



Association of Accounting Technicians of Sri Lanka

AA3 Examination - January 2019

**Questions and Suggested Answers
(AA34)**

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

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THE ASSOCIATION OF ACCOUNTING TECHNICIANS OF SRI LANKA

EDUCATION AND TRAINING DIVISION

**AA3 Examination - January 2019
(AA34) Processes, Controls and Audit**

SUGGESTED ANSWERS

SECTION – A

Four (04) compulsory questions

(Total 20 marks)

Suggested Answers to Question One:

Chapter 01 - Business Environment

- a)
- | | |
|-------------------------|-------------------------------|
| 1. Technological Forces | 2. Social and Cultural Forces |
| 3. Economical Forces | 4. Political Forces |
| 5. Legal Forces | |

(02 marks)

b) 1. **Technological Factors**

The business is affected by rapid change in development process, new software innovation and technical advancement, such as expansion of internet trends on online shopping and e-banking.

2. **Social and Cultural Forces**

This include the values, believes and behaviours of users and communities which affect the business such as level of education, increase in elderly population, life style etc...

3. **Economical Forces**

The aspects of economy that affects businesses are inflation, foreign exchange rate, interest rates, tax rates on technological industry, demand and supply factors unemployment global economic factors etc...

4. **Political Forces**

These forces describe how and to what extent the government of the country affects the business. This includes factors such as political stability, government policies, tax policies, price regulations, tariffs etc...

5. **Legal Factors**

These include regulation framework of a country such as consumer law, labour law, environmental law, health and safety law, Accounting and Auditing Standards Act, EPF Act etc...

(03 marks)

(Total 05 marks)

Suggested Answers to Question two:

Chapter 05 - Audit Process

1. **Existence:**

Samanthi needs to ensure the PPE belongs to the company are physically in existing for the verification.

2. **Rights and Obligations:**

The entity holds or controls the right to assets and liabilities are the obligations of the company.

3. **Completeness:**

Whether all PPE that should have been recorded have been recorded completely.

4. **Valuation and Allocation:**

PPE included in the financial statements at appropriate amounts and any resulting valuation or allocation adjustments are appropriately recorded.

(05 marks)

Suggested Answers to Question three:

Chapter 09 - Ethical Requirements Affecting an Audit of Financial Statements

a) **Provisions relating to auditor appointment and removal:**

1. Director or employee of the company.
2. A person who is a partner of or in the employment of a director or employee of the company.
3. A liquidator or an administrator or a person who is a receiver in respect of the property of the company.
4. A body corporate.
5. A person who holds any office referred to at (1), (2) or (3) above may not be appointed to act as auditor of a company for a period of 2 years after such person has ceased to hold that office.
6. A person referred to at (1), (2) or (3) above may not be appointed or act as auditor of a related company.

(02 marks)

b) **Acceptance Procedures:**

1. **Ensure professionally qualified to act.**
Consider whether they could be disqualified on legal or ethical grounds.
2. **Ensure existing resources are adequate.**
Consider available time, staff and technical expertise.

3. **Obtain references.**

Make independent enquiries if directors are not personally known.

4. **Communicate with present auditors**

Enquire whether there are reasons / circumstances behind the change which the new auditors ought to know, also as a courtesy.

(03 marks)

(Total 05 marks)

Suggested Answers to Question four:

a)

Chapter 05 - Audit Process

Misappropriation of Assets

Misappropriation of assets means theft to an entity's (eg. Cash, inventory) employees may be involved in such frauds in small and immaterial amounts. However, it can involve management who are usually more capable of disguising or concealing misappropriations in ways that are difficult to detect.

(02 marks)

Chapter 05 - Audit Process

b) **Conditions / Events which increase the risk of Fraud or Error:**

1. Management is dominated by person (MD) and there is no effective oversight board of directors.
2. Dominating person (managing director) is in a position of trust.
3. Failure to correct major weakness in internal controls.
4. Inadequate documentation / record of transactions (proper books of accounts)
5. Evasive or unreasonable responses by management to audit inquiries.

(03 marks)

(Total 05 marks)

End of Section A

Three (03) compulsory questions
(Total 30 marks)

Suggested Answers to Question Five:

Chapter 04 - Assurance Engagements and Related Services

(a) **Assurance Engagement and Related Services:**

Assurance Engagement is an engagement in which a **practitioner** express an opinion or conclusion designed to enhance the degree of confidence of the **intended users** other than the **responsible party** about the outcome of the evaluation of a **subject matter** against **certain criteria**. (03 marks)

(b)

Chapter 04 - Assurance Engagements and Related Services

Exs. for Assurance Engagements:

1. Statutory Audit
2. Assurance about Special Purpose Financial Statements
3. Assurance over adequacy of internal controls
4. Assurance over Environmental matters
5. Assurance over Regulatory Compliance (03 marks)

(c) The financial forecast relates to **future information**. Therefore it is not possible for the auditor to express **reasonable assurance on the future information**. Therefore, a **limited assurance engagement** would be performed. (04 marks)

(Total 10 marks)

Suggested Answers to Question Six:

Chapter 06 - Audit Evidence

(A)

a) **Types of Procedures:**

	Inspection		Observation
1	Examination of records, documents or assets	1	Looking at a procedure or process being performed by others.
2	Auditor is substantiating information that is or should be in the financial statements	2	It only confirms the way the procedure is taking place when auditor was watching.
	Eg.: Inspection of a bank statement, loan agreement, title deed etc...		Eg.: Observing physical stock verification, internal controls

(04 marks)

b)

Chapter 06 - Audit Evidence

Audit Procedures for Bank Reconciliation Statements:

1. Inspect cash control account (cash book) and agree “cash at bank balance” in bank reconciliations statement to cash book balance as at 31st March 2018.
2. Inspect bank statements and agree “cash at bank as per bank statement” in bank reconciliation statement to bank statement balance as at 31st March 2018.
3. Check arithmetic accuracy of bank reconciliation statement.
4. Check whether bank reconciliations are approved by a responsible official.
5. Test unpresented cheques and unrealized deposits by inspecting the bank statement(s) of subsequent period. *(03 marks)*

- (B)**
1. Agree the opening balance to prepaid expenses account as at 1st January 2018 to the previous years working papers and the financial statements.
 2. Inspect the rent agreement to identify the rent applicable for the period.
 3. Agree the amount paid with the bank statements, payment vouchers.
 4. Re-compute the rent expenses with reference to the rent agreement amount, considering the opening balance and agree the rent expenses charged and recorded in the income statement and prepaid expenses as at 31st December 2018. *(03 marks)*

(Total 10 marks)

Suggested Answers to Question Seven:

Chapter 07 - Further Considerations

(a)

External Confirmation:

- (i)
 1. Bank balances and other information from banks.
 2. Accounts receivable balances from the debtors.
 3. Stock held by third parties at bonded warehouse for processing or on consignment.
 4. Property title deeds held by lawyers or financiers for safe custody or as security.
 5. Investments purchased from stock brokers but not delivered at the balance sheet date.
 6. Loans from lenders.
 7. Accounts payable balances from creditors. *(03 marks)*

(ii)

Chapter 07 - Further Considerations

1. Inquire the reasons for refusal and seek audit evidence as to their validity and reasonableness.

2. Evaluate the implications of management's refusal on the risk of fraud and on the nature, timing and extent of other audit procedures.
3. Perform alternative audit procedures designed to obtain relevant and reliable audit evidence.

(04 marks)

Chapter 05 - Audit Process

(b) Agreeing the terms of the audit engagement:

1. The objective and scope of the audit.
2. The auditor's responsibilities.
3. Management's responsibilities.
4. Identification of the applicable financial reporting framework for the preparation of the financial statements.
5. Reference to the expected form and content of any reports to be issued by the auditor
6. Elaboration of scope of auditor.
7. Arrangements regarding planning and performance including audit team composition.
8. Expectation that management will provide written representations.
9. Fees and billing arrangements.
10. Involvement of other auditors, experts and internal auditors.
11. Arrangements to be made with predecessor auditor.
12. Elaboration of scope of audit.
13. The fact that due to the inherent limitations of an audit and those of internal control, there is an unavoidable risk that some material misstatements may not be detected, even though the audit is properly planned and performed in accordance with SLAUSs.
14. Any restriction of the auditor's liability when such possibility exists
15. A reference to any further agreements between the auditor and the entity.
16. Agreement of management to provide draft financial statements and other information in time to allow auditor to complete the audit in accordance with proposed time table.
17. Agreement of management to inform auditor of facts that may effect the financial statements, of which management may become aware from the date of the auditor's report to the date of issue of the financial statements.
18. Any obligations to provide audit working papers.

(03 marks)

(Total 10 marks)

End of Section B

Two (02) compulsory questions
(Total 50 marks)

Suggested Answers to Question Eight:

Chapter 02 - Governance, Risk and Compliance

(A) 1. **Risk assessment**

- Identify risks to the organization, both external and internal
- Analyze the risks, to establish their potential effect on the organization and achievement of the organization's objectives.
- Risk evaluation. Decide which risks are more significant than others, and identify those which should be treated or managed, to keep the risk within acceptable limits.

2. **Risk response : risk treatment**

- For each significant risk, decide the most appropriate way of managing the risk
- Implement risk treatment measures

3. **Monitor and review**

- Monitor the risk management system regularly, to check whether the treatment of risks is effective

(06 marks)

(B)

Chapter 03 - Key Business Processes of an Organization

- a) This refers to the assessment of the quality of internal control. Monitoring activities provide information about potential and actual breakdowns in control system that could make it difficult for an organization to accomplish its goals. Responsibility of monitoring internal controls rest with the board of directors of the company.

Management's monitoring of controls include considering whether they are operating as intended and they are modified as appropriate for changes in conditions.

(03 marks)

(B) (b)

Chapter 03 - Business Process and Internal Controls

(b & c)

(b) Strengths	(c) Objective
Use of the staff requisition form by the relevant department head in recruiting staff / employees	This will prevent unnecessary staff recruitment.
GM approves the staff requirements in weekly HR meetings	This will prevent unnecessary staff recruitment create proper placement of staff positions
In and out time of employees are monitored through the details obtained from finger print machines	This will provide a proper records on overtime and hours of work which have an impact in making the payments.
The company has a formal recruitment process of advertising and conducting interviews etc...	This will ensure that most suitable people are recruited.
Department supervisors and the relevant department head approves the overtime work requirements	This will minimize employees doing unnecessary overtime work.
All employees are paid by bank transfers including salary advances	This will ensure that salaries are paid only to the relevant staff. Further, it will have a proper record about the payments.
Accountant and head of finance approve the payroll	Ensures the accuracy of payroll calculation.
Regular internal audits on payroll	Ensures the accuracy of payroll calculation. Further, this will ensure that the system of staff recruitment placement and the payroll process works as expected.
<i>(05 marks)</i>	<i>(05 marks)</i>

(Total 10 marks)

(B) (c)

Chapter 03 - Business Process and Internal Controls

(a)

GENERAL CONTROL	EXAMPLE
Development of Computer Application	<ul style="list-style-type: none">- Standards over systems design, programming and documentation.- Approval by computer users and management.- Segregation of duties so that those responsible for design are not responsible for testing.- Training of staff in new procedures and availability of adequate documentation.
Prevention or detection of unauthorized changes to programs	<ul style="list-style-type: none">- Segregation of duties- Password protection of programs so that access is limited to computer operations staff- Restricted access to central computer by locked doors, keypads- Virus checks on software. Use of anti- virus software and policy prohibiting use of non-authorized programs or files.- Back-up copies of programs being taken and stored in other locations.
Testing and documentation of programme changes	<ul style="list-style-type: none">- Complete testing procedures- Documentation standards- Approval of changes by computer users and management- Training of staff using programme
Controls to prevent unauthorized amendments to data files	<ul style="list-style-type: none">- Physical security over remote terminals- Limited access to authorized personnel only- Firewalls- User identification controls such as passwords- Encryption of data
Controls to ensure continuity of operation	<ul style="list-style-type: none">- Storing extra copies of programs and data files off-site.- Protection of equipment against fire and other hazards.- Back-up power sources.- Disaster recovery Procedures – Availability of backup facilities.- Maintenance agreements and insurance.

(03 marks)

(b)

Chapter 03 - Business Process and Internal Controls

APPLICATION CONTROL	EXAMPLE
Controls over input completeness	<ul style="list-style-type: none">- Manual and programmed agreement of control totals.- Document count.- One-for-one checking of processed output to source documents.- Programmed matching of input to an expected input controls file.- Procedures over resubmission of rejected items.
Controls over input accuracy	<ul style="list-style-type: none">- Programs to check data fields (for example value, reference number, date) on input transactions for plausibility.- Digit verification
	<ul style="list-style-type: none">• Reasonableness test• Existence test
	<ul style="list-style-type: none">• Character checks• Necessary information• Permitted range- Manual scrutiny of output and reconciliation to source- Agreement of control totals
Controls over input authorisation	<ul style="list-style-type: none">- Manual checks to ensure information input is authorized- Input by authorized personnel
Controls over processing	<ul style="list-style-type: none">- Similar controls to input must be in place when input is completed, for example, batch reconciliations- Screen warnings can prevent people logging out before processing is complete
Controls over master files and standing data	<ul style="list-style-type: none">- One-to-one checking- Cyclical reviews of all master files and standing data- Record counts (Number of documentation processed) and hash totals (for example, the total of all the payroll numbers) used when master files are used to ensure no deletions- Controls over the deletion of accounts that have no current balance.

(03 marks)

(Total 25 marks)

Suggested Answers to Question Nine:

Chapter 08 - Audit Reporting

- A) a)
1. Whether sufficient appropriate audit evidence has been obtained.
 2. Whether identified uncorrected misstatements are material to the financial statements.
 3. Whether financial statements have been prepared in accordance with applicable financial reporting framework.
 4. Whether accounting policies selected and applied are consistent with the applicable financial reporting framework.
 5. Whether financial statements adequately disclose the significant policies selected and applied.
 6. Whether the accounting estimates made by management are reasonable.
 7. Whether the information presented in the financial statements is relevant, reliable, comparable and understandable.
 8. Whether the financial statements provide adequate disclosures to enable the intended users to understand the effect of material transactions and events on the information conveyed in the financial statements.
 9. Whether the terminology used in the financial statements including the title of each financial statement is appropriate.
 10. Whether the overall presentation, structure and content of the financial statements is satisfactory.
 11. Whether the financial statements including the related notes represent the underlying transactions and events in a manner that achieve fair presentation.

(05 marks)

(A) b)

Chapter 08 - Audit Reporting

A major catastrophe (i.e. fire) has taken place and has destroyed Mr. Mendis's shoes shop. This should have a significant effect on the continuity of business operations of the company. Therefore, it is necessary to draw users' attention to this matter because in the auditor's judgment, it is important that it is fundamental to users' understanding of the financial statements.

Accordingly, the auditor should include an Emphasis of matter paragraph describing the matter and providing the reference to the financial statements where management has disclosed this incident and its effect and the plan.

(05 marks)

(B)

Chapter 09 - Ethical Requirements Affecting an Audit of Financial Statements

(B) (a) **Self-interest Threat**

The threat that a financial or other interest will inappropriately influence the professional accountant's judgement or behaviour. Self interest threats may arise as a result of the financial or other interests of members or of immediate or close family.

Examples:

- A member of the assurance team having a direct financial interest in the assurance client.
- A firm having undue dependence on total fees from a client.
- A member of the assurance team having a significant close business relationship with an assurance client.
- A member of the audit team entering into employment negotiations with the audit client.

(B) (b) **Self-review Threat**

Self review threats arise when a member reviews his or her own work or advice as part of an assurance engagement.

Examples:

- A firm issuing an assurance report on the effectiveness of the operation of financial systems after designing or implementing the systems.
- A member of the assurance team being, or having recently been, a director or officer of the client.

(B) (c) **Advocacy Threat**

Advocacy threats arise in those situations where the audit firm promotes a position or opinion to the point that subsequent objectivity is compromised.

Examples:

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

(06 marks)

Chapter 09 - Ethical requirements affecting an audit of Financial Statements

- (C) a)
1. Establish the fundamental principle. In the above, key principle would be objectivity. (Independence)
 2. Identify threats to compliance with the fundamental principle. In the above case there is a threat of self-review.
 3. Evaluate significance of the threats identified. Threats are significant as there are no applicable safeguards.
 4. Apply safeguards where necessary to eliminate threat. If the safeguards will not eliminate or reduce the threats, the engagement shall not be accepted.

(04 marks)

Chapter 10 - Audit Quality

(C) (b) **Acceptance and continuance of client relationships**

A firm should only accept, or continue with, a client where,

- It has considered the integrity of the client and does not have information that the client lacks integrity
- It is competent to perform the engagement and has the required capabilities, including time and resources
- It can comply with ethical requirements including appropriate independence from the client

Policies and procedures to be considered when accepting and continuing the client relationship;

- (*) The firm to obtain such information as it considers necessary in the circumstances before accepting an engagement with a new client, when deciding whether to continue an existing engagement, and when considering acceptance of a new engagement with an existing client.
- (*) If a potential conflict of interest is identified in accepting an engagement from a new or an existing client, the firm to determine whether it is appropriate to accept the engagement.
- (*) If issues have been identified, and the firm decides to accept or continue the client relationship or a specific engagement, the firm has to document how the issues were resolved.

(05 marks)

(Total 25 marks)

End of Section C

Notice :

These answers compiled and issued by the Education and Training Division of AAT Sri Lanka constitute part and parcel of study material for AAT students.

These should be understood as Suggested Answers to question set at AAT Examinations and should not be construed as the “Only” answers, or, for that matter even as “Model Answers”.

The fundamental objective of this publication is to add completeness to its series of study texts, designs especially for the benefit of those students who are engaged in self-studies. These are intended to assist them with the exploration of the relevant subject matter and further enhance their understanding as well as stay relevant in the art of answering questions at examination level.

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