SRI LANKA

Association of Accounting Technicians of Sri Lanka

Level III Examination – July 2026

Question Paper and Suggested Answers

(3803) RISK, CONTROLS & AUDIT (RCA)

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THE ASSOCIATION OF ACCOUNTING TECHNICIANS OF SRI LANKA

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SUGGESTED ANSWERS

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

Suggested Answers to Question One:

Chapter 01

Agency theory explains the relationship between a principal, who owns or provide resources, and an agent who is appointed to act on principal's behalf. In the context of a listed company, shareholders are the principals, while directors/managers are the agents. The theory recognizes that agents may have different interests from principals, creating an agency problem. Therefore, monitoring and corporate governance mechanisms are needed to ensure that managers/directors (Agents) act in the shareholders (principals) best interests.

Stewardship theory explains the relationship where managers / directors act as stewards, meaning they are trusted to act in the best interest of the organization and its shareholders (principals). The theory assumes that managers are motivated by organizational success, long-term performance and shareholder interests, rather than their personal benefits. Therefore, this theory emphasizes that managers / directors exercise their stewardship responsibility towards their shareholders fostering trust, empowerment and corporation rather than strict monitoring.

(Total 05 marks)

Suggested Answers to Question Two:

Chapter 04

(i) Financial Statements Audit (Statutory Audit)

Objective:

The primary objective of a financial statements audit is to enable ABC Chartered Accountants, as the independent auditor, to express an opinion on whether the financial statements of Best PLC are prepared, in all material respects, and whether they give a true and fair view in accordance with the applicable financial reporting framework.

(ii) Compliance Audit

Objective:

The primary objective of a compliance audit is to provide assurance as to whether Best PLC has complied, in all material respects, with applicable laws, regulations, rules, contractual obligations, internal policies, procedures and other prescribed requirements.

(05 marks)

Suggested Answers to Question Three:

Chapter 02

(a)

- Designing effective audit procedures.
- Identifying areas of heightened risk
- Evaluating the adequacy of internal controls
- Ensuring the completeness and accuracy of financial information

(Expect only two ways)

(02 marks)

(b)

- By automating repetitive business tasks, efficiency and productivity can be improved.
- Human errors can be reduced while improving accuracy and transparency.
- Reducing labour costs and minimizing errors would cause for savings
- AI and Machine Learning analyze vast amounts of data to provide insights that that improve business decisions
- Knowledge workers can make themselves available for value adding activities, specifically focusing on decision making.
- These digital tools enable better collaboration across departments and between organizations by streamlining communication and information sharing.
- Businesses can achieve resource optimization through allocating resources effectively by identifying inefficiencies and areas for improvement.
- Al and RPA can improve personalization and responsiveness, providing enhanced experience for customers.
- A significant cost reduction can be achieved.
- It encourages innovations.
- It helps for better decision making.

(Expect only three advantages)

(03 marks)

(Total 05 marks)

Suggested Answers to Question Four:

Chapter 03

(a)

- **Operational risk**
  The uncertainties and hazards a company faces 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. According to this scenario , increased the low cost imports would lead to weaken marks PLC's competitive position leading to decline in profitability.
- **Fraud risk**
  The risk of possible losses due to fraudulent activity by an employee or an external party. According to this scenario, Head of sales has committed a fraud.
- **Compliance risk**
  The risk of failure to comply with an important law or regulation. A consequence of non-compliance with regulations may be losses from the cost of fines. There are some industries that are bound by specific regulations due to the significant risks involved in that industries. According to this scenario, failure to meet statutory financial reporting deadlines indicate non compliance with legal & regulatory requirements.
- **Reputation risk**
  The risk of losing the reputation the organization has in the public due to an unfavorable incident or series of actions. According to this scenario, frauds and timely reporting failures can damage the company's reputation, trust and confidence placed by company's investors, customers and other stakeholders.

(Expect only to explain two risks)
(03 marks)

(b)

- Trend Analytics
- Predictive Analytics
- Real – Time Monitoring
- Root cause Analytics
- Data Visualization
- Machine Learning & AI
- Comparative Analysis
- Scenario Analysis

(Expect only two techniques)
(02 marks)
(Total 05 marks)

End of Section A

(Total 30 Marks) **SECTION - B**

Suggested Answers to Question Five:

Chapter 02

(a)

Involves identifying, disclosing reviewing, and approving transactions with related parties to prevent any potential conflicts of interest that may arise from transactions with them. Typically governed by the related party transaction review committee.

(04 marks)

(b)

Business Process	**Automated Function**
Procurement	• Automated purchase requisitions and approvals • Automated purchase Order generation • Automated vendor comparison tools • Three-way invoice match • Purchase order tracking • Automated Invoice Approval ProcessSupplier Payment Automation
Payroll	• Time and attendance integration • Automated salary calculation • Pay-slips generation • Leave approvals and record-keeping • Payment processing • Payroll audit trials • Self-service employee portals • Workforce Scheduling Automation
Cash Management	• Real-time cash position monitoring via bank feed integration • Automated bank reconciliations • Scheduled payments • Cash flow forecasting tools • Payment approval workflow automation • Integration with payment gateways
Inventory Management	• Barcode and QR code scanning to record inventory transactions and real-time tracking of inventory items. • RFID (Radio Frequency Identification) for large-volume inventory tracking and management • Auto-reorder level setup • Warehouse management systems • Demand forecasting algorithms

	• Automated inventory reconciliation • Automated inventory valuation • Automated Alerts & Notifications (To notify the manager about stock shortages, overstocking, or expiry dates)
PPE	• Asset tagging with barcodes • Automated depreciation calculation based on asset class • Automated maintenance scheduling tools • Capital expenditure (CapEx) approval workflows • Asset disposal and revaluation tracking • Asset usage monitoring

(Expect only two ways)

(03 marks)

(c)

- Shortage of professionals with expertise
- Poor data quality and privacy concerns hinder effective implementation
- Updates and new systems may not be compatible with existing systems
- These novel technology-savvy models are often vulnerable to cybersecurity threats.
- Challenges on management changes as existing employees may not willing to adopt new systems.
- Skills gap.
- Compliance risks.
- Scalability & maintenance
- The development and integration of these technologies usually requires substantial investment of investment.

(Expect only three challenges)

(03 marks)

(Total 10 marks)

Suggested Answers to Question Six:

Chapter 03

(a)

- **Risk reduction**
  Management may decide that a risk should be reduced because it is currently too high and so unacceptable.

  The company can reduce the impact or likelihood of the risk by diversifying its revenue sources, improving operational efficiency, and investing in new markets or services. This reduces dependence on a single customer (government projects), which currently accounts for 87% of revenue.

- **Risk transfers**
  Risk transfer is a risk management and control strategy that involves the contractual shifting of a pure risk from one party to another.

The company can transfer or share risks through joint ventures, strategic partnerships and appropriate insurance arrangements. This will allow the company to share financial and operational risks with other parties and reduce the adverse impact of unexpected losses.

- **Risk Avoidance:**
  Risk avoidance is the elimination of hazards, activities and exposures that can negatively affect an organization's assets.

  High Path Construction Ltd. can avoid the risk entirely by not relying heavily on government road projects. For example, the company may diversify into private construction projects or other infrastructure sectors so that it is not exposed to government policy changes.

- **Risk Acceptance:**
  Risk acceptance or risk retention means the fact of accepting the identified risk and not taking any other action in order to reduce the risk.

  In this case, **High Path Construction Ltd.** may acknowledge its dependence on government projects, but, decide to continue operations while preparing contingency plans to manage potential losses if the risk occurs.

(Expect only two techniques)

(04 marks)

(b)

- Cybersecurity Risks
- Data privacy & compliance risks
- Technology integration failures
- Over dependence on technology
- Risk on skill gaps

(Expect only 03 ways)

(03 marks)

(c)

Risk assessment is the process of evaluating and identified risk to determined its significance and potential impact on the organization. This process helps priorities risks and inform the development of appropriate mitigation strategies

(03 marks)
(Total 10 marks)

Suggested Answers to Question Seven:

Chapter 02 & 03

(a)

(1) Businesses can conduct sustainability assessments more often.

(2) Ensure that all the processes are conducted in an Eco-friendly manner.

(3) Use energy-efficient equipment and optimize workflow to reduce energy consumption.

(4) Make sure to take every possible action to minimize the waste production.

(5) Integrate with digital tools such as AI, ML, RPA, etc. to reduce errors, increase precision, and lower resource waste.

(6) Align with Global Reporting Initiatives (GRI), or other industry-specific sustainability standards and reporting frameworks.
(7) Train employees on sustainable practices.

(8) Continuous monitoring.

(9) Adopt a fair-trade supplier selection policy.

(10) Supplier sustainability evaluation and selection.

(11) Purchase environmental materials from suppliers who follow environmental friendly practices.

(Expect only two practices)

(02 marks)

(b)

- Risk of shortage of important inventory items
- Risk of excessive inventory levels
- Physical risk to inventory
- Risk of errors in stock records
- Risk of accepting goods without referring to the order details
- Risk of issuing inventories to people who should not receive those.
- Risk on Theft or misappropriation of inventories.
- Risk on Damage or deterioration of inventories.
- Risk Inventory obsolesce or expiry.

(Expect only four risks)

(04 marks)

(c)

- Weakness in planning
- Human errors
- Collusion among employees
- Limitations in resources
- Complexity of business operations
- Resistance to change
- Management override

(Expect only four limitation)

(04 marks)

(Total 10 marks)

End of Section B

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

Suggested Answers to Question Eight:

Chapter 06, 07 & 08

(a)

(i) Risk appetite indicates the amount of risk an organization is willing to accept in pursuit of value. Therefore, the risk appetite of the organization, should align with its strategy.

(04 marks)

(ii)

- Governance and culture
- Strategy and objective setting
- Performance
- Review and Revision
- Information, communication and reporting

(Expect only four elements)

(04 marks)

(b)

(1) Minimize financial, operational, and reputational losses by addressing risks before they escalate.

(2) With a clear risk mitigation plan, organizat based on a thorough understanding of potential risks and their impacts. organizations can make informed decisions confidential

(3) Streamline operations by identifying and eliminating inefficiencies or potential disruptions in business

(4) Can be better equipped to respond to unforeseen events and continue operations with minimal disruption.

(5) Adhere to relevant laws, regulations, and industry standards, avoiding legal issues and penalties.

(6) By proactively addressing risks, organizations demonstrate responsibility and commitment to stakeholders, boosting their reputation and gaining trust from customers, investors, and partners.

(7) Long-term cost savings by preventing costly incidents or accidents that could have been avoided.

(8) Promote a culture of risk awareness, ensuring that employees and stakeholders are well prepared for potential challenges.\

(9) Can allocate resources more efficiently to areas that matter most, improving overall productivity and focus.

(10) Gain a competitive edge by demonstrating their ability to operate smoothly even in uncertain environments

(Expect only four advantages) ***(04 marks)***

(c)

(1) Fraud Detection and Prevention:
Internal auditors can use Al and data analytics to identify unusual or suspicious transactions relating to laboratory services income of Rs.315.122 million and pharmacy sales income of Rs.60.327 million. For example, Al can detect duplicate invoices, unauthorized discounts, cancelled sales, or laboratory tests performed without corresponding billing records. This helps auditors identify potential fraud and verify that revenue has been accurately recorded.

(2) Risk Assessment and Analysis:

Internal auditors can use Al and data analytics to analyze revenue trends and identify high-risk areas. For example, unusual fluctuations in laboratory service income, unexpected declines in pharmacy sales, or abnormal transaction can then focus their patterns may indicate errors or misstatements. Auditors can then audit procedures on these areas to verify the accuracy and completeness of revenue.

(3) Continuous Auditing and Monitoring:

Internal auditors can use data analytics tools to continuously monitor laboratory and pharmacy transactions throughout the year. The system can automatically compare laboratory test records with invoices issued and pharmacy sales with cash receipts and inventory movements. Any discrepancies can be flagged immediately for investigation, helping to ensure that revenue is complete and accurately recorded.

(4) Automation of Routine Audit Tasks:

Internal auditors can use Al-powered systems to automatically reconcile laboratory test records with billing data and pharmacy sales transactions with accounting records. Automation reduces manual effort and human error while allowing auditors to examine a larger number of transactions, thereby improving the reliability of revenue verification.

(5) Enhancing Audit Planning and Scoping:

Internal auditors can use Al and data analytics to identify areas of revenue that require greater audit attention. For example, if data analysis shows unusual laboratory revenue trends or a high number of pharmacy sales adjustments, auditors can allocate more resources to these areas. This enables a more focused and effective audit of laboratory services income and pharmacy sales income.

(Expect only explanation of two ways)

(04 marks)

(d)

- Review of the accounting and internal control systems.
- Examination of financial and operating information.
- Review the economy, efficiency and effectiveness of operation.
- Review of compliance.

- Review the safeguarding of assets.
- Review of the implementation of corporate objectives.
- Identification of significant business and financial risks.
- Special investigations into particular areas, for example, suspected fraud.

(Expect only three risks)

(03 marks)

(e)

1. Familiarity threat

Partner Samanthi previously completed her articles at Ranil's audit firm**,** and Ranil is now a director of Medi Lab (Pvt) Ltd. This previous close professional relationship may create a familiarity threat, causing Samanthi or the audit team to become too sympathetic towards Ranil or management and less professionally sceptical.

2. Intimidation threat

Management's indication that continued cooperation and flexibility is expected in order to renew the audit engagement may create an intimidation threat**.** The auditor may feel pressure to avoid challenging management or reporting contentious matters for fear of losing the client.

3. Self-interest threat

It may also create a self-interest threat**,** because SA Associates has an interest in retaining and extending the audit engagement. This could compromise objectivity and professional scepticism**.**

(Expect only two threats) ***(04 marks)***

(f)

The following safeguards can eliminate or reduce the threats to an acceptable level:

1. Change or remove the affected audit personnel
   Samanthi should not be involved in the audit if her previous relationship with Ranil creates a significant familiarity threat. Another independent partner could review or lead the engagement.

2. Independent engagement quality/control review
   Arrange an independent review by a suitably qualified partner who is not involved in the audit, particularly for significant judgements, accounting estimates and the proposed audit opinion.

3. Strengthen independence and governance oversight
   Discuss the independence concerns with the independent internal audit team/Board or those charged with governance, and ensure that the audit engagement and any

renewal are based on professional considerations rather than management pressure.

4. Leadership of the firm that stresses the importance of compliance with the fundamental principles.
5. Policies and procedures to implement and monitor quality control of engagements.
6. 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.
7. Documented internal policies and procedures requiring compliance with the fundamental principles.
8. Policies and procedures that will enable the identification of interests or relationships between the firm or members of engagement teams and clients. (Expect only three methods)

(03 marks)

(Total 25 marks)

Suggested Answers to Question Nine:

Chapter 03 & 05

(a)

The following matters require special attention when performing the audit of Magical Ltd.:

1. Inventory cut-off and valuation – Goods worth Rs. 3 million dispatched before 31 March 2026 were recorded in April 2026. This indicates a cut-off error and may result in incorrect inventory and cost of sales.
2. Trade receivables impairment – The company does not have a proper impairment model, and the audit recalculation identified an under-provision of Rs. 1.8 million. The adequacy of the impairment allowance. Therefore, it requires particular attention.
3. Revenue recognition – Revenue recognition is a significant fraud risk because sales staff receive incentives based on revenue targets, creating pressure to recognise revenue prematurely.
4. Management attitude and internal controls – Management is highly focused on revenue growth even at the expense of internal controls and compliance. This increases the risk of management override, fraud and material misstatement.
5. Continuous loss incurred by company
6. The company results in weaker internal controls and less compliance with laws and regulations.
7. Incentives paid.

(Expect only 4 methods)

(*04 marks*)

(b)
Fraud and risk factors are events and conditions that indicate an incentive/pressure to commit/provide an opportunity to commit fraud.

Revenue recognition is considered a significant risk because:

1. Management pressure and incentives – Sales staff receive incentives based on achieving revenue targets, creating an incentive to record revenue prematurely or incorrectly.
2. Bill-and-hold arrangements – Revenue may be recognised even though goods have not yet been delivered to the customer. This creates a risk that the conditions for revenue recognition have not been satisfied.
3. Extra products sent to distributors – Sending additional products to distributors to increase reported sales may represent channel stuffing, resulting in fictitious or premature revenue and potentially overstated revenue and profits.

Therefore, there is a heightened risk of fraudulent revenue recognition and management override of controls.

(03 marks)

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

(Expect only three factors)

(03 marks)

(d)

The management of Magical Ltd. has the primary responsibility for preventing and detecting fraud. Management should:

1. Establish and maintain effective internal controls designed to prevent and detect fraud and errors.
2. Create an ethical culture and appropriate tone at the top, including clear policies regarding honesty, integrity and compliance with laws and regulations.
3. Identify and assess fraud risks and implement appropriate controls to mitigate those risks, including controls over revenue recognition and sales incentives.

4. Monitor the effectiveness of internal controls and take appropriate corrective action when weaknesses or suspected fraud are identified.

(04 marks)

(e)

ABC Associates should perform, among others, the following procedures:

1. Perform cut-off testing by examining sales invoices, dispatch notes and delivery documents immediately before and after 31 March 2026 to determine whether revenue has been recognised in the correct accounting period.
2. Examine bill-and-hold transactions and verify whether the relevant revenue-recognition criteria have been satisfied before revenue was recognised.
3. Confirm trade receivables and sales balances with customers, particularly significant and unusual year-end transactions.
4. Examine subsequent sales returns and credit notes issued after year-end to identify premature or fictitious revenue recognition.
5. Investigate unusual sales transactions and additional goods supplied to distributors, including comparing quantities invoiced with quantities actually ordered/accepted by customers and assessing whether channel stuffing has occurred.
6. Apply analytical procedures on sales.
7. Review contracts for proper recognition criteria, specially to identify the point at which the control has passed to the customers.
8. Test manual journal entries for override risk as the scenario indicates this is an area of concern.
9. Check subsequent payments against invoices.
10. Match invoices to dispatch notes and customer acknowledgments.

(Expect only five procedures)

(05 marks)

(f)

- <u>Inventory cut-off</u>

  The Rs. 3 million inventory cut-off error exceeds the overall materiality of Rs. 2.5 million. Since management refuses to correct it, it represents a material uncorrected misstatement.

- <u>Trade receivables impairment</u>

  The Rs. 1.8 million under-provision is individually below the Rs. 2.5 million materiality level. However, it must be considered together with other uncorrected misstatements.

- <u>Aggregate impact on audit report</u>

  The total identified misstatements are:

  Rs. 3.0m + Rs. 1.8m = Rs. 4.8m

  Since Rs. 4.8m is above Rs. 2.5m, the aggregate effect is material.

  Therefore, if management refuses to make the necessary adjustments, the auditor would generally need to issue a modified opinion.

Since the aggregate uncorrected misstatements amount to Rs. 4.8 million, which exceeds the overall materiality of Rs. 2.5 million, and management refuses to adjust the financial statements, ABC Associates should consider issuing a qualified opinion, provided the misstatements are material but not pervasive.

(06 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.

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