoes**” prepares the financial statements for the period ended 30th September 2018.

The auditor has determined that the preparation of financial statements on going concern basis and disclosure made in the financial statements in this respect is appropriate, according to the given mitigation plan of **Mr. Mendis**.

You are required to:

- (a) **State** five(05) matters that need to be considered in forming the auditor’s opinion on financial statements of an entity. (05 marks)
- (b) **Assess** whether there are any other implications to the Auditor’s Report of the financial statements of **Beta shoes** for the period ended 30th September 2018. (05 marks)
- (B) Compliance with the fundamental principles may potentially be threatened by a broad range of circumstances and relationships.

You are required to:

Identify two(02) examples each for the following threats to compliance with fundamental principles:

- (a) Self-interest threat.
- (b) Self-review threat.
- (c) Advocacy threat. (06 marks)
- (C) **Hunt Ltd.**, which is engaged in the business of jewellery is a recurring statutory audit client of **Steve & Storm partners (S & S)**. **Hunt Ltd.** recently requested **S & S** to assist them in all matters related to income tax including calculating the income tax liability which should be recorded in their books of accounts.

You are required to:

- (a) **Explain** the steps that **S & S** would need to perform with respect to acceptance of the additional engagement as the tax consultant of **Hunt Ltd.** (04 marks)
- (b) **Explain** the element of “Acceptance and Continuance of client relationships” if **S & S** has established a system of Quality Control within their firm. (05 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. |