

Examiner's Report

AA3 EXAMINATION - JANUARY 2017

(AA34) PROCESSES, CONTROLS AND AUDIT

General Comments

Processes, Controls, and Audit (AA34) included nine (9) compulsory questions based on the study text. There were three (3) sections; **Section A** contained four (4) compulsory questions carrying five (5) marks each, **Section B** contained three (3) compulsory questions carrying ten (10) marks each, and **Section C** contained two (2) compulsory questions carrying twenty-five (25) marks each.

The entire questions paper was based on the study text and have tested the theoretical knowledge of the candidates and its application in a practical environment. If candidates have thoroughly gone through the study text and have done past paper questions of its application in a practical environment, and easily could have reached pass marks for this paper.

Performance of the candidates were at a fairly satisfactory level. There were significant number of candidates who have secured high marks and which indicated the fact that those candidates have studied and understood the theoretical knowledge given in the study text and its application in a real auditing and business environment. Further, there were considerable number of candidates obtained low marks. I believe, based on their answers, they have not studied the study text, and not done past paper questions. If they have done so, they would have easily gained more than 50 marks.

Majority of candidates have attempted and answered all questions in the paper, however, I noted that there were some parts of the questions not answered. I believe those unanswered questions were not done mainly due to poor time management, lack of knowledge, or poor examination techniques etc. Apart from the above, the following general observations were noted during the marking process:

- Lack of analytical skills.
- Illegible hand writing.
- Writing short answers where high marks were available.
- Writing lengthy answers where low marks were available.
- Identified the issues in the case, however, not given answers in line with the questions.
- Not planning the answers and ending up with providing irrelevant answers.
- Not following the "**Action Verb**" given at the end of the question paper.

Section A

Four (04) Compulsory Questions

Question No. 01 (Marks Allocated 05)

This question tested three (3) Economic Factors and two (2) Technological Factors related to the company engaged in developing software program for corporate customers operating overseas.

Performance for this question was satisfactory. There were significant number of candidates who have obtained full marks for the question. However, there were several irrelevant answers given by candidates such as advantages and disadvantage of having local and foreign IT businesses, factors to be considered in setting up an IT business, various developments in IT industries and the countries that are applying such developments etc.

Question No. 02 (Marks Allocated 05)

This question consisted of two parts. Part A tested the knowledge of three (3) Internal risks affecting the business of selling mobile phones, and the Part B tested the two (2) type of techniques to mitigate the above Risk.

Overall Performance for this question was not satisfactory, and majority of candidates were able to secure lesser marks for both parts. A very few candidates were able to obtain full marks for this question. There were a lot of irrelevant answers for Part A such as profitability, management, brand differentiation, going concern of the company, and wrong management decisions, etc. For Part B, there were irrelevant answers such as control environment, production control, Internal controls, setting up CCTV cameras, employing security guards, satisfy employees, have proper business plans, have proper IT control Systems etc. for which no marks were awarded.

Question No. 03 (Marks Allocated 05)

There were two parts consisted in this question.

Part A tested the knowledge of the candidates regarding the three (3) matters that the audit partner should communicate to the members of the audit team under the direction.

Part B tested the candidates' knowledge regarding the two (2) functions included under the supervision by a partner when conducting an audit.

Overall performance was at an average level. Significant number of candidates were able to secure high marks for Part A, however, they got low marks for Part B. There were irrelevant answers for Part A such as how to express an audit opinion, type of audit opinion, limitation of audit, terms and conditions of engagement letters, time limits of the audit engagements, management responsibility, auditor build up confidentiality etc. Under Part B also there were number of irrelevant answers. Some candidates have understood audit supervision as audit quality control, and have written quality control measures in their answers.

Question No. 04 (Marks Allocates 05)

The question consisted two parts, Part A, tested the meaning of “Control Environment”, Part B, tested the knowledge of three (3) types of internal controls included in “Control Activities”.

The performance for this question was very poor. A very few candidates were able to get full marks and significant number of candidates were not able to obtain marks for this questions. There were number of irrelevant answers, under Part A, most of candidates have written control environment as group of people appointed by the management, environment related to the auditors and it consists of audit procedures and documentation, some other candidates given their answer as the control environments consists of internal and external controls. Under Part B, irrelevant answers, such as Internal controls related to sales, debtors, purchases, creditors & stocks, were given. Some of the candidates have understood the question requirement as categories of internal control and included operation, financial, compliance in their answers.

Section B

Three (03) Compulsory Questions

Question No. 05 (Marks Allocated 10)

This question is based on the areas of Code of Ethics issued by the Association of Accounting Technicians of Sri Lanka (AAT Sri Lanka). This question consisted of two parts.

Part A tested the knowledge of Four (4) Fundamental Principles applicable for the members of AAT Sri Lanka. Majority of the candidates were able to get full marks and performance of the candidates were fairly satisfactory. However, there were candidates, who have misread the question and given highly irrelevant answers and for which no marks could be awarded. Some of the examples for irrelevant answers given were independent, reliability, completeness, correctness, giving an independent opinion, accountability, assurance, independent audit procedures etc.

Part B tested the knowledge of the threats to compliance with the Fundamental Principles of Self-Interest, Advocacy, and familiarity. Though, this was a very easy question, the performance for this question was at an average level. There were a few candidates who were able to secure high marks for the question, however, majority of candidates have misunderstood the concepts and have given highly irrelevant answers. Under self-Interest, irrelevant answers such as work according to its owned ideas, work according to AAT principles, giving wrong decision for his owned interest etc. was mentioned. Under advocacy threat, irrelevant answers such as work according to wrong advise, work according to advise given by higher officers & management and advise obtained from external parties, etc. were given. Under Familiarity threat, irrelevant answers such as carrying out audits without considering personal friendship, disclose information incorrectly, friendliness with AAT etc. were given.

Question No. 06 (Marks Allocated 10)

This question was based on the case study related to **Fashions (Pvt) Ltd.** engaged in retail business of ladies' wear and comprised of two parts.

From **Part A** of this question, the examiner tested the knowledge of the impact on the issues given in the case study to the "auditors' report" for the year ended 31st March 2016. Further, it was tested that as to how the candidate identify the relationship between the "audit materiality" and the issues given in the scenario, and accordingly, an impact to the auditors' report. However, the performance for this part of the question was at an average level. Most of the candidates have tried to identify the effect on auditor's report in each of the information given under (1) to (3) of the question, rather than giving the impact of the issue expected in the question. Further, a very few candidates were able to identify the relationship between the value of under provision for non-moving stock items and the audit materiality. Most of other candidates were not able to identify the issue. Thus, a significant number of candidates were ended up with providing number of irrelevant answers for which no marks could be awarded. Some of the irrelevant answers were:

- there were no proper control environment.
- there is a possibility of increasing profits.
- the company is managed by two shareholders.
- the apparel of old design can be sold at discounted price.
- the company may ending of incurring losses.
- giving a modifying or qualifying opinion rather than analyzing the impact of the audit opinion of the issue.

From Part B of the question, it was required to identify the difference between "a modified audit report" and audit report with "emphasis of matter paragraph" providing appropriate examples for each. This part of the question was very simple and performance was also at an average level. However, the performance was better than the part (A) of the question. A few candidates were able to get high marks for this question. Most of the candidates have identified the differences but have not given examples. Significant number of candidates have differentiated between modified audit reports and the qualified audit report, and some candidates have explained three types of modified audit reports in detail rather than differentiating from an audit report with emphasis of matter paragraph. Because of the above irrelevant answers, the candidates were not able to secure high marks for this part of the question.

Question No. 07 (Marks Allocated 10)

In this question, the examiner tested the knowledge of the candidates on key elements of "an assurance engagement". The performance for this question was at an average level and there were few candidates who could secure high marks and most of the candidates were able to obtain average marks for this question. Some candidates have identified components; however, they have not explained such components appropriately and those candidates were able to obtain less mark. Majority of the candidates were not able to understand the question and accordingly have given irrelevant answers such as discussing level of assurance engagements rather than explaining the key elements of the assurance engagement, and some have explained different approaches of gathering audit evidence such as vouching, observation, calculation, calling for confirmation, etc.

Section C

Two (02) compulsory questions only

Question No. 08 (Marks allocated 25)

Part A included four (4) sub questions and tested the candidates' knowledge on the following areas:

Under **Part (a)**, the examiner tested the candidates' knowledge on how the internal control weaknesses should be identified in a real business environment based on the case study given. A few candidates who have got analytical ability were able to secure high marks for this part of the question. Most of the candidates were lacking in applying the theory in to the real business environment and unable to secure marks. The performance for this part of the question was at an average level. The candidates without proper subject knowledge mentioned in their answers that "payment of Overtime (OT) twice a month as a weakness in an internal control", some candidates without understanding the meaning of attendance bonus, mentioned that "payment of attendance bonus based on attendance records is not correct and it is a weakness". Apart from the above, there were number of irrelevant answers such as:

- OT is calculated by the payroll systems.
- OT payments are based on attendance records.
- production supervisor decides the overtime rates.

Under **Part (b)**, it was required to give recommendations to overcome the internal control weaknesses identified under part (a) above. The candidates who were able to identify the internal control weaknesses, have given appropriate recommendations to overcome those weaknesses. There were candidates who have identified weaknesses appropriately, however, they have not provided recommendations in line with the weaknesses identified by them. The performance for this part of the question was at an average level. Majority of candidates, without having an appropriate subject knowledge, have given irrelevant answers as recommendations to overcome the weaknesses in the internal control system, such as:

- all employees to be entered into the payroll system by Human Resource (HR).
- enter payroll with an approval of the executive of HR.
- attendance bonus rates should be decided by HR manager.
- payroll should be maintained by HR executive.
- payment of salary should be made once a month to avoid cost and to save time.
- attendance bonus should be decided based on the performance, etc.

Under **Part (c)**, it was tested the risks associated in a computerized payroll system.

A few candidates who have subject knowledge and understood the question were able to get full marks for this question and overall performance for this question was at an average level. The candidates who have not understood the question have given number of irrelevant answers and for those answers no marks were given.

Examples for some of the irrelevant answers are:

- payment may have made to employees who have resigned from the company.
- establish a finger mark machine to record attendance.
- get signature from employees to certify that the salary was received.

Finally, from part (d), it was tested the knowledge of three (3) general controls and two (2) application controls to strengthen and protect information included and entered to the payroll system. This was a very simple question. The performance for this question was very poor and most of the candidates have mixed the “general controls” with “application controls” it is indicated that most of the candidates were not able to differentiate the above two concepts, and obtained no marks for this part of the question. For example, “password protection”, “physical security”, “virus checks on software” were given as application controls.

Part B included three sub questions based on the given case study.

Part (a) tested the knowledge of additional audit procedures to be performed to obtain sufficient and appropriate audit evidence on the given areas. The candidates’ knowledge on those areas were very poor and as a result, they were not able to secure adequate marks for this part of the question. However, there were only a handful of candidates who could secure high marks for this part. There were number of irrelevant answers for which most of the candidates were not able to obtain any marks. They were:

- checking the subsequent settlement which, as per the question, has already been checked.
- checking the title deed of the property, whereas the increase is pertaining to the machinery.
- Checking the loan agreement which, as per the question, has already been checked.

Part (b) of the question, tested the candidates’ knowledge on analytical procedure for trade debtors and gross profit based on the information provided in the financial statements of the case study. The performance for this part of the question was above the average and most of the candidates were able to secure full marks. However, there were candidates without proper subject knowledge instead of identifying analytical procedures, given irrelevant answers such as calling for confirmations, obtaining management representations, checking stock reports, checking sales, sales returns and bad debts etc.

Part (c) tested the knowledge of the candidates’ on assertions on the account balances given in the financial statements. This was a very simple question and most of the candidates were able to obtain full marks and overall performance for this part of the question was satisfactory. However, some candidates instead of naming the audit assertions for account balances at the period end financial statements such as completeness, rights and obligations, valuation and allocation, existence, they have written irrelevant answers such as cut off testing, third party confirmation, reconciliation to control accounts, etc.

Question No. 09 (Marks Allocated 25)

Part A included four (4) sub questions; 1 question from theory and 3 questions based on the given case study.

Part (a) tested the meaning of audit risk. Majority of the candidates were able to secure full marks for this part of the question and performance for this question was satisfactory. However, there were candidates, who do not have subject knowledge, have given irrelevant answers such as:

- the risk that affect the audit opinion.
- risk in obtaining sufficient appropriate audit evidence.
- audit risk is the risk in expressing an audit opinion about material misstatements.

Part (b) tested the knowledge on “understanding about the company and its environment”. Since this was a very simple question the candidates should have obtained full marks for this part of the question. There were considerable number of candidates who could secure full marks for this question. Overall performance was at an average level. Considerable number of candidates have provided irrelevant answers such as:

- inquire from company employees and previous year auditors to get an understanding about the company and its environment
- observation of company activities
- understanding about the milk market and suppliers, etc.

Part (c) tested, based on the case study given, knowledge of the candidates to identify significant risk areas to be addressed when performing the audit of that company. All risk areas that need to be provided in the answer are clearly given in the question, and what the candidates should have done was only to read the question carefully and understand the content of the question. Majority of the candidates were not able to understand the question and as a result, they were not able to obtain high marks for this part of the question. There were only handful of candidates able to secure full marks for this question. Overall performance for this question was fairly satisfactory.

Part (d) tested two types of information that might be included in the permanent audit file of that company. Majority of the candidates were able to provide with correct answer and secured full marks. Overall performance of this part of the question was satisfactory, and however, due to lack of knowledge of some of the candidates, they have given irrelevant answers such as: copy of fixed asset register, copy of audit plan, debtors / creditors / bank confirmation and bank statements, etc. as the information to be included in permanent file.

Part B included three (3) sub questions.

Part (a) tested the knowledge of the audit procedure to be performed in reviewing the land valuation. The candidates who have gone through the study texts were able to secure high marks. Majority of candidates have not given accurate answers. Thus, overall performance of this part of the question was very poor. It was asked to list the procedure for reviewing the land valuation. Majority of candidates were not able to provide the expected answer and instead, most of them have given irrelevant answers such as “checking the deed, checking the land balances, observing the valuation process, calculation of depreciation, compare the valuation of land with financial statements balance, estimate the extend of the land, etc.

Part (b) tested the meaning of a written representation by the management. This was a very simple question. Most of the candidates were able to secure high marks and overall performance of this part of the question was satisfactory. There were a few candidates who could not secure marks as they have given irrelevant answers such as:

- the management representation is a letter which confirm the management responsibility
- management representation is more reliable than third party evidence etc.

Part (c) tested the understanding of the quality and reliability of the management representation as an audit evidence. Only a very few candidates who have understood the question were able to secure full marks for this part of the question. Most of the candidates have written as:

- management representation is more reliable audit evidence than the third party evidence.
- the auditor should obtain management representation as audit evidence each and every possible time.
- some candidates mentioned the meaning and definition of management representation rather than discussing the quality and reliability of management representation as an audit evidence.

Overall performance for this part of the question was at an average level.

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Suggestions to enhance the Competency Level of Candidates in order to Improve Performance at the Examination:

- Candidates must study the study text and understand its contents.
- Refer articles, magazine in relation to this subject and other reading material related to auditing.
- Understand the definition of action verbs and practice as the candidates have to answer the question based on the action verbs list given at the end of the question paper.
- Study the contents of the past papers and practice at least last five years' examination papers and try to understand the way in which the questions are being set.
- The candidates should understand the relationship between the theory given in the question papers and examiner's expectation of its application at the examination.
- The candidates should study and understand as to what areas in the study text have been tested in the past question paper and make short notes of those areas in the study text.
- The candidate should practice answering the past paper question based on the time given in the question papers and accordingly, it will improve the time management at the examination.
- Write short notes of each study chapter given in the study text and study as and when you get free time to remember the contents of syllabus
- Candidates should write legibly at the examination.
- The candidates should carefully read the instructions given in the examination paper prior to start answering the questions in the paper.
- The candidates should have a clear and balance mind set at the examination in order to understand the question and provide with appropriate and accurate answers required in the question.
- The candidates should allocate time for the questions based on the marks given and accordingly, the candidate should effectively be able to answer all the questions given in the paper.
- Answers should be numbered appropriately and accurately as given in the question paper.
- Very important to understand the relationship between theory and its application in the question, wherever requested, write with examples.
- Check twice whether all required questions were answered and appropriately numbered prior to hand over the answer scripts.