



Association of Accounting Technicians of Sri Lanka

January 2017 Examination - AA3 Level

**Questions and Suggested Answers
(AA34)**

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

Association of Accounting Technicians of Sri Lanka
No. 540, Ven. Muruththettuve Ananda Nahimi Mawatha,
Narahenpita, Colombo 05.

Tel : 011-2-559 669

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

AA3 Examination - January 2017
(AA34) Processes, Controls and Audit

SUGGESTED ANSWERS

SECTION – A

Four (04) compulsory questions
(Totak 20 marks)

Suggested Answers to Question One:

- Economic factors affecting the business of Uniweb Lanka (Pvt) Ltd.
 1. Interest rates
 2. Inflation
 3. Foreign exchange rates
 4. Unemployment
 5. Economic Development
 6. Political polices
 7. Tax polices

- Technological factors affecting the business of Uniweb Lanka (Pvt) Ltd.
 1. Product innovation
 2. Technological Advances
 3. Rapid change production process

(05 marks)

Suggested Answers to Question Two:

(A) EMobile (Pvt) Ltd may be affect flowing internal risks

1. Risk in operation – failure in company operation
2. Fraud Risk – possible losses due to fraudulent activity of employee or external parties
3. Reputation Risk - loss of goodwill
4. Compliance Risk - failure to comply company regulatn in companion

(03 marks)

(B) EMobile (Pvt) Lt may use flowing types of techniques to mitigate the risks

1. Risk avoidance
2. Risk reduction
3. Risk transfer
4. Risk acceptance

(02 marks)

(Total 05 marks)

Suggested Answers to Question Three:

(A) Audit partner should communicate to the members of the audit team flowing matters under the direction

1. Audit team member’s responsibilities
2. Objectives of the work performed
3. The nature of the entities business
4. Arrears that require special attention
5. Problems that audit team members may face
6. Detailed approach to the audit engagement

(03 marks)

(B) Functions under the supervision when conducting an audit

1. Tracking the progress of the audit engagement
2. Consideration of capabilities of individual members of the audit team
3. Addressing issues audit approach
4. Identifying matters for consultation or consideration by more experienced member’s of the audit engagement

(02 marks)

(Total 05 marks)

Suggested Answers to Question Four:

- (A) Control Environment is the set of standards, processes, and structures that provide the basis for carrying out internal control across the organization.

Alternative Answer

Control Environment means the culture of the organization and its attitudes to risk.

Risk awareness culture should be created by the leader of an organization

(02 marks)

- (B) Types of internal control included in the control activities

1. Segregating of duties
2. Physical controls
3. Authorizing and approval
4. Management controls
5. Supervising Controls
6. Organization controls
7. Personnel controls

(03 marks)

(Total 05 marks)



End of Section A

**Three (03) compulsory questions
(Total 30 marks)**

Suggested Answers to Question Five:

(A) fundamental principles applicable for the members of AAT Sri Lanka

1. Integrity
2. Objectivity
3. Professional competence
4. Due care
5. Confidentiality
6. Professional behavior

(04 marks)

(B)

(a) Self-interest threat – The threat that a financial or other interest will inappropriately influence the professional accountant’s judgment or behaviour.

Examples

1. A member of the assurance team having a direct financial interest in the assurance client.
2. A firm having undue dependence on total fees from a client.
3. A member of the assurance team having a significant close business relationship with an assurance client.
4. A firm being concerned about the possibility of losing a significant client

(b) Advocacy threat – arise in those situation where audit firm promotes a position or opinion to the point that subsequent objectivity is compromised

Examples

1. The firm promoting shares in an audit client.
2. A professional accountant acting as an advocate on behalf of an audit client in litigation or disputes with third parties

(c) Familiarity threat – The threat that due to a long or close relationship with a client or employer, a professional accountant will be too sympathetic to their interests or too accepting of their work.

Examples

1. A member of the engagement team having a close or immediate family member who is a director or officer of the client.
2. A member of the engagement team having a close or immediate family member who is an employee of the client who is in a position to exert significant influence over the subject matter of the engagement.
4. director or officer of the client or an employee in a position to exert significant influence over the subject matter of the engagement having recently served as the engagement partner.
5. A professional accountant accepting gifts or preferential treatment from a client, unless the value is trivial or inconsequential.

(06 marks)

(Total 10 marks)

Suggested Answers to Question six:

- (A) Assessment of the impact of the issue described above to the auditor's report of Latest Fashions (Pvt) Ltd. for the year ended 31st December 2016.

In this case, inventory valued at cost. However, NRV value is lower than the cost. This does not meet the valuation under LKAS -02 Inventory. LKAS -02 - **Inventories require inventories/stock to be included at the lower of cost and net realizable value.** It may therefore be necessary to reduce the inventory/stock figure to reflect net realizable value. This is contrary to LKAS -02, the error is material as it represents 30 mn (50mn-20mn) and hence management should adjust the financial statements. If management refuses to amend this error, then the audit report will need to be modified.

As management has not complied with LKAS 02 and the error is material but not pervasive, then a **qualified opinion** would be necessary. A basis for qualified opinion paragraph would be needed and would explain the material misstatement in relation to the incorrect treatment of inventory valuation and the effect on the financial statements. The opinion paragraph would be qualified 'except for'. When the auditor expresses his opinion on the Financial Statements of the company, the auditor should state in the opinion paragraph that, in the auditor's opinion, except the effects of the matters described on the basis for Qualified opinion paragraph, the financial statements present fairly in all material respects in accordance with the applicable reporting framework.

(04 marks)

(B) Modified audit reports are issued when:

- The auditor concludes that, based on the evidence obtained the financial statements as a whole are not free from material misstatement; or
- The auditor is unable to obtain sufficient appropriate audit evidence to conclude that the financial statements as a whole are free from material misstatements.

Modification to the auditor's report has an impact to the audit opinion.

Eg:- A circumstance when the auditor has been appointed after the year end and as a result of that auditor is unable to observe the physical inventory verification of the company.

Entity's financial records have been destroyed.

Auditor includes an emphasis of matter paragraph in the audit report when the auditor decides that users of the financial statements should pay attention to a specific matter appropriately or presented in the financial statements, that in the auditor's judgement, the particular matter is fundamental to users' understanding of the financial statements. The inclusion of Emphasis of matter paragraph in the auditor's report does not affect the auditor's opinion.

Eg:- Existence of an uncertainty relating to a future outcome of an exceptional litigation.

(06 marks)

(Total 10 marks)

Suggested Answers to Question seven:

The key elements of the assurance engagement

1. **Three party relationship**

The three parties are:

- The intended user of the information
- The practitioner
- The person providing information (the responsible party)

2. **Subject matter**

This is the data to be attested. It has been prepared by the responsible party. It can take many forms including

- Financial statements (historical financial information)
- Non- financial information (key performance indicators)
- Processes (internal controls)
- Behaviors (compliance with laws and regulations)

3. **Suitable criteria**

The subject matter is evaluated or measured against criteria (standard or any benchmark) in order to reach an opinion. These criteria will depend on the nature of the subject matter.

4. **Evidence**

Sufficient appropriate evidence needs to be gathered to support the required level of assurance

5. **Assurance report/ conclusion**

The practitioner presents his conclusion or opinion in an assurance report to the intended user.

(10 marks)



End of Section B

Two (02) compulsory questions
(Total 50 marks)

Suggested Answers to Question Eight:

(A)

(a) Internal control weaknesses in the payroll system

1. Punch card wiping process is not supervised by any officer
2. New appointments of the company are done by the HR department and employees are entered in the payroll by HR executive
3. Overtime payments are calculated by payroll system
4. Attendance bonus entered by payroll clerk to the payroll
5. Payroll clerk paid salary to employee in cash and acknowledgement is not obtained from employee

(04 marks)

(b) Recommendation

1. This process should be supervised by a responsible officer to prevent one individual swiping for multiple employees.
2. New employees should be entered into the payroll by the payroll clerk when an authorized staff appointment form is received from HR department.
3. All OT should be authorized by a responsible officer prior to the payment.
4. Once the clerk enters the data, all entries should be double checked against the amounts decided by the production supervisors.
5. Payroll clerk should obtain acknowledgements to confirm the payments to correct employees.

(04 marks)

(c) The main risks in the payroll process are followings

The system is being at risk by a virus or some other fault or breakdown which spreads across the system.

1. The system is being invaded by an unauthorized user who could then
 - Affect the smooth operation of the system
 - Obtain commercially sensitive information
 - Due to a virus or some other fault or breakdown.

(02 marks)

(d) (i) **General Controls;**

- Password protection for the module. So that access is limited to computer operations staff.
- Physical security over remote terminals.
- Virus checks on software, use of anti-virus software.
- Backup copies of programs being taken and stored in other locations.
- Training of staff in new software.

(03 marks)

(d) (ii)

- Controls over input completeness
 - Manual and programmed agreement of control totals
 - Document count
 - One- for-one checking of processed output to source documents
- Controls over input accuracy
 - Programs to check data fields (for example value, reference number, date) on input transaction for plausibility
 - Digit verification
 - Reasonableness test
 - Existence test
- Controls over input authorization
 - Manual check to ensure information input is authorized
 - Input by authorized personnel
- Controls over processing
- Controls to ensure continuity of operation

(02 marks)

(B)

(a) Additional Audit procedure

Trade Debtors

1. Debtors confirmation
2. Checking good dispatch notes, invoices and customer acknowledgment
3. Obtained direct conformation

Property plant and Equipment

1. Physical verification of PPE
2. Check the ownership of the assets with the relevant original supporting documents such as deeds.
3. Check whether all the additions are authorized by the relevant officials
4. Confirming accounting policy is consistent and reasonable

Bank Loan

1. Inspection of Legal validity of an agreement
2. Loan balance confirmation from bank
3. Checking of bank loan settlement and interest payment amount and presentation in financial statement.

(06 marks)

(b) Identification of Analytical procedures

Trade Debtors

	2016	2015
	Rs.	Rs.
Sales	1,005,630	700,250
Debtors	209,500	116,700

Comparison with the previous year $(92,800 / 116,700) \times 100 = 79\%$

Debtors Collection Period	$209,500/1,005,630 \times 365$	$116,700/700,250 \times 365$
	76.04	60.83
	76 Days	61 Days

Debtors collection period has increased significantly when compared with 2015, It should pay attention to this area since five debtors are available at the end of 31.04.2016 from these 5 debtors, one debtors has been recognized as bad debts.

Gross Profit

	2016	2015
	Rs.	Rs.
Sales	1,005,630	700,250
Gross Profit	452,630	343,130
Gross Profit Margin	$452630/1005630 \times 100$	$343130/700250 \times 100$
	45%	49%

Gross profit margin has slightly decreased in 2016 with comparing 2015. Even though increased sales value , but cost of sales have increased more than the rate increased in sales. It should pay attention the reason for this.

(02 marks)

(c) **Assertions**

1. Existence
2. Rights and obligations
3. Completeness
4. Valuation and allocation

(02 marks)

(Total 25 marks)

Suggested Answers to Question Nine:

- (A) (a) Audit risk is the risk that the auditor expresses an inappropriate audit opinion when the financial statements are materially misstated.

It is function of the risk of material misstatement and the risk that the auditor will not detect such misstatement.

(02 marks)

- (b) Areas that you need to obtain an understanding about ADP and its environment.

1. Industry, regulatory and other external factors, including the applicable financial reporting framework
2. Nature of the entity and its accounting policies
3. Objectives and strategies and related business risks
4. Measurement and review of the entity's financial performance
5. Internal control

(03 marks)

- (c) Areas that indicate significant risk to be addressed when performing the audit of ADP.

Significant risk is those that require special audit consideration.

The following factors indicate that a risk might significant

1. Both collecting milk from famers and payments to those famers done by one person (Account executive). - There may be Risk of fraud.
2. 3 times Changes of accountant during the year and present accountant is not professionally qualified – Since company has 3 subsidiaries, there may have complex transaction that require professional knowledge. Therefore, financial statement may have material misstatements.
3. Demand for the products of ADP is declining due to new competitor called “Treemo” has emerged in the industry of ADP. Treemo has made a large investment in advertising and promotions and captured a significant market share.
4. There is significant transaction with a related party- it is identified that significant amount of inter-company sales have been made closer to the year end.
5. several significant amounts have been paid to a lawyer – Those are unusual transactions. The company may be having legal cases for which there may be unidentified liabilities.

(08 marks)

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- (d) Types of information that you might include in the permanent audit file of ADP.
1. Legal status of the entity organization structure
 2. Important legal documents
 3. Industry, regulatory details within which entity operates
 4. Certificate of incorporation articles of association
 5. Statutory requirements to be complied by the entity
 6. Entity's information system and internal control system documentation
 7. Complete list of books and records maintained by the company
 8. Copies of, and extracts from, important agreement that will be of relevance form year to year
 9. Details of major fixed assets such as property

(02 marks)

(B)

- (a)
1. Evaluate the professional competence of the expert.
 2. Check the relevance and reasonableness of the value determined by the valuer.
 3. If the valuation involves significant assumptions, auditor should check the relevance and reasonableness of those assumptions.
 4. If valuer's work involves use of source data, the relevance, completeness and accuracy of that source data should be checked.

(04 marks)

- (b) "A written representation by management"

A written representation is a (written) statement by management provided to the auditor to confirm certain matters or to support other audit evidence.

(02 marks)

- (c) Written representations are more reliable than oral representations, since oral representations can be retracted. However, although written representations are a form of audit evidence, they do have their limitations. They are from an internal source and on their own they do not provide sufficient appropriate audit evidence about the issues they relate to. Information from third party source is stronger evidence than that gained from within the entity.

(04 marks)

(Total 25 marks)

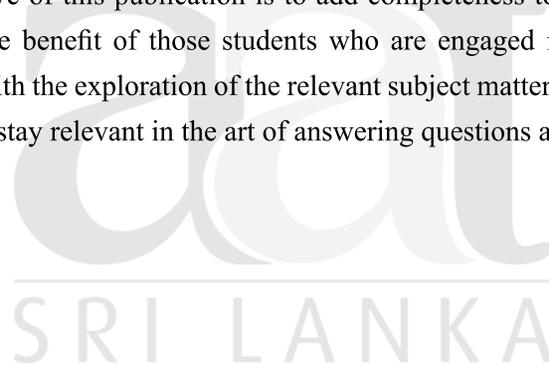
End of Section C

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