



## ASSOCIATION OF ACCOUNTING TECHNICIANS OF SRI LANKA

### AA3 EXAMINATION - JANUARY 2018

#### (AA34) PROCESSES, CONTROLS AND AUDIT

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

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

20-01-2018  
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**

**Tastee Ltd.** which is a registered company in Sri Lanka is engaged in the business of manufacturing and selling biscuits throughout Sri Lanka. External environment affects the operation of **Tastee Ltd.**

**You are required to:**

**Identify** three(03) components of external environment affecting the business of **Tastee Ltd.** with an example for each component. (05 marks)

##### **Question 02**

**Breez (Pvt) Ltd.** is a limited liability company incorporated 15 years ago. The business is growing and profitable. The directors are planning to list the company in the Colombo Stock Exchange. A remuneration committee and an audit committee are appointed by a listed company as per the Code of Best Practice on Corporate Governance.

**You are required to:**

- (a) **Identify** three(03) functions of the audit committee. (03 marks)
- (b) **State** a function of the remuneration committee. (02 marks)

(Total 05 marks)

### Question 03

"Quality control procedures should be adopted to practice at the firm level and individual audit level".

**You are required to:**

**State** five(05) elements of a system of quality controls.

(05 marks)

### Question 04

"Reasonable assurance is a fairly high level of assurance. In a reasonable assurance engagement, the practitioner reduces assurance engagement risk to an acceptably low level in the circumstances of the engagement to obtain reasonable assurance as the basis for a positive form of expression of the practitioner's conclusion."

**You are required to:**

(a) **State** an example for reasonable assurance engagement.

(02 marks)

(b) **Explain** the reason for expressing an opinion in a negative form by a practitioner in a limited assurance engagement.

(03 marks)

(Total 05 marks)

————— *End of Section A* —————

## **SECTION B**

Three (03) compulsory questions

(Total 30 marks)

### Question 05

(A) The auditor shall design and perform audit procedures that are appropriate in the circumstances for the purpose of obtaining sufficient and appropriate audit evidence.

**You are required to:**

(a) **State** what is meant by sufficiency and appropriateness of audit evidence.

(04 marks)

(b) **Explain** the term "external confirmation" with an example.

(02 marks)

(B) **Rathna PLC** operates a defined benefit plan for its employees to pay when the employees are retired from their services. **Rathna PLC** uses a qualified actuary to perform the calculation to estimate the liability related to defined benefit obligation as at the end of the reporting period. The actuary has used key assumptions (e.g. discount rate, salary increment rate, employee turnover rate etc.) in deriving the defined benefit obligation at the period end. You have been assigned to perform work on the liability arising from the defined benefit obligation and evaluate the adequacy of the work performed by the actuary.

**You are required to:**

**Explain** two(02) matters that you would consider in assessing appropriateness and adequacy of the actuary's work as work performed by an expert.

(04 marks)

(Total 10 marks)

## Question 06

- (A) **Sofa (Pvt) Ltd.** is engaged in manufacturing of furniture items. You are the Audit Senior of the team auditing the financial statements of the company for the year ended 31<sup>st</sup> March 2017. New audit engagement letter was not given by your firm since your audit firm has done the last year audit of the company.

**You are required to:**

- (a) **State** the purpose of an engagement letter. (03 marks)
- (b) **Identify** three(03) factors that auditor may decide to revise the terms of audit engagement letter of **Sofa (Pvt) Ltd.** (03 marks)

- (B) You are the engagement partner of the statutory audit of **Rasa Kesel (Pvt) Ltd. (RK)**, a company engaged in the business of selling bananas throughout Sri Lanka. **RK** is one of your audit clients for a number of years and is one of the largest clients of your firm. Your firm is a small entity with a few staff.

The managing director of **RK** approached you recently and requested whether the audit team can perform a full and in-depth review of the internal control system, report on weaknesses identified on internal control and propose recommended remedial actions for those weaknesses. **RK's** Managing Director emphasized that this review is part of its drive to improve business efficiency. This would be a separate engagement to be performed before the audit commences.

**You are required to:**

**Explain** two(02) threats to independence of the auditors with respect to the audit and acceptance of the proposed engagement. (04 marks)  
(Total 10 marks)

## Question 07

You have just completed the external audit of **Sevana Services (Pvt) Ltd.** which is located at Rathnapura. Accounting records for three months of this company were completely unavailable due to the adverse weather condition and flood situation.

Soon thereafter the completion of the audit, you handed over the draft auditor's report to the Managing Director of the company.

**You are required to:**

- (a) **Explain** when an auditor should express an unmodified audit opinion. (03 marks)
- (b) (i) **Explain** the reason as to why the auditor should include an emphasis of matter paragraph in the auditor's report. (03 marks)
- (ii) **State** two(02) examples of circumstances where the auditor includes an emphasis of matter paragraph. (04 marks)  
(Total 10 marks)

## **SECTION C**

Two (02) compulsory questions.

(Total 50 marks)

### **Question 08**

- (A) **Swarna Ceramics (Pvt) Ltd. (SC)** is engaged in retail sale of ceramic items. The showroom is located at No.555, Nugegoda and its stores are located at No.565, Nugegoda.

When purchase items are received to the stores, stores clerk raises the Goods Received Note (GRN) and sends it to the office. Damaged items are identified during the receiving point in order to notify it to relevant supplier.

When customers select items from the showroom they have to make the payments to the showroom cashier. Showroom cashier prepares manual invoices. Customers collect the invoices from showroom and produce it to the stores clerk. Stores clerk prepares the dispatch note and handover it to the labour staff who loads the items to the customer vehicles.

You are the newly appointed Accountant of the company and you have observed the following:

- Monthly physical stock verification has not been carried out for last two months. October 2017 report shows shortages of items.
- There were customers' complaints that customers have received lesser number of items than they have paid for.
- Outside the stores, there were a load of damaged items.
- Showroom cashier has deposited less amount of cash on a particular day than the actual cash collection of that date. When you inquired about this she told you that she has spent that money for purchasing staff welfare items.

You have discussed with the management of **SC** regarding the importance of having a computerized information system for invoicing, stock maintenance and other financial processes.

**You are required to:**

- (a) **Identify** five(05) internal control weaknesses in the sales process detailed above. (05 marks)
- (b) **State** a recommendation each as to how the management of **SC** would overcome each of those weaknesses identified in (a) above. (05 marks)
- (c) **Identify** three(03) IT General Controls that should exist in a computerized information system for invoicing, stock maintenance and other financial processes. (03 marks)
- (d) **State** two (02) examples for each of the IT General controls identified in (c) above. (06 marks)

- (B) **Tesco Sri Lanka (TSL)** is a company that operates a chain of restaurants in Colombo.

The parent of **TSL (Tesco Global – TG)** monitors the performance of **TSL** regularly. For this purpose, **TG** has set out a specific set of Key Performance Indicators (KPIs) to measure the customers' satisfaction of **TSL's** restaurants. The method of calculating each KPI has been specifically set out in **TG's** operating manual available to **TSL**. Data should be taken from customers' feedback forms relevant for the quarter. At the end of each quarter, **TSL** is required to submit quarterly statement of this set of KPIs to **TG**.

To check the reliability of this statement, **TG** requires the statement of KPIs for the quarter ended 30<sup>th</sup> September 2017 to be reviewed by the external auditor of **TSL**. The external auditor is expected to issue an assurance report on this statement.

**You are required to:**

**Discuss three(03) key elements of an assurance engagement to be performed by the external auditor of **TSL** to provide an assurance report.**

(06 marks)

(Total 25 marks)

### Question 09

**Tiara Ltd.** is a company registered in Sri Lanka that owns and operates a clothing store. It imports and sells evening dresses of the latest French fashion trends to high-spending customers. Its customers are well informed and very fashion conscious and any out-of-season dresses available in its stores lose their marketability very quickly. The fashion industry in Sri Lanka is highly competitive and is driven by customer preferences.

The fashion trend in the first half of the year was the maxi dress, and was very popular among its customers. Anticipating high demand for the maxi dress, **Tiara Ltd.** imported Rs.15 million worth of maxi dresses in February 2017. By August 2017, the sleeveless dress has become very popular among its customers. As at 31<sup>st</sup> December 2017, **Tiara Ltd.** had Rs.5 million worth inventory of sleeveless dresses and Rs.2 million worth inventory of maxi dresses remaining in its store.

You have been assigned the audit of **Tiara Ltd.** for the year ended 31<sup>st</sup> December 2017.

**You are required to:**

- (a) **Identify** three(03) general areas of business you need to consider when understanding the entity and its environment with an example for each.

(06 marks)

- (b) (i) **Recognize** an audit risk related to inventory that you would expect to identify.

(03 marks)

- (ii) **Explain** two(02) audit procedures that you would perform in response to the risk identified in (i) above.

(04 marks)

- (iii) **Identify** another substantive procedure you would plan to perform to test valuation of year-end inventory balance of **Tiara Ltd.**

(02 marks)

(c) **Compare** the following types of audit procedures to obtain audit evidence with an example for each procedure:

(i) Inquiry Vs observation.

(ii) Re-calculation Vs re-performance.

(06 marks)

(d) You have been provided with the following reconciliation of a supplier's statement. The reconciliation relates to a creditor of **Tiara Ltd.**

	Rs.	Rs.
Balance as per creditor's ledger		150,000
Add:		
Goods dispatched by supplier but not entered in the ledger	60,000	
Returns not yet recognized by the supplier	18,000	
Payments not yet recognized by the supplier	200,400	278,400
<b>Balance as per Supplier's Statement</b>		<b>428,400</b>

**Identify** two(02) audit procedures that you would plan to perform on this reconciliation.

(04 marks)

(Total 25 marks)

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*End of Section C*

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## **ACTION VERB CHECK LIST**

<b>Knowledge Process</b>	<b>Verb List</b>	<b>Verb Definitions</b>
<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).

<b>Knowledge Process</b>	<b>Verb List</b>	<b>Verb Definitions</b>
<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.

<b>Knowledge Process</b>	<b>Verb List</b>	<b>Verb Definitions</b>
<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.