



Association of Accounting Technicians of Sri Lanka

Level III Examination – January 2026

Suggested Answers

(303) FINANCIAL CONTROLS & AUDIT (FCA)

Association of Accounting Technicians of Sri Lanka

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A publication of the Education and Training Division

THE ASSOCIATION OF ACCOUNTING TECHNICIANS OF SRI LANKA

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(303) FINANCIAL CONTROLS & AUDIT

SUGGESTED ANSWERS

(Total 20 Marks)

SECTION - A

Suggested Answers to Question One:

Chapter 01 Business Environment and Governance framework

(a)

- Sole proprietorships
- Partnerships
- Limited Liability Companies
- Corporations
- State owned enterprises
- Company limited by guarantee

(03 marks)

(b) A Limited Liability Company

(02 marks)

(Total 05 marks)

Suggested Answers to Question Two:

Chapter 02 Risk Management Framework

Internal Risks

- Risk in Operation
- Fraud risk
- Compliance risk
- Reputation risk
- Finance Risk
- Technologies and cyber security risk

External Risks

- Political factors
- Economic factors
- Social factors
- Technical factors
- Environmental factors

- Legal factors
- Industry specific risk
- Market and competitive risk
- Supply chain risk

(05 marks)

Suggested Answers to Question Three:

Chapter 04 Assurance Engagement and Related Services

(a)

Reasonable assurance	Limited assurance
<ul style="list-style-type: none"> • An audit gives the reader reasonable assurance on the truth and fairness of the financial statements, which is a high, but not absolute, level of assurance. • The auditor's report does not guarantee that the financial statements are correct, but that they are true and fair within a reasonable margin of error. • Gives a positively worded assurance opinion. • Performs very thorough procedures to obtain sufficient appropriate evidence-Test of controls and substantive audit procedures. • The practitioner gathers sufficient appropriate evidence to be able to draw reasonable conclusions. • Concludes that the subject matter confirms in all material aspects with identified suitable criteria. 	<ul style="list-style-type: none"> • Limited assurance is a moderate or lower level of assurance than reasonable assurance. • It reflects the limited amount of testing and evaluation possible, and the greater risk of the auditor's opinion being incorrect. • Gives a negatively worded assurance opinion. • Performs fewer procedures-mainly enquiries and analytical procedures. • The practitioner gathers sufficient appropriate evidence to be able to draw limited conclusions. • Concludes that the subject matter with respect to identified suitable criteria, is applicable to the circumstances.

(03 marks)

(b) The most appropriate assurance type that GSB Associates may provide is an **assurance engagement on prospective financial information**, whereby the Chartered Accountant provides **limited assurance** that the forecast is properly prepared based on reasonable assumptions. It is not possible to perform a reasonable assurance engagement on information about the future.

(02 marks)

(05 marks)

Suggested Answers to Question Four:

<i>Chapter 09 Quality Requirements for an audit of financial statements</i>
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(a)

The objective of the firm is to establish and maintain a system of quality control to provide it with reasonable assurance that.

- The firm and its personnel comply with professional standards and applicable legal and regulatory requirements.
- Reports issued by the firm or engagement partners are appropriate in the circumstances.

(03 marks)

(b)

- Consistency in the quality of engagement performance
- Supervision
- Review

(02 marks)

(Total 05 marks)

<i>End of Section A</i>

Suggested Answers to Question Five:

Chapter 05 & 06 - Risk Assessment and Audit Process / Audit Evidence

(a)

- Industry, Regulatory, and other external factors such as the nature and composition of revenue streams, including government and related party transactions
- Nature of the entity, such as dependence on large institutional buyers (SPC & Army)
- Internal controls, such as the Approval process for bulk government sales
- Financial performance of the entity selection application of accounting policies, revenue recognition such as when revenue is recognized (dispatch date, delivery date, acceptance date)
- Objectives, strategies and related business risks.

(03 marks)

(b)

- Test of Details – Vouching Sales Transactions :Trace from sales invoice, sales order, delivery note, shipping documents, and customer acknowledgement.
- Cut-off Testing at Year-End: Examine sales transactions recorded just before and just after 31st December 2025
- Analytical Procedures on Revenue: Compare gross profit margins by product (especially new cancer vaccines)
- Review of Related Party Sales: Verify whether transactions are at arm’s length
- Check the bank statement.
- Check the revenue recognitions policy and ensure revenue has recognized accordingly.
- Check the pricing as the entity is in a regulated industry.
- Review whether there are any sales contracts/agreements with customers& compliance with them.

(04 marks)

(c)

Sufficiency - The measure of the quantity of audit evidence. The quantity of audit evidence needed is affected by the auditor’s assessment of the risks of material misstatement and by the quality of such audit evidence.

Appropriateness - The measure of the quality of audit evidence; that is, its relevance and its reliability in providing support for the conclusions on which the auditor’s opinion is based.

(03 marks)

(Total 10 marks)

Suggested Answers to Question Six:

Chapter 07 Audit Reporting

(a)

(i) Impairment of Debtors

Due to ERP system failure, the auditor is unable to obtain sufficient appropriate audit evidence regarding debtors' impairment. Since debtors represent 23% of total assets and the potential misstatement (Rs. 6 million) exceeds materiality (Rs. 5 million), the matter is material. The auditor need to assess the pervasiveness and if it is pervasive it would result in disclaimer of opinion due to unavailability of audit evidences. If it is not pervasive , a qualified audit opinion will be likely given.

(ii) Provision for slow moving items: If this cannot be resolved with appropriate audit evidences why the provision is not required and if provision is required, and management is in disagreement this would result in a modification to the auditor's report. The auditor is also required to assess the pervasiveness of the matter individually and in aggregate with other material misstatements (if any) noted.

(07 marks)

(b)

The auditor shall express an unmodified opinion when the auditor concludes that the financial statements are prepared, in all material respects, in accordance with the applicable financial reporting framework.

(03 marks)

(Total 10 marks)

Suggested Answers to Question Seven:

Chapter 08 - Ethical Requirements

(a) Financial Interest:

1. **Ramith** having the knowledge of the confidential and sensitive data of the Marvels PLC (insider information) and trading shares of this company triggers the risk to independence as he is having financial interest of the entity he has been auditing as the audit manager.
2. **Employment with Audit Client:** Pursuing employment relationship with an audit client and its related entity as a key audit team member, while the audit is ongoing triggers a risk of familiarity or intimidation threats. When a former audit manager joins the audit client there is a risk of bias towards the client, audit firm may be reluctant to challenge management. The former audit manager may explain knowledge gained during the audit.
3. There is a close relationship between a firm / member of the firm. It may be a threat to independence.
4. Long Association and economic dependence. Long audit tenure (25 years) create excessive

trust between auditors.

5. Marvel PLC contributes 23% of Zing Associate's total revenue, which is highly significant, which may create self-interest and intimidation threat.
6. Self-review threat will be created if Zing Associates accepts internal audit of assignment of IT company. If the service affects financial system or controls that will be audited independence will be nicely impaired. Since it is PLC and part of a large group accepting an internal audit is not permitted if providing financial process recommendations as it creates **self-review threat**.

(b)

1. **Self Review threat** – Carrying out the internal audit of a significant subsidiary and providing recommendations to address such processes weaknesses in is a self-review threat. The auditor is auditing the systems and processes designed by them.
2. **Self Interest Threat** - The audit fee the firm receives from Marvel PLC is a significant portion of the firm's total fees. Audit firms have undue dependence on total fees from a client.
3. **Familiarity Treat** - There is a close relationship with the client and the firm. Marvel PLC has been audited by Zing Associates for the last 25 years. It creates familiarity threats.

(c)

- (1) Leadership of the firm that stresses the importance of compliance with the fundamental principles.
- (2) Leadership of the firm that establishes the expectation that members of an assurance team will act in the public interest.
- (3) Policies and procedures to implement and monitor quality control of engagements.
- (4) Documented policies regarding the need to identify threats to compliance with the fundamental principles, evaluate the significance of those threats, and apply safeguards to eliminate or reduce the threats.
- (5) Documented internal policies and procedures requiring compliance with the fundamental principles.
- (6) Policies and procedures that will enable the identification of interests or relationships between the firm or members of engagement teams and clients.
- (7) Policies and procedures to monitor and, if necessary, manage the reliance on revenue received from a single client.
- (8) Using different partners and engagement teams with separate reporting lines for the provision of non-assurance services to an assurance client.
- (9) Policies and procedures to prohibit individuals who are not members of an engagement

team from inappropriately influencing the outcome of the engagement.
(10) Timely communication of a firm's policies and procedures, including any changes to them, to all partners and professional staff, and appropriate training and education on such policies and procedures.

(11) Designating a member of senior management to be responsible for overseeing the adequate functioning of the firm's quality control system.

(12) Advising partners and professional staff of assurance clients and related entities from which independence is required.

(13) A disciplinary mechanism to promote compliance with policies and procedures.

(14) Published policies and procedures to encourage and empower staff to communicate to senior levels within the firm any issue relating to compliance with the fundamental principles that concerns them.

(15) Discuss ethical issue with those charged with governance of the client.

(16) Rotating senior assurance team personal.

(03 marks)

(Total 10 marks)

End of Section B

Suggested Answers to Question Eight:

Chapter 03 & 05 Internal Control System and Business Process

(a)

Preventive Controls

- Proper Segregation of Duties
- Formal Authorization Procedures with Approval Limits
- Three-way matching of purchase orders, GRN and supplier invoices
- Access control over the ERP system
- Supervision of employees at work.
- Attendance sheet should be cross checked with the payroll before processing the payment.
- Maintenance of checklists
- Periodic maintenance service to plant and machinery.

Detective Controls

- Periodic Internal Audit Review
- Supplier Statement Reconciliation
- Analytical Review of Purchase Trends
- Physical Inventory Verification
- CCTV Surveillance and Monitoring
- Bank Reconciliation
- Performing employees' head count in the factory premises and compare with attendance records.
- Cross reference of two after delivery

(04 marks)

(b)

1. Authorization of Material Requisition Notes (MRN)

Control Activity:

Production Supervisors prepare Material Requisition Notes and must be approved by the Production Manager before being forwarded to the Stores Department.

Purpose:

To ensure that materials are issued only for valid and authorized production requirements, preventing unauthorized usage or misappropriation of inventory.

2. Segregation of Duties in Stores Function

Control Activity:

The Stores Clerk dispatches materials and prepares the Item Issued Note, which is then signed and authorized by the Stores Manager.

Purpose:

To ensure proper segregation between custody of inventory and authorization functions, reducing the risk of fraud, errors, and unauthorized removal of inventory.

3. Documentation and Authorization of Material Returns

Control Activity:

Return Notes are prepared for materials returned from production and are acknowledged with signatures from both the Production Supervisor and the Production Manager.

Purpose:

To ensure completeness and accuracy of inventory records by properly recording returned materials and preventing manipulation or concealment of shortages.

4. Periodic Physical Verification by Internal Auditors

Control Activity:

Physical verification of raw materials and finished goods is carried out by Internal Auditors and book balances are reconciled with physical counts.

Purpose:

To detect discrepancies, theft, damage, or recording errors, and to ensure the existence and accuracy of inventory balances reported in the financial statements.

5. Check the physical balance with system balance

Control Activity:

Arithmetical and accounting controls to check the physical balance with system balance.

Purpose:

To check the correct and accurate recording and processing of transactions.

6. Physical Control

Control Activity:

Install CCTV Cameras

Purpose:

To prevent unauthorized access,

(06 marks)

(c)

1. Reliability and Accuracy of Financial Reporting

One objective of the internal control system is to ensure that financial information is accurate, complete, and reliable. In Duro (Pvt) Ltd., proper documentation of material requisitions, item issued notes, return notes, and ERP integration helps ensure that inventory balances, cost of production, and turnover of Rs. 1.12 billion are correctly recorded and fairly presented in the financial statements.

2. Operational Efficiency and Effectiveness

Internal controls help ensure that business operations are conducted efficiently and in line with management policies. For Duro (Pvt) Ltd., controls over material issuance and inventory management help minimize wastage, prevent production delays, and ensure that imported raw materials are used economically, especially since they are purchased in bulk quantities.

3. Compliance with Applicable Laws and Regulations

Another key objective is to ensure that the company complies with relevant laws and regulations. As Duro (Pvt) Ltd. imports raw materials, it must comply with customs regulations, tax laws, and other statutory requirements. Effective internal controls help ensure accurate documentation, proper recording of transactions, and adherence to legal requirements, thereby avoiding penalties, fines, or legal disputes.

(05 marks)

(d)

- Suppliers are unable to provide goods, or cannot provide goods to the required quantity
- Goods that are not required are ordered
- Goods may be purchased at an excessive price
- Goods are not delivered or are delivered in bad condition.
- Supplier submits an invoice for an incorrect amount or for goods that have not been delivered
- Supplier may deliver more goods or fewer goods than ordered

(04 marks)

(e)

1. Access Controls

Control:

Implementation of user access controls to restrict unauthorized access to the ERP system.

Example:

Each employee is assigned a unique user ID and password, with access rights limited based on job responsibilities (e.g., Stores Clerk can record inventory issues but cannot modify purchase orders). Periodic review of user access rights is performed by the IT Department.

2. Testing and documentation of programmed changes controls

Control:

Controls over changes made to the ERP system to ensure only authorized and tested changes are implemented.

Example:

Any modification to the ERP system must be formally requested, approved by management, tested in a separate test environment, and only then implemented by authorized IT personnel, with proper documentation maintained.

3. Controls to ensure continuity of operations**Control:**

Regular data backup and disaster recovery procedures to ensure business continuity.

Example:

Daily automated backups of ERP data are performed and stored offsite or in cloud storage. A disaster recovery plan is maintained and periodically tested to ensure data can be restored in case of system failure or cyberattack. Storing extra copies of programs and data files off-site. Protection of equipment against fire and other hazards.

4. Development of computer applications**Example:**

Standard over systems design, programming and documentation
Approval by computer users and Management.
Segregation of duties so that those responsible for design are responsible for testing.
Training of staff in new procedures and available of adequate documentation.

(06 marks)

(Total 25 marks)

Suggested Answers to Question Nine:

<i>Chapter 05 & 06 - Risk Assessment and Audit process / Audit Evidence</i>
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(a)

- Revenue Recognition (Risk of Overstatement)
- Related Party Transactions
- Going Concern
- Consolidation of Newly Acquired Company
- Inventory balance and Cut-off Issues
- Advance received from customers
- Losses of the business in past years & profit for the year
- Incentives to management
- Changes in accounting policies
- Trade Receivables

(05 marks)

(b)

- Elements of the financial statements
- Whether there are items on which users tend to focus
- Nature of the entity, industry and economic environment
- Entities' ownership structure and economic environment
- Relative volatility of the benchmark

(04 marks)

(c) (i)

- Risk of fraud
- It is an unusual transaction
- It is a significant transaction with a related party
- The complexity of the transaction
- Attitudes
- Opportunities
- Incentive pressure

(02 marks)

(ii)

The primary risk of fraud in the audit of Reko PLC is the intentional overstatement of revenue. Revenue is the company's key performance indicator, and management incentives are directly tied to revenue growth. This creates significant pressure on management to manipulate revenue figures.

During the year, the company changed its accounting policy to recognize revenue upon confirmation of orders, before goods are dispatched to customers. In addition, substantial year-end adjustments of Rs. 84.5 million were recorded, which is highly significant compared to the reported annual revenue of Rs. 18.35 million.

Furthermore, inventory items were recorded as sold but had not been delivered to customers, and no customer acknowledgments were available. This suggests the possibility of premature or fictitious revenue recognition.

According to SLAuS 240, there is a presumed risk of fraud in revenue recognition. In this case, the incentive structure, change in accounting policy, significant year-end adjustments, and cut-off issues collectively indicate a high risk of management intentionally overstating revenue to present improved performance and meet shareholder expectations.

(04 marks)

(b)

- Management's assessment of the risk that the financial statements may be misstated due to fraud
- Management's process for identifying and responding to the risk of fraud
- Management's communication to those charged with governance in respect of its process for identifying and responding to the risk of fraud

- Management communication to employees regarding its views on business practices and ethical behavior
- Knowledge of any actual, suspected or alleged fraud.
- Inquiries of internal audit for knowledge of any actual, suspected or alleged fraud, and its views on the risk of fraud.
- Obtaining an understanding of how those charged with governance oversee management's processes for identifying and responding to the risk of fraud and the internal control established to mitigate these risks.
- Inquiries of those charged with governance for knowledge of any actual, suspected or alleged fraud.
- Evaluating whether any unusual relationship have been identified in performing analytical procedures that may indicate risk of material misstatement due to fraud.
- For significant transactions outside the normal course of business, evaluate whether they have been entered in to engage in fraudulent financial reporting or to conceal misappropriation of assets.

(05 marks)

(e)

- Enquire of management and the directors as to whether transactions have taken place with related parties that are required to be disclosed in the financial statements.
- Review prior-year working papers for names of known related parties.
- Review minutes of meetings of shareholders and directors and other relevant statutory records such as the register of directors' interests.
- Review accounting records for large or unusual transactions or balances, in particular transactions recognized at, or near, the end of the financial period.
- Review confirmations of loans receivable and payable, and confirmations from banks. Such a review may indicate the relationship, if any, of guarantors to the entity.
- Review investment transactions, for example, purchase or sale of an interest in a joint venture or other entity.
- Review the entity's tax returns, returns made under statute, and other information supplied to regulatory agencies for evidence of the existence of related parties.
- Review invoices and correspondence from the lawyer for indications of the existence of related parties or related party transactions.

(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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