



Association of Accounting Technicians of Sri Lanka

July 2016 Examination - AA3 Level

**Questions and Suggested Answers
Subject No : 34**

**PROCESSES, CONTROLS AND AUDIT
(PCA)**

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THE ASSOCIATION OF ACCOUNTING TECHNICIANS OF SRI LANKA
EDUCATION AND TRAINING DIVISION

AA3 Examination - July 2016
(34) Processes, Controls and Audit

SUGGESTED ANSWERS

SECTION – A

Four (04) compulsory questions
(20 Marks)

Suggested Answers to Question One:

a **Integrity**

The principle of integrity imposes an obligation on all professional accountants to be straightforward and honest in all professional and business relationships.

b. There are two types of assurance engagements,

1. Reasonable Assurance Engagements

High level assurance but not 100% absolute assurance. Practitioner expresses his opinion in positive form.

Example - Annual Statutory Audit,

2. Limited Assurance Engagements

Lower level assurance than reasonable assurance, Practitioner expresses his opinion in negative form.

Examples – Prospective Financial Information, Internal control , Non-financial Information

Suggested Answers to Question Two:

a. **Agency conflicts**

In present business scenarios, Directors are delegated responsibility for managing the affairs of the company by the owners. Therefore, they act as trustees/agents for the shareholders. Agents are likely to have different motives to principals. They may be influenced by factors such as financial rewards, labour market opportunities and relationships with other parties that are not directly relevant to principals.

As a result of information asymmetries and self-interest, Principals lack reasons to trust their agents and will seek to resolve these.

b. **Corporate governance guidance for 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 governance is crucial and he is responsible for running the board.
3. The board should ensure the availability within it of those with sufficient financial 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.
5. There should be a formal and transparent procedure for appointment of new directors to the board
6. Shareholders should be kept advised of relevant details in respect of directors.

Suggested Answers to Question Three:

a. **Elements of a system of quality control in an audit firm**

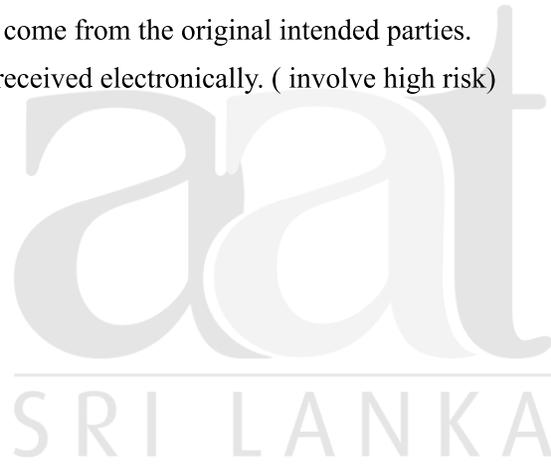
1. Leadership responsibilities for quality within the firm
2. Relevant ethical requirements
3. Acceptance and continuance of client relationships.
4. Human Resources.
5. Engagement Performance – maintain standard for the performance
6. Monitoring

b. **Audit procedure to verify existence of Property, Plant and Equipment**

1. Check fixed assets register to ensure completeness
2. Conduct physical verification – Existence
3. Check board minutes for the approval of addition and disposals of PPE during the year
4. Check the depreciation and impairment test for valuation
5. Check control system to PPE

Suggested Answers to Question Four:

- a. **Instances where external confirmation may be used**
1. Bank balances and other information from banks.
 2. Accounts receivable balances from the customers. (Debtors.)
 3. Stock held by third parties at bonded warehouses for processing or on consignment.
 4. Property title deed held by lawyers or financiers for the safe custody or as security.
 5. Investments purchased from stock brokers but not delivered at the balance sheet date.
 6. Accounts payable balances from creditors.
- b. **factor that might indicate doubts about the reliability of the response to an external confirmation request sent by the auditor.**
- Confirmation was received by the auditor indirectly.
 - Appeared not to come from the original intended parties.
Eg. Responses received electronically. (involve high risk)



End of Section A

**Three (03) compulsory questions
(30 Marks)**

Suggested Answers to Question Five:**a). Impact of the above to the Auditor’s report of RLPL**

At March 31, 2016, Profit will be reduced by 15 million, if building cost should have been capitalized.

In accordance with IAS 16, Property, Plant and Equipment, capitalization of cost for building should be done.

In case of disagreement by management, the auditor may consider issuing a qualified report.

b). “emphasis of matter paragraph” in an Auditor’s report

Auditor includes an emphasis of matter paragraph in the audit report when the auditor decides users of the audited financial statements should pay attention to a specific matter appropriately disclosed or presented in the financial statements that in the auditor’s judgment, the particular matter is fundamental to users’ understanding.

However, inclusion of an emphasis of matter in the auditor’s report does not affect the auditor’s opinion.

c). Important matters stated in the “introductory paragraph” of Auditor’s report

1. Identify the entity whose financial statements have been audited.
2. State that the financial statements have been audited.
3. Identify the title of the each elements of the financial statements.
4. Identify the date or period covered by each financial statements.
5. Refer to the summary of significant accounting policies and other explanatory notes.

Suggested Answers to Question Six:**a). Documents that contain in the current audit file**

1. Audit plan, Risk Assessment, detail audit programme.
2. Ratio Analysis, Analytical reviews done for transactions and balances
3. Copies of supporting documents used to verify amounts.
4. Record of the nature, timing, and extent of audit procedures performed and conclusions reached.
5. evidences for reviewing and supervising assistants work

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6. Evidences that who performs the audit procedures and when they were performed and conclusions reached
 7. Trail balance for the period
 8. Basis of conclusions and opinion
 9. Evidence of particular non compliances identified
- b. **Ways that the audit team of SSPL can gain an understanding about the company, its industry and environment**
1. Inquires of management
 2. Analytical procedures.
 3. Observations and inspection.
 4. Prior period knowledge
 5. Client acceptance and continues process
 6. Discussion by the audit team
 7. Information from other engagements undertaken for the entity
 8. Permanent audit file
 9. Audit working papers of previous years audit files.
 10. Information from the client website.
 11. Publications or websites related to industry the client operate
- c. **procedures listed of the above scenario** **Financial statement assertion**
- | | | |
|---|---|--------------------------|
| (i) Sales cut-off. | - | Completeness / Cut-off |
| (ii) Select a sample of invoices to verify whether those have been approved. | - | Rights and obligations |
| (iii) Review the accounting policy on depreciation of Property, Plant and Equipment. | - | Valuation and allocation |
| (iv) Call for direct confirmations on the balances outstanding as at 31st March 2016 from selected debtors. | - | Existence |

Suggested Answers to Question Seven:

A).

a). objectives of an internal control system

1. Reliability of Financial Reporting
2. Effectiveness and efficiency of operations
3. Compliance with applicable laws and regulations

b). Components of the Committee of Sponsoring Organizations' (COSO) Internal Control System Framework.

1. Control Environment
2. Risk assessment
3. Control activities
4. Information and communications
5. Monitoring

B)

a). Internal control weaknesses in the internal control system of JEPL

1. Collection and entering in to cash book by same person
2. Customer collection entered in petty cash book without entering to main cash book
3. Uses collected cash from customers for incurring of petty cash expenses without depositing in to the bank account
4. Encash of cheque received by local customer without depositing in to bank account
5. Direct settlement of foreign buyers through the USD bank account.

b). Recommendation each as to how the management of JEPL would overcome each to those weaknesses identified in (a) above

1. All collection (Cash/Cheques) should be deposited to bank account.
2. Cash /cheques receipts should be entered in main cash book.
3. Cash collection , deposits and entering to cash book should be segregated and delegate authority in to different officers without making all activities by one person
4. Introduce imprest for petty cash and reimburse should be done by writing cheques through the main cash.
5. Responsible officer of company should authorized to settle due amounts of foreign buyers through the USD bank Account.

End of Section B

Two (02) compulsory questions
(Total = 50 marks)

Suggested Answers to Question Eight:

A) Types of Audit Procedures

1. **Inquiry** - Consists of seeking information of knowledgeable persons both financial and non – financial within the entity or outside the entity. Strength of evidence depends on the knowledge and integrity of source of information.
2. **Observation** - Consists of looking at a procedure or process being performed by others. It is of limited use, as it only confirms the procedure take place when the auditor was watching.
3. **Inspection** - Means the examination of records, documents or tangible assets. By carrying out inspection procedures, the auditor is substantiating information that is or should be in the financial statements. Inspection can provide evidence of existence but not necessarily about ownership or value.
4. **Recalculation** - Consists of checking the arithmetical accuracy of source documents and accounting records. It is deemed to be a reliable source since work is carried out by the auditor.
5. **Re performance** - Means the auditor’s independent execution of procedures of controls that were originally performed as part of the entity’s internal controls. . It is also deemed to be a reliable source because it is carried out by the auditor.

B)

a) Analytical Procedure – Inventory

1. Analysis of Actual stock residence period vs policy trend analysis of stock residence period

	2016	2015
	Rs.	Rs.
Closing Stock	836,500	735,060
Cost of Sales	8,700,000	9,400,000
Stock Residence Period	$\frac{836,500 \times 365}{8,700,000}$	$\frac{735,060 \times 365}{9,400,000}$
	<u>35 days</u>	<u>28.5 days</u>

The above actual stock residence period can be compared with stock residence policy of the company. If there are significant variances between actual stock items based on the demand and production pattern.

2. Reasonableness Test

This involves calculating the expected stock levels of each stock item based on the demand and production pattern.

b) Additional Audit procedures to obtain adequate audit evidence regarding relevant balances for the matters noted 1-4 by Mr. Aravinda.

Matter -1 - Debtors balance

- i. Check subsequent realization of debts
- ii. Checked dispatch notes accepted by buyers.
- iii. Check age of the debts to seek adequate provision bad debts has been provided for

Matter -2 - Net salary Difference - 1 million

- i. Check arithmetical accuracy in respect of calculation relating to net wages
- ii. Check journal entries relating to salaries and wages
- iii. Ensure statutory and other deductions are made promptly.

Matter -3 - Asset Purchased during the year -Machinery – Rs. 80 million

- i. obtain a detailed schedule in support of additions to PPE
- ii. check the ownership of the assets with the relevant original supporting documents. – invoice.
- iii. Check the board minute for the approval process
- iv. Check physical existence of assets.

Matter -4 - Property plant Equipment

- i. Inspect additions or if initial audit, inspect all assets.
 - a. Vouch a sample from accounting records to underlying documentation.
 - b. Vouch a sample from the accounting records to the physical assets.
- ii. Analyze repairs and maintenance.
 - a. Evaluate debits in repairs and maintenance account to determine proper recording (whether these have been capitalized).
 - b. Evaluate additions to PPE to determine proper recording (non capitalizing items may have been taken place).
- iii. Vouch additions and disposals by examining documentation relative to authorization of purchase, recording of purchase, PPE schedules for assets.
- iv. Examine management representation letter for information concerning PPE.

c. Weaknesses of given audit working paper

- The name of the client has not been given.
- The period covered by the audit not marked
- The file reference has not indicated
- The initials of the member of staff who reviewed the working papers and the date on which the review was carried out have not done
- Given audit working paper has not met following the characteristics, as detailed given in the follows.

It should state a clear audit objective, usually in terms of an audit assertion (for example, ‘to ensure the completeness of trade debtors).

It should state the full extent of the test (ie how many items were tested and how this number was determined). This will enable the preparer, and any subsequent reviewers, to determine the sufficiency of the audit evidence provided by the working paper.

The working paper should clearly and objectively state the results of the test, without bias, and based on the facts documented.

The conclusions reached should be consistent with the results of the test and should be able to withstand independent scrutiny.

(25 marks)

Suggested Answers to Question Nine:

A)

a) procedures Sidath Associates should follow before accepting the appointment as the external auditor of BB.

- Before accepting a new client relationship, a professional accountant in public practice shall determine whether acceptance would create any threats to compliance with the fundamental principles.
 - (a) Ensure that the outgoing auditors’ removal or resignation has been properly conducted in accordance with national legislation. The new auditors should see a valid notice of the outgoing auditors’ resignation, or confirm that the outgoing auditors were properly removed.
 - (b) Ensure that the new auditors’ appointment is valid. The new auditors should obtain a copy of the resolution passed at the general meeting appointing them as the company’s auditors.
 - (c) Set up and submit a letter of engagement to the directors of the company.

b) Following weaknesses can be identified in the draft engagement letter

1. Auditors responsibility is not included
2. Inherent limitations of an audit are not mentioned.
3. Elaboration of scope of audit
4. Arrangements regarding planning and performance, including audit team composition are not included
5. Expectation that management will provide written representation is not included
6. Agreement of management to provide draft financial statements and other information in time to allow auditor to complete the audit in time are not included
7. Fees and billing arrangements, not included
8. Involvement of other auditor, experts and internal auditors are not included
9. Arrangements to be made with predecessor auditor are not included

B).

a) Examples for controls over input completeness

1. Manual and programmed agreement of control totals.
2. Document count.
3. One- for – one checking of processed output to source documents.
4. Programmed matching of input to an expected input controls file.
5. Procedures over resubmission of rejected items.

b) Examples for controls over input accuracy

1. Programs to check data fields on input transactions
2. Digital verification – Reasonable test, existence test, character checks, permitted range
3. Manual scrutiny of output and reconciliation to source
4. Agreement of control totals

C).

a) Operating indicators that may cast significant doubt about the going concern assumption of an entity.

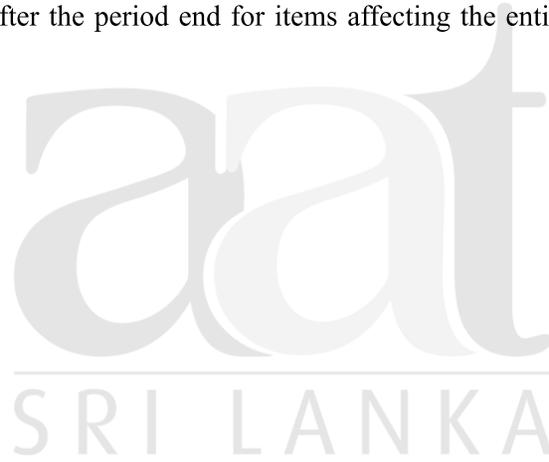
1. Management intentions to liquidate or cease operation
2. Loss of key management without replacement
3. Loss of a major markets, key customers, license, or principles suppliers
4. Labour difficulties

-
5. Shortage of important supplies
 6. Emergence of a highly successful competitor

b) Audit procedures that the auditor could apply in performing going concern review

1. Analyze and discuss cash flows, profit, and other relevant forecasts with management
2. Analyze and discuss the entity's latest available interim financial statements.
3. Review the terms of debentures and loan agreements
4. Read minutes of meetings of shareholders and board of directors.
5. Enquire of the entity's lawyer regarding litigation and claims.
6. Assess the financial ability of such parties to provide additional funds
7. Review event after the period end for items affecting the entity's ability to continue as a going concern

(25 marks)



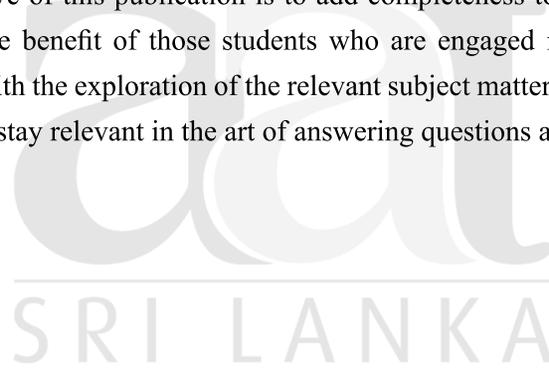
End of Section C

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