



ASSOCIATION OF ACCOUNTING TECHNICIANS OF SRI LANKA

AA3 EXAMINATION - JULY 2015

(AA34) PROCESSES, CONTROLS AND AUDIT

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

(1) **Time:** 03 hours.

(2) **Structure of Question Paper and the Marks Allocation:**

Section	Requirement	Marks
A	All questions are compulsory.	20
B	All questions are compulsory.	30
C	Only two out of three questions should be answered.	50
Total Marks		100

01-08-2015

Afternoon

[2.00 – 5.00]

No. of Pages : 09

No. of Questions : 10

(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.**

SECTION A

Four (04) compulsory questions

(Total 20 marks)

Question 01

Galaxy (Pvt) Ltd. appointed **NN Associates**, a firm of Chartered Accountants as their statutory auditors. The auditor is responsible for the audit of financial statements and to express an opinion as to the true and fair view of the financial statements.

(a) **Identify** the three(03) parties involved in an Assurance Engagement. (03 marks)

(b) **State** two(02) fundamental principles in the Code of Ethics **NN Associates** should demonstrate as the auditor of **Galaxy (Pvt) Ltd.** (02 marks)

(Total 05 marks)

Question 02

Kanchana is the Audit Manager for the recurring audit of a private limited company. When reviewing the permanent audit file, before starting his field work, he noted that previous engagement letter is filed in the permanent audit file.

- (a) **State** three(03) matters to be included in an engagement letter for a **recurring** audit client. (03 marks)
 - (b) **State** two(02) other information included in a permanent audit file. (02 marks)
- (Total 05 marks)

Question 03

Audit evidence is all the information used by the auditor in arriving at conclusions on which the auditor's opinion is based.

- (a) **State** two(02) factors that influence the reliability of audit evidence. (02 marks)
 - (b) **State** three(03) procedures an auditor may perform to identify possible related party transactions. (03 marks)
- (Total 05 marks)

Question 04

You are the Audit Manager of **W Associates**, a firm of Chartered Accountants. You are given a team to conduct the audit of **GT Holdings PLC**, a finance company. There will be a meeting of you and the audit partner in charge with the Audit Committee of **GT Holdings PLC**.

- (a) **State** three(03) general areas that you should obtain knowledge under Industry, Regulatory and Other External factors of **GT Holdings PLC**. (03 marks)
 - (b) **Identify** two(02) functions of the Audit Committee. (02 marks)
- (Total 05 marks)

End of Section A

SECTION B

Three (03) compulsory questions

(Total 30 marks)

Question 05

Fashions Trend (Pvt) Ltd. is a manufacturing company. The number of employees in the company's factory exceeds 200. Those employees are paid monthly salaries, overtime payments and attendance allowances.

The employee turnover of the company is relatively high. The Human Resource Division prepares the payroll of the company and it is checked by the Financial Accountant. The payroll is approved by the General Manager and then the net salary of each employee is remitted to the respective bank accounts.

After payment of salaries for the month of April 2015, four newly joined employees have complained that their salaries have not been remitted to their bank accounts and another 10 employees have complained that their overtime is under paid.

The management now has a concern whether there had been over payment of salaries as well.

You are required to,

- (a) **State** three(03) conditions or events which increase the risk of fraud in an entity. (03 marks)
- (b) **Explain** the responsibility of the auditor when it comes to fraud. (03 marks)
- (c) **Identify** four(04) controls **Fashions Trend (Pvt) Ltd.** could consider to implement to mitigate the risk of under or over payment of salaries to its employees. (04 marks)

(Total 10 marks)

Question 06

Nalin is the audit manager of the audit of **Dial Speed (Pvt) Ltd.** which is in the business of selling mobile phones, tablet computers and related accessories. The company is having its sales centers in the main cities of the country. During the planning meeting, **Nalin** instructed his team to have skeptical mind in performing the audit of the company.

Nalin stated that a new model of mobile phone has been introduced by the company and therefore there is a risk that the old model mobile phones will remain without being sold.

You are required to,

- (a) **Differentiate** "Professional Skepticism" from "Professional Judgment". (05 marks)
- (b) **Explain** two(02) audit procedures the auditor should perform to address the valuation assertion of the closing inventories at **Dial Speed (Pvt) Ltd.** (05 marks)

(Total 10 marks)

Question 07

- (a) **Ceylon Networks (Pvt) Ltd.** is a newly formed company, registered under the Companies Act No. 07 of 2007. Board of Directors of the company is considering appointing of its first auditor of the company.

You are required to,

- (i) **State** two(02) persons who may not be qualified to get appointed as an auditor of the company. (02 marks)
- (ii) **Explain** the process of appointing the first auditor of the company. (03 marks)
- (b) Extract of the Audit Report on the Financial Statements of **Energy Beverages PLC** for the year ended 31st March 2015 is given below:

Extract of the Audit Report:

Basis for opinion

We were appointed as auditors of the company on 30th June 2014 and thus did not observe the counting of the physical inventories at the beginning of the year. We were unable to satisfy ourselves by alternative means concerning inventory quantities held at 31st March 2014. Since opening inventories enter into the determination of the financial performance and cash flows, we were unable to determine whether adjustments might have been necessary in respect of the profit for the year reported in the income statement and the net cash flows from operating activities reported in the cash flow statement.

Opinion

In our opinion, except for the possible effects of the matter described in the basis for opinion paragraph, the financial statements present fairly, in all material respects, the financial position of **Energy Beverages PLC** as at 31st March 2015, and its Financial Performance and its cash flows for the year then ended in accordance with Sri Lanka Accounting Standards.

You are required to,

- Identify** the type of modified audit opinion issued to **Energy Beverages PLC** for the year ended 31st March 2015 and **Explain** the reason for giving such an opinion. (05 marks)

(Total 10 marks)

End of Section B

SECTION C

Answer any two (02) questions only.

(Total 50 marks)

Question 08

- (a) **State** the five(05) components of the Internal Control System Framework. (05 marks)
- (b) **Identify** three(03) risks in a procurement process and **State** a possible control to mitigate each of the identified risks. (06 marks)
- (c) **SH International (Pvt) Ltd.** is a company manufacturing consumer goods. This company has a distribution network through agents appointed island wide.

Agents place orders over the phone contacting **Shiroma**, an Accounts Executive of the company. She records these orders in a note book and prepares the Invoice and sends it to the Stores Manager. According to the Invoice, goods are sent to the relevant location.

Goods returned are recorded by the Stores Manager in a Return Note. **Shiroma** prepares Credit Notes for these stock returns and enters those to the debtors ledger.

Mrs. Wahid is the Sales Manager and she calls agents and asks for payments when funds are not sufficient to buy raw materials. **Shiroma** records agents' receipts and maintains the Debtors' Receivable Register. Rs. 12.5 million has been written off as bad debts during the financial year ended 31st March 2015. At the end of each month, **Shiroma** observes a physical verification of a sample of the stock at the store.

You are required to:

- (i) **Identify** four(04) internal control weaknesses in the internal control system detailed above. (04 marks)
- (ii) **Explain** how you would overcome each of these weaknesses. (06 marks)
- (iii) **Identify** two(02) controls to be implemented by the management of **SH International (Pvt) Ltd.** on the sales process and **State** whether those are preventive or detective controls. (04 marks)

(Total 25 marks)

Question 09

- (a) **Explain** three(03) elements of a Quality Control System. (06 marks)
- (b) Prevention or detection of unauthorized changes to computer programmes is an IT general control.
- (i) **Explain** the purpose of implementing IT general controls in an entity. (04 marks)
- (ii) **Identify** four(04) controls an organization can consider to prevent or detect unauthorized changes to computer programmes in an entity. (04 marks)

- (c) **Sunil** is the audit senior for the financial audit of **Design Furniture (Pvt) Ltd.**, a company manufacturing furniture for office and domestic use. The company has two manufacturing plants at Nittambuwa and Horana. The head office is located in Colombo. The sales are made through the company's own showrooms in different areas of the island. Each showroom obtains orders from customers and those are updated in the IT system. The showroom staff have access to the inventory and invoicing sections of the IT system which are connected to the accounting system. The Finance Department, Procurement Department and IT Department are located in the head office.

The draft financial statements of the company for the year ended 31st March 2015 and the financial statements of the company for the year ended 31st March 2014 are provided below with the relevant notes.

Statement of Comprehensive Income (Rs.'000)

for the Year ended 31 st March	2015	2014
Sales	1,200	900
Cost of Sales	(865)	(620)
Gross Profit	335	280
Selling and Distribution Expenses	(85)	(54)
Administrative Expenses	(43)	(34)
Operating Profit	207	192
Finance Expenses	(20)	(16)
Profit Before Tax	187	176
Tax Expenses	(75)	(58)
Profit for the year	112	118
Other Comprehensive Income	-	-
Total Comprehensive Income for the year	112	118

Statement of Financial Position (Rs.'000)

As at 31 st March	2015	2014
Non-Current Assets:		
Property, Plant and Equipment	890	695
Current Assets:		
Inventories	98	75
Trade and Other Receivables	30	22
Cash and Cash Equivalents	85	50
	213	147
	1,103	842
Equity and Liabilities:		
Stated Capital	390	350
Retained Earnings	320	202
	710	552
Non-Current Liabilities:		
Borrowings	150	115
Defined Benefit Obligations	20	15
	170	130
Current Liabilities:		
Trade and Other Payables	134	100
Borrowings	89	60
	223	160
	1,103	842

Notes to the accounts for the year ended 31st March 2015:

- (1) During the year, the company has written off some old production machineries and purchased new machineries.
- (2) During the year, the company rented out a warehouse in Horana to a third party and an additional warehouse was constructed in Nittambuwa.

Sunil is given the task of assessing the risks of the audit of **Design Furniture (Pvt) Ltd.**

You are required to:

- (i) **State** five(05) risk assessment procedures **Sunil** could perform for **Design Furniture (Pvt) Ltd.** in order to identify and assess the risk of material misstatements. (05 marks)
 - (ii) **Identify** three(03) areas **Sunil** needs to focus on when performing the audit of **Design Furniture (Pvt) Ltd.** based on the above information. (06 marks)
- (Total 25 marks)

Question 10

- (a) As per SLAuS 570 - Going concern, the auditor's responsibility is to obtain sufficient appropriate audit evidence about the appropriateness of management's use of the going concern assumption in preparation of the financial statements.

State five(05) financial events or conditions that may cast doubt about the going concern assumption in preparation of financial statements. (05 marks)

- (b) **Flex Plastic (Pvt) Ltd.** is a plastic products manufacturing company. The company is using imported raw materials for their production process.

The summary of inventories as at 31st March 2015 and 31st March 2014 are as follows:

	31st March 2015 (Rs'000)	31st March 2014 (Rs'000)
Raw materials	125,000	90,000
Work in progress	75,000	45,000
Finished goods	365,000	245,000
Total	565,000	380,000

The sales and cost of sales for the year ended 31st March 2015 and 31st March 2014 are given below:

	31st March 2015 (Rs'000)	31st March 2014 (Rs'000)
Sales	2,000,000	1,400,000
Cost of sales	(1,720,000)	(1,176,000)
Gross profit	280,000	224,000

Raw materials

There are four main raw materials being used for production. These four categories are further classified in the inventory module based on the colour, size etc. In total, there are about 200 items of raw materials. The unit prices of all these raw materials are similar and valued at the weighted average cost which is calculated by the system. However, Stores Manager and the Finance Manager has the administrative rights to the inventory module and they can change the prices in the system.

You are the Audit Senior for this engagement.

You are required to:

- (i) **Explain** "observation" which is a type of audit procedure and **state** limitations of it. (04 marks)
- (ii) **Identify** two(02) analytical procedures you would perform to obtain audit evidence on inventories of this company as at 31st March 2015. (02 marks)
- (iii) **State** two(02) audit procedures you would perform to check the accuracy of valuation of raw materials as at 31st March 2015. (04 marks)
- (c) The following working papers prepared by an audit junior on trade receivables have been submitted for your review:

Working Paper				
Prepared by: Sf		Date:		
Reviewed by:		Date:		
Client:				
Calling confirmations from debtors				
We have selected following 6 debtors out of 110 debtors in the listing and sent confirmation requests under our control:				
<i>Debtor</i>	<i>Balance as at 31st March 2015 (Rs.)</i>	<i>Reply received</i>	<i>Balance confirmed (Rs)</i>	<i>Difference (Rs)</i>
<i>Fair trading</i>	<i>150,000</i>	<i>No</i>	<i>N/A</i>	<i>N/A</i>
<i>Alpha Trading</i>	<i>2,678,000</i>	<i>No</i>	<i>N/A</i>	<i>N/A</i>
<i>Matara Stores</i>	<i>55,000</i>	<i>Yes</i>	<i>55,000</i>	<i>0</i>
<i>Sammera & Co.</i>	<i>5,000</i>	<i>No</i>	<i>N/A</i>	<i>N/A</i>
<i>Quick traders</i>	<i>86,000</i>	<i>Yes</i>	<i>54,500</i>	<i>31,500</i>
<i>N & N (Pvt) Ltd.</i>	<i>575,000</i>	<i>No</i>	<i>N/A</i>	<i>N/A</i>

(N/A = Not Available)

- (i) **Explain** three(03) weaknesses, in terms of the adequacy of the audit procedures performed by the junior on the debtors' confirmation process stated above. (06 marks)
- (ii) **State** four(04) other weaknesses noted in the above working paper. (04 marks)
- (Total 25 marks)

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.