



**Association of Accounting Technicians of Sri Lanka**

**July 2020 Examination - Level III**

**Suggested Answers (303)**

**(303) FINANCIAL CONTROLS & AUDIT**

**Association of Accounting Technicians of Sri Lanka**

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**THE ASSOCIATION OF ACCOUNTING TECHNICIANS OF SRI LANKA**  
**Level III Examination-July 2020**  
**(303) FINANCIAL CONTROLS & AUDIT**  
**SUGGESTED ANSWERS**

(Total 20 Marks)

**SECTION - A**

***Suggested Answers to Question One:***

***Chapter 01 – Business Environment and Governance Framework***

**(a) Principles of Corporate Governance**

- i. Keep the interest of stakeholders in mind
- ii. Treating shareholders equally
- iii. Identifying the roles of the Board of Directors
- iv. Ethical behavior
- v. Transparency

**(02 marks)**

**(b) Guidance on role of Board of Directors**

- i. The Board should meet regularly. Board meetings should be held at least once in every quarter of a financial year in order to effectively execute the board's responsibilities, while providing information to the board on a structured and regular basis; ideally monthly, or as agreed by the Board.
- ii. The chairman's role in preserving good Corporate Governance is crucial. As the person responsible for running the board, the chairman should preserve order and facilitate the effective discharge of Board functions.
- iii. The Board should ensure the availability within it of those with sufficient financial acumen and knowledge to offer guidance on matters of finance.
- iv. It is preferable for the Board to have a balance of Executive and Non-Executive Directors such that no individual or small group of individuals can dominate the Board's decision taking.
- v. There should be a formal and transparent procedure for the appointment of new Directors to the Board.
- vi. All Directors should be required to submit themselves for re-election at regular intervals and at least once in every three years.
- vii. Boards should periodically appraise their own performance in order to ensure that Board responsibilities are satisfactorily discharged.
- viii. Shareholders should be kept advised of relevant details in respect of Directors.
- ix. The Board should be required, at least annually, to assess the performance of the CEO.

**(03 marks)**

(Total 05 marks)

### Suggested Answers to Question Two:

#### Chapter 01 - Business Environment and Governance Framework

##### External Risks

- i. Interest rate fluctuation
- ii. Changes in the inflation rates
- iii. Fluctuations in the exchange rate
- iv. Non-availability of goods to meet the customers demand due to import restrictions
- v. Imposing the new tax on the industry in which the business exists
- vi. Change in the life style of the customers due to COVID 19
- vii. Due to the technological changes the developed products can become obsolete
- viii. Strict regulations imposed by the government
- ix. Change in the attitudes of majority of the population

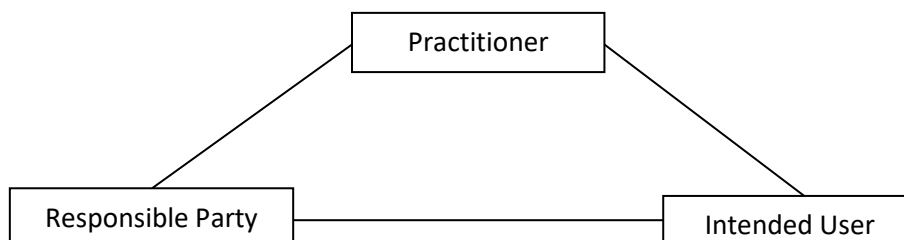
##### Internal Risks

- i. Absenteeism of the employees to the duty
- ii. Close down of business operations due to the COVID 19
- iii. Inadequate supplies to the production
- iv. Inability to meet the demand of the customers due to limited resources
- v. Drop in revenue and profit
- vi. Loss of key employees to the business due to COVID 19
- vii. Inability of the entity to meet with the required technological development to meet customer requirements (eg. technology involve with supplying order through on-line)

(05 marks)

### Suggested Answers to Question Three:

#### Chapter 04 - Assurance Engagements and Related Services



A three-party relationship is one of the five elements of an assurance engagement required by SLISAE 3000 (Revised). These parties are typically: the responsible party, users, and the practitioner.

The **responsible party** performs operations or provides information for the benefit of or relevant to users. They are responsible for the subject matter over which assurance is sought.

**Users** are the recipients of services, assets or information of the responsible party. Users may also receive information in relation to the operations of the responsible party.

The **practitioner** engages to perform an assurance engagement in relation to the subject matter or

the subject matter information that the responsible party is responsible for.

The practitioner agrees with the engaging party the scope of the engagement, the reporting requirements and ensures that there is appropriate access to the personnel and information of the responsible party and, if applicable, external parties including the users.

**(05 marks)**

***Suggested Answers to Question Four:***

***Chapter 09 – Requirements for an Audit of Financial Statements***

**(a) Elements of a system of quality controls**

1. Leadership Responsibilities for quality within the firm
2. Relevant Ethical Requirements
3. Acceptance and continuance of client
4. relationship Human Resources
5. Engagement Performance
6. Monitoring

**(03 marks)**

**(b) Two Activities that could be included on an individual engagement**

A review consists of consideration of whether:

- The work has been performed in accordance with professional standards and applicable legal and regulatory requirements;
- Significant matters have been raised for further consideration;
- Appropriate consultations have taken place and the resulting conclusions have been documented and implemented;
- There is a need to revise the nature, timing and extent of work performed;
- The work performed supports the conclusions reached and is appropriately documented;
- The evidence obtained is sufficient and appropriate to support the report; and
- The objectives of the engagement procedures have been achieved

**(02 marks)**

**(Total 05 marks)**

***End of Section A***

***Suggested Answers to Question Five:***

***Chapter 7 – Audit Reporting***

(a)

- i. Title
- ii. Addressee
- iii. Basis for Opinion
- iv. Key Audit Matters
- v. Other Information
- vi. Auditor's Responsibilities for the Audit of the Financial Statements
- vii. CA Sri Lanka Membership Number of the Engagement Partner
- viii. Signature of the Auditor
- ix. Auditor's Address
- x. Date of the Auditor's Report

**(05 marks)**

(b)

- I. Whether sufficient appropriate audit evidence has been obtained.
- II. Whether identified uncorrected misstatements are material individually or in aggregate to the financial statements
- III. Whether the accounting policies selected and applied are consistent with the applicable financial reporting framework.
- IV. Whether the accounting estimates made by management are reasonable.
- V. Whether the information presented in the financial statements is relevant, comparable and understandable.
- VI. Whether the financial statements provide adequate disclosures to enable the intended users to understand the effect of material transactions and events .
- VII. Whether terminology used in the financial statements including title of each financial statements is appropriate.
- VIII. Whether the financial statements achieve fair presentation.

**(03 marks)**

(c) **Types of modified opinions**

- i. A qualified opinion
- ii. An adverse opinion
- iii. A disclaimer of opinion

**(02 marks)**  
**(Total 10 marks)**

## ***Suggested Answers to Question Six:***

### **Chapter 8 – Ethical Requirements**

#### **(a) Safeguards to be implemented**

- i. Implementation of policies and procedures to monitor and, if necessary , manage reliance on revenue received from single client
- ii. Engage different partners and engagement teams with separate reporting lines for the non-assurance service to an assurance client
- iii. Implement documented policies regarding the need to identify threats to compliance with the fundamental principles, evaluate the significance of those threats, and apply safeguards to reduce threats.
- iv. Implementing rotation policy for senior assurance team. In the given scenario **Saman**, who is in charge of audit since 3 years, could be removed from this engagement.
- v. Establish policies and procedures to monitor quality control engagements
- vi. Establish documented internal policies and procedures requiring compliance with the fundamental principles
- vii. Implement independence requirement for assurance client. Firm shall be independent of audit client
- viii. Implement disciplinary mechanism to promote compliance with policies and procedures
- ix. Disclosing to those charge with governance of the client the nature of review provided exact of fees charged
- x. Having a professional accountant who was not a member of the assurance team to review the assurance work performed
- xi. Get advices from an independent third party

**(06 marks)**

#### **(b) Threats to compliance with the fundamental principles of ethics**

##### **Self-interest threat**

Self-interest threat arisen due to a firm entering into a contingent fee arrangement relating to an assurance engagement. Rukman Associates earns a significant amount of its revenue (nearly 35%) from accounting and annual audit services from HTP Freight Services (Pvt Ltd). Further, Mr. Rukman is the engagement partner for the audit of HTP science 2010.

##### **Self-review Threat**

Self-review Threat is 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. If Rukman Associates accepts the assignment for valuation of equity instruments, the valuation will be audited by RA Associates itself.

### **Familiarity Threat**

The threat is arisen due to a long or close relationship with a client or employer. Mr. Rukman as the engagement partner for the audit of HTP (Pvt) Ltd has made a long relationship with the client since 2010.

**(03 marks)**  
**(Total 10 marks)**

### ***Suggested Answers to Question Seven:***

<b>Chapter 5 - Risk Assessment and Audit Process</b>
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**(A) Matters to include in a Planning Memorandum**

- I. Major changes in the client's business, organization or accounting systems
- II. Changes in law, accounting standards or the firm's procedures
- III. Other relevant background information
- IV. Problems encountered in previous years and other points brought forward
- V. current tax position
- VI. Time and cost budgets and staffing plans
- VII. Timetable and accounting assistance from the client
- VIII. Overall audit strategy
- IX. Detailed audit approach for each major area, stating the degree of reliance on internal
- X. Control; and control, analytical review and substantive procedures and giving approximate sample sizes for the main substantive procedures

**(04 marks)**

**(B)**

**(a) Form and content of working papers get affected**

- i. The size and complexity of the entity.
- ii. The nature of the audit procedures to be performed.
- iii. The identified risks of material misstatement.
- iv. The significance of the audit evidence obtained.
- v. The nature and extent of exceptions identified.
- vi. The need to document a conclusion; and
- vii. The audit methodology and tools used.

**(03 marks)**

**(b) Information included in the permanent audit file**

- i. Legal status of the entity, Organization structure Important legal documents
- ii. Industry, regulatory details within which entity operates
- iii. Certificate of Incorporation, Articles of association
- iv. Statutory requirements to be complied by the entity
- v. Entity's information system and internal control system documentation
- vi. Complete list of books and records maintained by the Company
- vii. Copies of, and extracts from, important agreements that will be of relevance from year to year
- viii. Details of major fixed assets such as property
- ix. Accounting schedules of continuing relevance, such as fixed assets depreciation lapsing schedules and leased asset finance cost allocation schedules

- x. Group structure and the history of investment in subsidiaries, associates and other major investments
- xi. Masters of audit programmes, etc.
- xii. Location in the computer disc library of word processor masters and spreadsheet layouts

(03 marks)

(Total 10 marks)

**End of Section B**

**SECTION - C**

**Suggested Answers to Question Eight:**

**Chapter 3 - Internal Control System and Business Process**

(A)

(a) Internal Control Weaknesses	(b) Recommendation
1. Attendance records are not reviewed and approved by an authorized officer prior to the processing of the payroll. This will lead to non-detection of errors and susceptible for fraud.	1. The attendance records should be reviewed and approved by an authorized officer of the Company
2. Monthly payroll is not calculated and approved by the HR Executive and HR manager respectively.	2. Monthly payroll should be approved by both HR manager and Finance & Administration Manager
3. There is no proper segregation of duties. Payroll module should be updated to the SAP system by the Accounts Executive who makes the payment as well.	3. There should be a proper segregation of duties.
4. Payroll reconciliations are not prepared. This will lead to non-detection of errors and making fraudulent payments.	4. Monthly payroll reconciliations should be prepared and reviewed by an authorized officer prior the approval of the payment
5. There is no proper general controls over the ERP system and does not ensure the segregation of duties due to the availability of a single user account. There is a question on the integrity of the accounting system	5. Separate user login should be assigned to each users of the divisions to prevent unauthorized access and to increase the credibility of accounting system
<b>(03 Marks)</b>	<b>(03 Marks)</b>

(c) **Objectives of effective payroll process**

- i. Employees are only paid for the days that they have actually worked
- ii. To ensure that payments are made only to the actual employees
- iii. Employees are paid at the correct rate
- iv. Deductions are accurately considered when making the payments
- v. Records are updated accurately to the correct employee
- vi. Correct amounts are paid to the employees and other regulatory authorities such as



Provident Fund and tax Department

- vii. Payments are made on time
- viii. All payroll related payments are recorded accurately in the correct ledger accounts in the correct period and in the correct amounts

**(02 Marks)**

**(d) General Controls**

<b>General Control</b>	<b>Examples</b>
<b>Development of Computer Application</b>	<ul style="list-style-type: none"> <li>- Standard over systems design, programming and documentation</li> <li>- Approval by computer users and Management</li> <li>- Segregation of duties so that those responsible for design are not responsible for testing</li> <li>- Training of staff in new procedures and available of adequate documentation</li> </ul>
<b>Prevention or detection of unauthorised changes to programs</b>	<ul style="list-style-type: none"> <li>- Segregation of duties</li> <li>- Password protection of programs so that access is limited to computer operation staff</li> <li>- Restricted access to central computer by locked doors.</li> <li>- Virus check on software. Use of anti-virus software and policy prohibiting use of non-authorized programs or files</li> <li>- Back-up copies of programs being taken and stored in other locations</li> </ul>
<b>Testing and documentation of program changes</b>	<ul style="list-style-type: none"> <li>- Complete testing procedures</li> <li>- Documentation standards</li> <li>- Approval of changes by computer users and management</li> <li>- Training of staff using programme Controls to prevent</li> </ul>
<b>unauthorised amendments to data files</b>	<ul style="list-style-type: none"> <li>- Physical security over remote terminals</li> <li>- Limited access to authorised personnel</li> <li>- Firewalls</li> <li>- User identification controls such as passwords</li> <li>- Encryption of Data</li> </ul>
<b>Controls to ensure continuity of operations</b>	<ul style="list-style-type: none"> <li>- storing extra copies of programs and data files off-site</li> <li>- Protection of Equipment against fire and other hazards</li> <li>- Back-up power sources</li> <li>- Disaster recovery procedures - Availability of back up facilities</li> <li>- Maintenance agreements and insurance</li> </ul>

**Application Controls**

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

(5 Marks)

(B)

(a) **Objectives of internal control system**

**I. Reliability of Financial Reporting**

It is the responsibility of management to prepare financial statements to meet the common use of most users. Therefore, financial statements need to be reliable but do not require to provide all information that users may need to make economic decisions.

Management also has a legal responsibility to ensure that information is fairly prepared in accordance with requirements such as Generally Accepted Accounting Principles (GAAPs) & Sri Lanka Accounting Standards.

The above requires good internal controls to be introduced over financial reporting.

**II. Effectiveness and Efficiency of operations**

Controls with an organization are also meant to encourage efficient and effective use of resources, including personnel, to optimize the company's goals. An important part of these controls is accurate information for internal decision making.

**III. Compliance with Laws and Regulations**

There are many laws and regulations that organizations are required to follow which are directly and indirectly related to accounting. Compliance with these laws and regulations are vital for the functions of an organization and noncompliance of certain laws may affect the going concern ability of the organization.

**IV. Safeguard of assets of the business**

Controls should be in place to ensure that the assets are deployed for their proper purchases and are not vulnerable to misuse or theft.

**V. Prevention and detection of fraud and errors**

When organizations increase in its' size and complexity the nature of fraudulent practices becomes more and controls must be capable of addressing these.

**VI. Timely preparation of Financial Statements**

Organizations should be able to fulfill their legal obligations to submit their accounts accurately and on time. They are also responsible to submit financial statements to the shareholders in a timely manner. For this purpose internal controls could be applied.

**(04 Marks)**

**(b) Control Activities**

- i. Segregation of duties
- ii. Physical controls
- iii. Authorization and Approval
- iv. Management controls
- v. Supervision controls
- vi. Organization controls
- vii. Arithmetic and Accounting controls
- viii. Personnel Controls

**(04 Marks)**

**(C) Inherent limitations of internal controls**

- i. Controls may not be well designed
- ii. Controls may not be implemented as required. Therefore, even a well-designed controls may not be able achieve its objectives
- iii. Continue changes in operational risks. As a result of the pre designed controls may fail to address new risks
- iv. Cost of designing and implementing controls does not justify the benefits delivered from those controls.
- v. Poor risk awareness culture within the organization. Directors should take the leadership to implement a culture which values controls over the processes of the organization
- vi. Non routine transactions are not covered. Most internal controls tend to direct at routine transactions rather than non-routine transactions
- vii. Human errors - Even if internal controls are well designed, there can be break down.
- viii. Personnel may misunderstand instructions. They may make judgmental mistakes or they may commit error due to carelessness, Distraction or fatigue

**(04 Marks)**

**(Total 25 Marks)**

***Suggested Answers to Question Nine:***

**(A)**

**(a) Areas need special attention**

1. Revenue recognition point – as per the given details it is at the time of invoicing rather than the point at which risks and rewards pass to the customer
2. Sales made to related parties – whether the goods are sold at the fair value (arm's length transaction)
3. Incentives – incentives made based on the sales for the year

4. Trade Receivables – significant amount of receivables (130 Mn from 180 Mn) is from related parties
5. More credit period has given for related parties
6. Related Party Transactions – whether transactions have been approved by the related party transaction committee
7. The approved credit limits for the customers including related parties
8. Impairment of trade receivables
9. Valuation of inventory as at the year end.

**(04 Marks)**

- (b)**
1. Bank Confirmations to confirm the bank balances at banks
  2. Inventory held by third parties at bonded warehouses for processing or on consignment
  3. Property title deeds held by lawyers or financial institutions for safe custody or as securities.
  4. Investments purchased from stock brokers but not sold at the reporting date.
  5. Confirm the loans or leases balances from lenders
  6. Account payable balances to trade or other creditors
  7. Bank confirmations to confirm fixed deposit balances at banks
  8. Related party receivables
  9. Confirmation from solicitors to confirm the status of legal cases

**(03 Marks)**

- (c)** Test of controls are performed to obtain audit evidence about the operating effectiveness of controls in preventing or detecting and correcting material misstatements at the assertion level.

Substantive procedures are audit procedures performed to detect material misstatements at the assertion level. Substantive procedures must always be carried out for material classes of transactions, account balances and disclosures. **(03 Marks)**

- (d)** The management of BC (Pvt) Ltd **(02 Marks)**

**(e) Related party transactions**

1. Sales made to related parties (Associate Company and MD's wife) in the month of March and year consist of 66% and 33% respectively. Audit should consider whether these are actual sales occurred during the respective period.
2. Managing Director is entitled for an incentive payment based on the sales for the year. Therefore, sales made to his spouse is required to be considered as a potential factor for fraud risk. Auditor should focus on the occurrence as a key assertion for revenue
3. Auditor should consider the approved credit terms and credit limits to the related parties
4. Auditor needs to ensure that performed transactions are approved by the related party transaction committee
5. It need ensure the transactions are done at the market rate
6. Auditor needs to ensure whether the related party transactions have been properly disclosed in the financial statements

**(02 Marks)**

**(B)**

**(a) Importance of materiality**

- i. Identify and assess the risks of material misstatement
- ii. Determine the nature, timing and extent of further audit procedures
- iii. Determine the amount of audit work necessary to facilitate audit efficiency and effectiveness
- iv. Determine the applicability of accounting standards which normally apply only to material items
- v. Evaluate uncorrected misstatements during the audit
- vi. Evaluate what level of error is likely to lead to a modified opinion

**(03 Marks)**

**(b)**

1. Depreciation on building - The misstatement is below the materiality threshold and hence no significant impact on the audit.
2. The un-accrued electricity and water charges for the month of March 2020 is only Rs 1 Mn. The misstatement is below the materiality level and there is no any significant impact on the overall financial statements.
3. As per LKAS 23 ,an entity shall cease capitalizing borrowing costs when substantially all the activities necessary to prepare the qualifying asset for its intended use or sale are complete.  
Accordingly, 25Mn borrowing cost incurred after constructing the building is a material misstatement. Since it is above the materiality threshold of Rs. 10Mn and if any case management refuses to adjust the financial statements, the impact to the financial statements to be evaluated.
4. The total of the uncorrected misstatement is Rs. 26.2 Mn which resulted in reducing the profit for the year ended 31<sup>st</sup> March 2020 and which is material to the overall financial statements. The auditor needs to communicate the un-adjusted audit differences to the management or those charged with governance to adjust the financial statement balances. If management does not agree, the auditor needs to evaluate its impact to the auditor's opinion.

**(07Marks)**

**(Total 25 Marks)**

**End of Section B**

***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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