SRI LANKA

Association of Accounting Technicians of Sri Lanka

July 2018 Examination - AA3 Level

Questions and Suggested Answers
(AA34)

PROCESSES, CONTROLS AND AUDIT
(PCA)

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THE ASSOCIATION OF ACCOUNTING TECHNICIANS OF SRI LANKA

EDUCATION AND TRAINING DIVISION

AA3 Examination - July 2018
(AA34) Processes, Controls and Audit

SUGGESTED ANSWERS

SECTION – A

Four (04) compulsory questions
(20 Marks)

Suggested Answers to Question One:

(A) 1. Partnership
2. A private limited liability Company
3. Sole proprietorship *(02 marks)*

(B)
1. Increase in Profit
2. Growth
3. Increase in market share
4. survival *(03 marks)*

(Total 05 marks)

Suggested Answers to Question Two:

	Reasonable Assurance	Limited Assurance
1	Provides fairly high level of assurance	Provides lower level of assurance
2	Positive form of opinion is expressed	Negative form of opinion is expressed
3	Needs significant amount of testing and evaluation to express the opining	Does not need higher level of testing and evaluation
4	Practitioner reduces the risk of expressing an incorrect opinion to an acceptably low level	There is a greater risk that the practitioner gives an incorrect opinion.

(05 marks)

Suggested Answers to Question Three:

(i) **Existence -** This refers that Inventory amounts recorded in the balance sheet exist and are represented by physical inventory at the balance sheet date.

Audit Procedures:

- Observe the physical inventory count
- Cutoff analysis
- Check the value of physical inventory count with balance that appeared in the balance sheet
- Confirm existence of inventory

(ii) **Valuation and Allocation -** Inventory is included in the financial statements at appropriate amounts and any resulting valuation or allocation adjustments are appropriately recorded.

Audit Procedures:

- Check whether inventory are recorded at the lower of cost or net realizable value (NRV)
- Vouch and test inventory pricing
- Perform analytical procedures

(iii) **Rights and Obligations -** Check whether Regent Gems hold the right to the inventory of gemstones recorded in the balance sheet.

Audit Procedures:

- Review consignment agreements
- Examine the invoices for evidence of ownership
- Review the minutes of board meeting

(iv) **Competences -** Inventory should be correctly recorded in the financial statements of the company.

Audit Procedures:

- Perform cutoff tests
- Verify the mathematical accuracy of inventory
- Reconcile physical inventory amounts with perpetual records

(05 marks)

Suggested Answers to Question Four:

(a) The objective of the firm is to establish and maintain a system of quality control is:

1. To provide the company with reasonable assurance that the firm and its personnel comply with professional standards and applicable legal and regulatory requirement.
2. To ensure the reports issued by the firm or engagement partners are appropriate in the circumstances.

(03 marks)

(b)

The firm should only accept , or continue with , a client where,

1. it has considered the integrity of the client and does not have information that the client lacks integrity.
2. it is competent to perform the engagement and has the required capabilities, including time and resources.
3. it can comply with ethical requirements including appropriate independence from the clients.

(02 marks)

(Total 05 marks)

End of Section A

SECTION –B

Three (03) compulsory questions
(30 marks)

Suggested Answers to Question Five:

(A)

1. Control environment
2. Risk assessment
3. Control activities
4. Information and communication
5. Monitoring

(03 marks)

(a)

Inherent Risk – The susceptibility of an assertion about a class of transaction, account balance or disclosure to a misstatement that could be material, either individually or when aggregated with other misstatements, before consideration of any related controls.
Inherent risk is the risk that items will be misstated due to the characteristics of those items. The auditors must use their professional judgement and all available knowledge to assess inherent risk. If no such information or knowledge is available then the inherent risk is high.

(03 marks)

(b) (i)

The merge of Cups Ltd and Butter Cakes Ltd involve **significant management intervention**. Further, this requires application of complex accounting principles or calculations and forms **an unusual transaction**. The application of control procedures do not followed and involves a great manual intervention. Based on the above this scenario gives rise to **a significant risk**.

(b) (ii)

Leased out an office space is a **routine and non-complex** transaction in a "World Trade Center". The basis of accounting and payment terms are clear (non-complex). This scenario is less likely give rise to **significant risk** than unusual truncations or matters of management judgement.

(04 marks)

(Total 10 marks)

Suggested Answers to Question six:

(a) A modified opinion is required when;

The auditor **concludes** that, based on the evidence obtained, the financial statements as a **whole** are **not free from material misstatements.**

Eg:
1. Inappropriateness of selected accounting policies.
2. Wrong application of selected accounting policies.
3. Inappropriateness or inqdequacy of disclosures in the financial statements.

OR

The auditor is **not able to obtain sufficient appropriate audit evidence** to **conclude** that the financial statements as a **whole** are free from material misstatement.

Eg:
1. Circumstances are beyond entity's control;
   Eg: Entity's financial records have been destroyed;
2. A circumstance where the auditor has been appointed after year end and as a result of that auditor is unable to observe the physical inventory verification of the Company.
3. Instance where the management prevents auditor from requesting external confirmations for certain account balances.

(04 marks)

(b)

SLAuS 705 sets out **3** possible **types** of modifications; as **qualified** opinion, a **disclaimer** of opinion and an **adverse** opinion. 95% of all accounting records were destroyed in May 2017. Consequently, the auditor will **not be able** to obtain **suffcient appropriate audit evidence** to conclude that the financial statement as a whole are free from **material** misstatement. The effect is expected to be **material** to the financial statements. The effect is expected to be so **pervasive** - it would not be confirmed to specific elements, amounts or items in the financial statements. Accordingly, a **disclaimer of opinion** would be issued.

(03 marks)

(c)

If the company had maintained proper backups of all the accounting records, the financial statements would be free from material misstatements and the auditor can express unmodified opinion.

(03 marks)

(Total 10 marks)

Suggested Answers to Question seven:

(a) (i)

Self-review threat - Self-review threat arises when member reviews his or her own work or advice as part of an assurance engagement.

(a) (ii)

Intimidation Threat - The threat that a professional accountant will be **deterred** from **acting** objectively because of actual or perceived pressures.

(04 marks)

(b)

Ann PLC pays a fee of Rs. 4 million from a total fee income of Rs. 12 million of De Silva & Associates. This is 1/3 of total fee income of De Silva & Associates. Therefore, there is an **undue dependence** on the **total fees** from this client. It is **highly probable** that this undue **dependence** creates a **financial interest** that would **inappropriately** influence the auditor's judgment / behavior.

Further, the firm is threatened with non - appointment if they continue to disagree with the **ANN PLC**. This may **deter** the audit firm from **acting objectively** because of pressure from client.

Accordingly, the circumstances of the scenario lead to a threat of (a) **self-interest** and (b) **intimidation**.

(06 marks)

(Total 10 marks)

End of Section B

SECTION –C

Two (02) compulsory questions
(Total 50 marks)

Suggested Answers to Question Eight:

(A) (a)

Corporate governance is important because the owners of a Company and the people who manage the company are not always the same. In some companies directors and shareholders are same. But in most cases specially in listed companies shareholders are different from the management. These scenarios, a need arises for a properly designed code to ensure no stakeholder remains disadvantaged. As board of directors manage the companies they are the responsible parties for the compliance with guidelines in corporate governance codes.

(04 marks)

(A) (b) Directors:

1. Every public company should be headed by an effective board, which should direct, lead and control the company.
2. The chairman's role in preserving Good Corporate Governance is crucial. As the person responsible for running the board, the chairman should preserve order and facilitate the effective discharge of board functions.
3. The board should ensure the availability within it of those with sufficient financial acumen and knowledge to offer guidance on matters of finance.
4. It is preferable for the board to have a balance of executive and non-executive directors such that no individual or small group of individuals can dominate the Board's decision taking.
5. There should be a formal and transparent procedure for the appointment of new Directors to the Board.
6. All Directors should be required to submit themselves for re-election at regular intervals and at least once in every 3 years.
7. Boards should periodically appraise their own performance in order to ensure that board responsibilities are satisfactorily discharged.
8. Shareholders should be kept advised of relevant details in respect of Directors.
9. The board should be required, at least annually, to assess the performance of the CEO.

Shareholders:

1. Boards should use the AGM to communicate with shareholders and should encourage their participation.
2. Directors should disclose to shareholders all proposed material transactions.
3. Individual shareholders should be encouraged to participate in general meetings of companies and exercise their voting rights.

(03 marks)

(B) (a) Steps in Procurement Process

- **Supplier selection**

  There should be a supplier selection process as to the quality and price. Whether to use one or more suppliers to purchase the goods required will depend on the factors such as;

  - Getting lowest price
  - Getting reliable quality of materials

- **Place purchase orders**

  A purchase requisition note should be raised from the manufacturing division and submitted to purchase division. It should contain the details of good required. Once purchasing department receives a purchase requisition note, raise a purchase order to the supplier concerned.

- **Receiving goods delivered**

  When the goods are delivered by the supplier , the goods need to be acknowledge by cross checking with the Purchase Order to ensure the price, quantity ordered and quality of the goods. Raise the Goods Received Note based on the same.

- **Making the payment**

  The supplier invoice needs to be checked with the Purchase Order and GRN. Invoice should be paid only when those have been formally approved by a person in authority.

(08 marks)

(B) (b) Risks that can be mitigated:

1. By identifying, authorizing the need of purchases, the risk of ordering the goods which are not required will be minimized.
2. The supervisor may purchase the materials at a higher price. When a supplier is selected and a price is agreed, the possibility of purchasing goods at an excessive price is mitigated.
3. By recording the goods received, it can be checked with the supplier invoice and ensure that correct price is applied prior to making and authorizing the payments. Thereby can avoid payment for goods that have not been delivered.

(06 marks)

(B) (c)

Internal control system of a company can only provide reasonable assurance achieving company's intended objectives due to its inherent limitations mentioned as follows:

- Control may not be well designed.
- Control may not be implemented as required. Therefore, even a well-designed control may not be able to achieve its objectives.
- Continuous changes in operational risks. As a result, the pre designed controls may fail to address new risks.
- Cost of designing and implementing control does not identify the benefit delivered from those controls.
- Non routine transactions are not covered.
- Human errors.

Therefore, **Mrs. Madapatha** cannot expect 100% errors free situation by implementing an internal control system.

(04 marks)

(Total 25 marks)

Suggested Answers to Question Nine:

(A)

Assurance engagement:

1. The audit firm is required to express an opinion or conclusion. In an assurance engagement, it is required for a practitioner to express an opinion or a conclusion.
2. Statement of related party transactions for 6 months ended 30th June 2018 prepared by the client's management / directors. This is the subject matter which is one element required in an engagement for it to be an assurance engagement.
3. Statement is prepared in accordance with the LKAS 24, which is the criteria applied to the subject matter.
4. There is an intended user for this engagement. i.e. regulator.

Considering the above, this is considered as an assurance engagement.

(05 marks)

(B) (a)

Audit evidence is all of the information used by the auditor in arriving at the conclusions on which the auditor's opinion is based. Audit evidence includes both information contained in the accounting records underling the financial statements and other information gathered by the auditors such as confirmation from third parties.

Eg. Direct bank confirmation received from bank confirming the account balance as at a particular date.

Confirmation received from a trade debtor confirming the balance payable to a company

(04 marks)

(B) (b)

Areas to be inquired from the accountant:

1. Software Developments Revenue has dropped by 58% and Annual Maintenance revenue too has dropped by 82%. Is there any particular reason for this?
2. This may even affect the going concern of the business? What steps has the management taken to face this situation?
3. EPF / ETF expenses do not show the minimum statutory % payment. Any reason?
4. Office maintenance cost is too high compared to the previous year. Is there any particular reason for that?
5. There is a bank loan of Rs. 6.1 million in the Statement of Financial position. But why there is no any interest expense in the income statement?
6. Rs. 3.1 million worth of Land and Buildings have been disposed during the year? Is this due to crucial in business activities or to manage the working capital requirements? This too indicates the going concern issue.
7. Debtors value as at the 31st March 2017 is unusually high compared with the previous year balance. Is this debt value recoverable? What is the reason to increase the debt value like this?
8. Creditors value is too high compared to the previous year. What steps management has taken to settle the creditors balances?
9. What is the related party transaction balance and how has it arisen during the year?
10. Salaries value is less by Rs. 5 million compared to last year. Is this due to staff resignations or due to redundancy?
11. There is no gratuity expense or liability in accounts. Have these liabilities been settled during the year?
12. Depreciation on Property, Plant and Equipment has not been charged to income statement.

(08 marks)

(B) (c)

Audit procedures (RPT)

- Inquire of management and directors as to whether there are any further transactions have taken place with related parties that are required to be disclosed in the financial statements.
- Review the prior year working papers for names of known related parties.
- Review minutes of meetings of shareholders, directors and other statutory records such as register of director's interest.
- Review accounting records for large and unusual transactions or balances, transactions recorded at, or near the end of the financial period.
- Review confirmations of loans receivable and payable and confirmations from banks, review of relationships, guarantors to the entity.
- Review of investment transactions, purchase or sale of interest in joint venture.
- Obtain a confirmation from related party for the payable balance as at the year end.
- Inquire as to the names of all pension and other trusts established for the benefit of employees and the names of their management trustees.
- Inquire as to the affiliation of directors and officers with other entities.
- Obtain a confirmation from the relevant related parties for the balance outstanding at the balance sheet date and agree with the balances recorded by the entity.

(06 marks)

(B) (d)

If the management does not provide one or more requested written representations, the auditor shall;

- Discuss the matter with the management.
- Re-evaluate the integrity of management and evaluate the effect this may have on the reliability of representations and audit evidence in general.
- Take action, including determining the impact of the auditor's report.

(02 marks)

(Total 25 marks)

End of Section C

Notice :

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