SRI LANKA

Association of Accounting Technicians of Sri Lanka

Level III Examination – January 2022

Suggested Answers

(303) FINANCIAL CONTROLS & AUDIT (FCA)

Association of Accounting Technicians of Sri Lanka
No.540,Ven. Muruththettuve Ananda Nahimi Mawatha,
Narahenpita, Colombo 05.
Tel : 011-2-559 669

A publication of the Education and Training Division

THE ASSOCIATION OF ACCOUNTING TECHNICIANS OF SRI LANKA

Level III Examination - January 2022

(303) FINANCIAL CONTROLS & AUDIT

SUGGESTED ANSWERS

(Total 20 Marks) **SECTION - A**

Suggested Answers to Question One:

Chapter 01- Business Environment and Governance Framework

(a)

1) Greater transparency
2) Greater accountability
3) Operational efficiency
4) Better risk responding abilities
5) Less likely to be mismanaged
6) Lesser conflicts and frauds
7) Assuring internal controls
8) Improving decision making
9) Compliance with laws
10) Encouraging positive behavior
11) Reputation and relationships
12) Better management

(03 marks)

(b)

1) **Oversight Responsibility** – Board oversight and responsibilities, management accountability and authority and the authority and responsibilities of committees.

2) **Talent & Culture** – Performance management and incentives, business & operating principles and leadership development & talent programs.

3) **Infrastructure** – Policies & procedures, reporting & communication and technology.

(02 marks)
(Total 05 marks)

Suggested Answers to Question Two:

Chapter 02- Risk Management Framework

1) Risk in Operations

The uncertainties and hazards a company face when it attempts to do its day-to-day business activities within a given field or industry. This can result from breakdowns in internal procedures, people and systems.

Examples:

- Information systems of the organization is hacked and information was robbed
- Unexpected machine breakdowns
- Labor strikes
- Unexpected shortages in supplies and failures to meet customer orders
- Hacking information systems of the organization

2) Fraud Risk

The risk of possible losses due to fraudulent activity by an employee or an external party.

Examples:

- Theft of organization's assets
- Performing fraudulent transactions
- Assisting to execute fraudulent transactions
- Presenting inaccurate financial information with the intention of committing a fraud
- Misuse of entity's data/ information
- Producing inaccurate financial information deliberately

3) Compliance Risk

The risk of failure to comply with an important law or regulation. A consequence of noncompliance with regulations may be losses from the cost of fines.

Examples:

- Employee fails to comply with company rules and regulations
- Failure to maintain the required capital adequacy ratio by a bank prescribed by the Central Bank of Sri Lanka
- An Insurance company fails to submit quarterly financial statement to Insurance Board
- Failure to pay EPF & ETF
- Failure to pay taxes
- Failure to hold AGM
- Failure to submit BOI reporting

4) Reputation Risk

The risk of losing the reputation the organization has in the public due to an unfavorable incident/s or series of actions.

Examples:

- Failure to perform business practices in an environmental friendly manner
- Providing low quality products

- Failure to meet customer requirements
- Failure to comply with good business practices

(05 marks)

Suggested Answers to Question Three:

Chapter 02- Risk Management Framework

1. **Three party relationship** – Auditor , Bank and SJ (Pvt) Ltd
2. **Appropriate subject matter** – Forecast report for 5 years
3. **Suitable criteria** – Opinion of the independent auditor on the forecasts
4. **Sufficient appropriate audit evidence** – Evidence on forecast
5. **A conclusion** – Report on the forecasts by the auditor

(05 marks)

Suggested Answers to Question Four:

Chapter 09 –Requirements for an Audit of Financial Statements

(a)

1. Professional education
2. Continuing professional development including training
3. Work experience
4. Caching by more experienced staff, for example other members of the engagement team
5. Individual guiding sessions and meetings
6. Group activities
7. Hiring an expert if required
8. Independence education for personnel who are required to be independent

(02 marks)

(b)

1. Engagement performance
2. Monitoring
3. Acceptance and continuous of client relationships
4. Human resources
5. Engagement performance
6. Relevant ethical requirements
7. Leadership responsibilities for quality within the firm

(03 marks)
(Total 05 marks)

End of Section A

Suggested Answers to Question Five:

Chapter 05 - Risk Assessment and Audit Process

(a)

Risk Assessment Procedures refers to the audit procedures performed to obtain an understanding of the entity and its environment including internal controls to identify and assess the risk of material misstatement, whether due to fraud or error, at the financial statement level and assertion levels.

(02 marks)

(b)

1. Inquiries of management and other third parties
2. Analytical procedures
3. Observation
4. Inspection
5. Inquiries from internal audit staff

(03 marks)

(c)

(i)

1. Acquiring a luxury apartment for Rs. 100 million from Managing Director.
2. Providing the acquired luxury apartment for the use of Managing Director's spouse who is the CFO of the company as her accommodation.
3. Adverse media publicity on misuse of assets by CFO.

(02 marks)

(ii)

An auditor conducting an audit in accordance with Sri Lanka Auditing Standards (SLAuS) is **responsible for obtaining reasonable assurance that the financial statements taken as a whole are free from material misstatement, whether caused by fraud or error**. Due to the inherent limitations of an audit, there is an unavoidable risk that some material misstatements due to fraud may not be detected. The potential effects arising from misstatements due to fraud are significantly higher than a material misstatement due to an error.

(03 marks)
(Total 10 marks)

Suggested Answers to Question Six:

Chapter 5 - Risk Assessment and Audit Process

(a)

Professional skepticism is an attitude that includes a questioning mind and a reasonable doubt, being alert to conditions which may indicate possible misstatement due to error or fraud.

The auditor should exercise **professional judgment** in planning and performing an audit of financial statements.

(03 marks)

(b) Assertions relating to PPE

1. **Existence** - Whether all the Property, Plant and Equipment appeared in the financial statements exist in the organization.
2. **Rights & Obligations** – Whether the entity controls the right to Property, Plant and Equipment.
3. **Completeness** – Whether all the transactions and events relevant to Property, Plant and Equipment have been considered and recorded.
4. **Valuation and allocation** – Whether Property, Plant and Equipment have been valued as per LKAS 16 and depreciation have been computed correctly.
5. **Presentation and disclosure** – Whether the balances of Property, Plant and Equipment have been correctly presented in the financial statements and disclosures have been adequately disclosed.

(04 marks)

(c)

1. To obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, thereby enabling the auditor to express and opinion on whether the financial statements are prepared, in all material respects, in accordance with an applicable financial reporting framework.

2. To report on the financial statements, and communicate as required by the Sri Lanka Auditing Standards (SLAuS), in accordance with the auditor's findings.

(03 marks)
(Total 10 marks)

Suggested Answers to Question Seven:

Chapter 08- Ethical Requirements

(a) Fundamental principles of professional ethics

1. Integrity

The principle of integrity imposes an obligation on all professional accountants to be straightforward and honest in all professional and business relationships. Integrity also implies fair dealing and truthfulness.

2. Objectivity

The principle of objectivity imposes an obligation on all professional accountants not to compromise their professional or business judgment because of bias, conflict of interest or the undue influence of others.

3. Professional Competence and Due Care

The principle of professional competence and due care imposes the following obligations on all professional accountants

- To act diligently in accordance with applicable technical and professional standards when performing professional activities or providing professional service.
- To maintain professional knowledge and skill at the level required to ensure that clients or employers receive competent professional service.

4. Confidentiality

The principle of confidentiality imposes an obligation on all professional accountants to refrain from:

- Disclosing outside the firm or employing organization confidential information acquired as a result of professional and business relationships without proper and specific authority or unless there is a legal or professional right or duty to disclose; and
- Using confidential information acquired as a result of professional and business relationships to their personal advantage or the advantage of third parties.

5. Professional Behavior

The principle of professional behavior imposes an obligation on all professional accountants to comply with relevant laws and regulations and avoid any conduct that the professional accountant knows or should know may discredit the profession.

(06 marks)

(b)

1. Self Interest Threat

The threat that a financial or other interest will inappropriately influence the professional accountant's judgment or behavior.

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 firm being concerned about the possibility of losing a significant client.

2. Self-Review Threat

The threat that a professional accountant will not appropriately evaluate the results of a previous judgment made or service performed by the professional accountant, or by another individual within the professional accountant's firm or employing organization, on which the accountant will rely when forming a judgment as part of performing a current activity or providing a current service.

Examples

- A firm issuing an assurance report on the effectiveness of the operation of financial systems after designing or implementing the systems.
- A firm having prepared the original data used to generate records that are the subject matter of the assurance engagement.
- A member of the assurance team being, or having recently been, a director or officer of the.
- Client A member of the assurance team being, or having recently been, employed by the client in a position to exert significant influence over the subject matter of the engagement.
- The firm performing a service for an assurance client that directly affects the subject matter information of the assurance engagement.

3. Advocacy Threat

The threat that a professional accountant will promote a client's or employer's position to the point that the professional accountant's 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.

4. 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

- A member of the engagement team having a close or immediate family member who is a director or officer of the client.
- 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.
- A 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.
- A professional accountant accepting gifts or preferential treatment from a client, unless the value is trivial or inconsequential.
- Senior personnel having a long association with the assurance client.

5. Intimidation Threat

The threat that a professional accountant will be deterred from acting objectively because of actual or perceived pressures, including attempts to exercise undue influence over the professional accountant.

Examples

- A firm being threatened with dismissal from a client engagement.
- An audit client indicating that it will not award a planned non-assurance contract to the firm if the firm continues to disagree with the client's accounting treatment for a particular transaction.
- A firm being threatened with litigation by the client.
- A firm being pressured to reduce inappropriately the extent of work performed in order to reduce fees.
- A professional accountant feeling pressured to agree with the judgment of a client employee because the employee has more expertise on the matter in question.
- A professional accountant being informed by a partner of the firm that a planned promotion will not occur unless the accountant agrees with an audit client's inappropriate accounting treatment.

(04 marks)
(Total 10 marks)

End of Section B

(Total 50 Marks) **SECTION - C**

Suggested Answers to Question Eight:

Chapter 03- Internal Control Systems and Business Processes

(a) Internal Control

The process designed, implemented and maintained by those charged with governance, management and other personnel to provide reasonable assurance about the achievement of an entities objectives with regard to reliability of financial reporting, effectiveness and efficiency of operations and compliance with applicable laws and regulations.

(03 marks)

(b) Weaknesses	(c) Recommendations
1. Revenue is recognized once in two months.	1. Revenue need to be recognized on monthly basis since the services are provided monthly.
2. All the invoices are raised by an executive in operations department.	2. There should be a proper authorization and sub division of work with regard to invoicing
3. Bank reconciliation statements are prepared only at the end of the financial year	3. Bank reconciliations should be prepared on monthly basis.
4. Agreements entered in between customers are kept in an open area.	4. Agreements should be kept under the proper custody.
5. Postdated cheques are kept with an executive in operations department until the date of the cheques.	5. A postdated cheque register need to be maintained and cheques should be kept under proper custody.
6. Comparison between budget and actual is done once in 6 months.	6. Budgets should be compared against actuals on monthly basis.
7. A proper procedure for review and approval of the invoices is not available.	7. Invoices should be reviewed and authorized by Financial Manager.
8. There is no monitoring over delivery of monthly reports to customers.	8. Monitor the delivery of monthly reports to customers.

(b) - *(05 marks)*
(c) - *(05 marks)*

(d)

IT General Control	Example from the scenario
Development of Computer Application	▪ No standard over systems design, programming and documentation ▪ Approval by computer users and management ▪ No segregation of duties so that those responsible for design are not responsible for testing

Prevention or detection of unauthorized changes to program	▪ Segregation of duties ▪ Password protection of programs so that access is limited to computer operation staff ▪ Restricted access to central computer by locked doors. ▪ Virus check 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 program changes	▪ No testing procedures carried out ▪ No proper documentation available ▪ Approval of changes by computer users and engagement ▪ No proper training provided to staff on relevant procedures
Controls to prevent unauthorized amendments to data files	▪ No physical security over remote terminals ▪ No restrictions on accessing to IT facility ▪ Absence of firewall ▪ User identification controls such as passwords ▪ Encryption of data
Controls to ensure continuity of operations	▪ Storing backups of programs and data files off-site ▪ Protection of Equipment against fire and other hazards ▪ Back-up power sources ▪ Disaster recovery procedures - Availability of back up facilities ▪ Maintenance agreements and insurance

(08 marks)

(e)

1. Communication and enforcement of integrity and ethical values
2. Commitment to competence
3. Participation by those charged with governance
4. Management's philosophy and operating cycle
5. Organization structure
6. Assignment of an authority and responsibility
7. Human resources policies and practices

(04 marks)

(Total 25 marks)

Suggested Answers to Question Nine:

Chapter 3- Internal Control Systems and Business Processes

(a)

1. Revenue system
2. Trade receivables
3. Income tax
4. Related party transactions
5. Administration expenses
6. Distribution expenses
7. Inventory
8. Property, Plant and Equipment
9. Cash and bank
10. Term loan

(05 marks)

Chapter 5 – Risk Assessment and Audit Process

(b)

1. Elements of the financial statements (e.g.: assets, liabilities, equity, revenue, expenses)
2. Whether there are items on which users tend to focus
3. Nature of the entity, industry and economic environment
4. Entity's ownership structure and financing
5. Relative volatility of the benchmark

(04 marks)

Chapter 6 – Audit Evidences

(c)

Management's responsibility for the preparation and presentation of the financial statements also encompasses a responsibility to assess the entity's ability to continue as a going concern. The below financial indicators give a sign on the entity’s ability to continue as a going concern.

Financial Indicators

- Net liability or net current liability position
- Fixed-term borrowings approaching maturity without realistic prospects of renewal or repayment
- Indications of withdrawal of financial support by creditors
- Negative operating cash flows (historical or prospective)
- Adverse key financial ratios
- Substantial operating losses or significant deterioration in the value of assets used to generate cash flows
- Arrears or discontinuance of dividends
- Inability to pay creditors on due dates
- Inability to comply with terms of loan agreements
- Change from credit to cash-on-delivery transactions with suppliers

- Inability to obtain financing for essential new product development or other essential investment

If the management considers the going concern assumptions is not appropriate they will need to prepare the accounts on a different basis.

(05 marks)

Chapter 7 – Audit Reporting

(d)

1. **Breach of the loan Covenants**

This would result that company has to settle the loan on demand. Hence the entire loan balance should be reclassified as current liabilities. If the management refuses to do so the auditor should consider modifying is opinion due to its' materiality.

2. **Stock Loss**

The carrying value of the inventory as at 31 December 2021 (reporting date) was Rs.44,493,000/-. However, this has been sold for Rs. 42,800,000 on 1st January 2022. The resulting loss of Rs. 1,693,000 is above the materiality threshold. This loss need to be adjusted through the Profit and Loss in accordance with the LKAS 10. Hence it should be adjusted in the financial statements. If management refuses to do so auditor needs to modify his opinion.

3. **Depreciation**

The company has charged only 50% of the depreciation amounting to Rs.1,250,000. Since the individual unadjusted amount is below the materiality level auditor needs to assure whether the total of the unadjusted exceeds the materiality threshold and adjust accordingly.

As a whole impact of the above matters is material. If the management does not adjust accordingly the auditor should modify opinion on this matter.

(07 marks)

Chapter 7 – Audit Reporting

(e) The auditor shall modify the opinion in the auditor's report when,

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

(04 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.