



ASSOCIATION OF ACCOUNTING TECHNICIANS OF SRI LANKA

AA3 EXAMINATION - JULY 2019

(AA34) PROCESSES, CONTROLS AND AUDIT

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

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

20-07-2019
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

Dilshan is the accountant of a company, which engages in import and retail trade of electrical items. He was asked to discuss the economic and legal factors that affect the business at a management meeting.

You are required to:

Identify three(03) economic factors and two(02) legal factors that **Dilshan** may discuss. (05 marks)

Question 02

The following matters were discussed by the Board of Directors at a recently held board meeting of **Lotus Ltd.**:

- (1) Closing the production line of a business unit due to poor performance.
- (2) Entering into a joint operation arrangement with another party to operate in a new market.
- (3) Performing of periodical fixed assets verification.

You are required to:

- (a) **State** a situation where the risk acceptance is considered as an acceptable method to mitigate risk. (02 marks)
- (b) **Identify** the risk mitigating method used for each of the risks given from (1) to (3) above. (03 marks)
(Total 05 marks)

Question 03

The auditor should identify and assess the risk of material misstatements through understanding of the entity and its environment, including the entity's internal control.

You are required to:

- (a) **Identify** three(03) areas of the entity and its environment where an auditor should obtain an understanding. (03 marks)
- (b) **List** two(02) components of the entity's internal control system. (02 marks)
(Total 05 marks)

Question 04

NZ Associates (NZ) is a firm of Chartered Accountants affiliated with a network of firms, which provides assurance services. The other information relating to **NZ** are given below:

- **Ravinath** is the managing partner of **NZ**.
- A manager, two (02) senior associates and five (05) associates work for **NZ**.
- Currently the manager is seconded to an overseas office and will not be available in office during next 6 months.
- One (01) senior associate and three (03) associates are presently on study leave for a month.
- **Ravinath** is directly involved in two large audits with agreed reporting deadline about a week's time.

You are required to:

- (a) **Identify** three(03) elements of system of quality control which are not managed well at **NZ**. (03 marks)
- (b) **Explain Ravinath's** responsibility for maintaining quality control within **NZ**. (02 marks)
(Total 05 marks)

End of Section A

SECTION B

Three (03) compulsory questions

(Total 30 marks)

Question 05

Sanjeev (Pvt) Ltd. is a BOI company and an audit client of **Kamal Associates**, a firm of Chartered Accountants. You are an audit senior and currently carrying out the statutory audit of **Sanjeev (Pvt) Ltd.** for the year ended 31st March 2019. Based on the provisions of the BOI agreement, the company is required to certify the revenue from export for the financial year from its auditor.

You are required to:

- (a) **Relate** the three party relationship and the subject matter to be considered by you in relation to the above engagement. (06 marks)
- (b) **Identify** four(04) requirements **Kamal Associates** should perform when accepting and managing the assurance engagement described above. (04 marks)

(Total 10 marks)

Question 06

(A) **Park Trading PLC** engages in selling of household items to the local market. **L.M Fernando & Co.**, a firm of Chartered Accountants is the statutory auditor of the company for the year ended 31st March 2019. The auditor has just started planning the audit of the company for the year ended 31st March 2019.

- The company recognizes revenue at the point of raising the invoice where the acceptance of goods will happen on the next day after raising the invoice.
- The audit partner briefed that ‘occurrence’ of revenue is one of the key areas to be focused on.
- The audit partner requested to adopt combined approach to test revenue of the company.

You are required to:

- (a) **Explain** what is meant by “combined approach”. (02 marks)
- (b) **State** three(03) substantive audit procedures that the auditor could perform to test occurrence of revenue of the company. (03 marks)
- (B) Preparing sufficient and appropriate audit documentation on a timely basis helps to enhance the quality of the audit. Auditor uses the working paper for that.

You are required to:

- (a) **Define** “audit documentation”. (02 marks)
- (b) **List** three(03) basic information included in the working paper. (03 marks)

(Total 10 marks)

Question 07

You are the audit manager of the audit of the financial statements of **IT Solutions (Pvt) Ltd.** for the year ended 31st March 2019. The company imports and sells IT related equipments.

Your review of the working papers revealed the following:

- Closing inventories as per the valuation report - Rs.12,677,850/-.
- In February and March, some items have been sold at a price less than the cost which is stated in the stock valuation report.
- The inventory value should be less by Rs.4,655,000/- if those are to be valued at lower of the cost and net realizable value.
- However the management has not agreed to adjust the value of the inventory in the financial statements.

You are required to:

- (a) **Explain** when an auditor should express an unmodified audit opinion. (03 marks)
- (b) **List** two(02) types of modified opinions. (02 marks)
- (c) **Assess** the impact of the above issues to the audit opinion on the company's financial statements for the year ended 31st March 2019. (05 marks)
- (Total 10 marks)

End of Section B

SECTION C

Two (02) compulsory questions.

(Total 50 marks)

Question 08

Sarath Engineering (Pvt) Ltd. is the sole agent in Sri Lanka for Japanese AC filters. The retail sales are done on cash basis and credit facilities are provided to the local agents. Presently there are 28 local agents and 2 retail outlets. The company's annual turnover is over Rs.100 million.

Sarath, the Chairman of the company has appointed your firm as the internal auditor of the company. You were requested by the audit partner to conduct monthly internal audits and submit a report on the observations. You just commenced the internal audit and noted the following:

Cash management:

- The accountant prepares excel sheets to record cash & cheque collections and payments and to record petty cash expenses.
- A receipt is issued for all cash /cheque receipts.
- Signed blank cheques are kept with the cashier to make urgent payments.
- Printed payment voucher and the relevant supporting documents are filed in the payment file immediately after the payment being made.
- Bank reconciliations are prepared by the cashier and last two months bank reconciliations have not been done due to his work load.

Inventory management:

- The store's manager has over 15 years of experience with the company and he has sound knowledge about the inventory items of the company.
- When shipments are delivered, Goods Received Note (GRN) is raised after verifying the physically received quantities with the list of items provided by the supplier.
- The physical inventory verification did not reveal any differences in inventory items.
- All issues are done with authorization and records are properly updated.
- There are Material Requisition Notes (MRN), all issues are done with approved invoice copies and a seal "ISSUED" is placed on the invoice.
- The store's manager conducts monthly physical stock verifications in the presence of accounts division representatives.

You are required to:

- (a) **List** two(02) key business processes of an organization other than cash management and inventory management processes. (02 marks)
- (b) **Identify** four(04) weaknesses in the cash management process explained above. (04 marks)
- (c) **Identify** four(04) strengths in the inventory management process of the company. (04 marks)
- (d) **Explain** three(03) analytical procedures that the internal auditor would perform to verify the accuracy of the records of **Sarath Engineering (Pvt) Ltd.** (06 marks)
- (e) During the initial discussion with **Sarath**, he is of the view that nothing can go wrong with inventory management of the company as the stores department is having a sound internal control system.
- Explain** whether you agree with **Sarath's** above statement. (05 marks)
- (f) Though the company has an in house developed computerized package it is utilized only for invoicing, recording, preparing customers' statements and maintaining the stock records.
- Your firm has emphasized the importance of utilizing the full accounting package with cash book, bank book and ledger accounts. **Sarath** inquired as to what possible controls the company should have in place to prevent or detect unauthorized changes to programs of the system.
- Identify** four(04) controls that should be in place to prevent or detect unauthorized changes to programs of the system. (04 marks)
- (Total 25 marks)

Question 09

- (A) You are the senior in charge of the audit of **TR (Pvt) Ltd.**'s financial statements for the year ended 31st March 2019. Details of Property, Plant and Equipments of **TR (Pvt) Ltd.** are as follows:

Cost

(Rs.'000)

Assets	Balance as at 01 st April 2018	Additions	Disposals	Balance as at 31 st March 2019
Land	58,000	-	-	58,000
Buildings	25,000	-	-	25,000
Machinery	25,670	3,450	-	29,120
Motor vehicles	10,450	-	2,400	8,050
Total	119,120	3,450	2,400	120,170

Depreciation

(Rs.'000)

Assets	Balance as at 01 st April 2018	Charge for the year	Disposals	Balance as at 31 st March 2019
Buildings	10,000	2,500	-	12,500
Machinery	15,402	3,080	-	18,482
Motor Vehicles	4,703	1,150	2,400	3,453
Total	30,105	6,730	2,400	34,435

Note:

At the end of the year, the land and buildings have been revalued by a professional valuer and revalued amounts are as follows:

Land : Rs.75,000,000/-

Buildings : Rs.30,000,000/-

You are required to:

- State** four(04) audit evidences that you could collect when you are performing audit procedures for the above mentioned Property, Plant and Equipments. (04 marks)
- State** three(03) audit procedures that you need to perform in auditing the revalued assets. (03 marks)
- Explain** two(02) important matters where written management representation is required. (04 marks)
- Identify** four(04) important matters that you should consider when dealing with the professional valuer regarding revalued assets. (04 marks)

- (B) Managing Director of **AB (Pvt) Ltd.** has requested **Sudath**, a partner of **R & R Associates**, a firm of Chartered Accountants to immediately accept the statutory audit engagement of **AB (Pvt) Ltd.** for the year ended 31st March 2019. **R & R Associates** has never worked before with **AB (Pvt) Ltd.**

You are required to:

Discuss whether **Sudath** can accept this audit immediately. (04 marks)

- (C) **UB (Pvt) Ltd.** is an audit client of **Eric Associates** since 2000. From the financial year 2018/19, **Nimal** became the audit partner for this engagement. The chairman of **UB (Pvt) Ltd.** has offered 5 days of stay in a Villa at Maldives as the New Year gift to **Nimal**.

The chairman has asked the audit manager of **Eric Associates** to join as the finance manager during the audit and the audit manager is negotiating the terms of employment with the Chairman. The audit team has identified that the company has capitalized Rs. 30 million as borrowing cost even after completing the construction of its new warehouse. The materiality determined for the audit is Rs. 15 million. The chairman informed the audit partner that he would impose a fee cut if he is not agreeing to the capitalization of the borrowing cost.

You are required to:

Explain three(03) threats to compliance with fundamental principles of ethics with reference to the above scenario. (06 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.