



Association of Accounting Technicians of Sri Lanka

Level III Examination - January 2021

Suggested Answers

(303) FINANCIAL CONTROLS & AUDIT (FCA)

Association of Accounting Technicians of Sri Lanka

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THE ASSOCIATION OF ACCOUNTING TECHNICIANS OF SRI LANKA

Level III Examination-January 2021

(303) FINANCIAL CONTROLS & AUDIT

SUGGESTED ANSWERS

(Total 20 Marks)

SECTION - A

Suggested Answers to Question One:

Chapter 1 - Business Environment and Governance Framework

Changes	External Environmental Factors
Government policy of granting "moratorium" on debt services	Political Forces
Government policy of implementing simple tax system	Political Forces
Reduction in interest rates	Economic Forces
Physical meetings were substituted with virtual meetings	Technology Forces
Introduction of laws and regulations to follow health guidelines	Legal Forces

(05 marks)

Suggested Answers to Question Two:

Chapter 2 - Risk Management Framework

(a) Risk Avoidance

Risk avoidance is the elimination of hazards, activities and exposures that can negatively affect an organization's assets. Whereas risk management aims to control the damages and financial consequences of threatening events, risk avoidance seeks to avoid compromising events entirely.

Example: Close down loss making business units

(03 marks)

(b) Strategies used for risk reduction

1. Diversification of Operations
2. Risk Sharing
3. Business Contingency Planning
4. Internal Controls for Operational Risks

(02 marks)

(Total 05 marks)

Suggested Answers to Question Three:

Chapter 4 - Assurance Engagements and Related Services

(a) Risk Avoidance

- Ethical and Quality control requirements
- Engagement Acceptance and Continuance
- Planning and performing Engagement
- Assessing the appropriateness of the subject matter
- Assessing the suitability of the criteria
- Materiality and assurance Engagement Risk
- Obtaining Evidence
- Documentation
- Preparing the assurance report

(03 marks)

(b) Elements of assurance engagements

- Three party Relationship
- Subject Matter
- Suitable Criteria
- Evidence
- Assurance Report

(02 marks)
(Total 05 marks)

Suggested Answers to Question Four:

Chapter 9 - Requirements for an Audit of Financial Statements

(a) Policies considered in quality control of an individual engagement

1. Consistency in the Quality of Engagement Performance
2. Supervision
3. Review

(02 marks)

(b) Matters included in a system of quality controls with regard to the integrity of a client

1. The identity and business reputation of the client's principal owners, key management, and those charged with its governance.
2. The nature of the client's operations, including its business practices.
3. Information concerning the attitude of the client's principal owners, key management and those charged with its governance towards such matters as aggressive interpretation of accounting standards and the internal control environment.
4. Whether the client is aggressively concerned with maintaining the firm's fees as low as possible.

5. Indications of an inappropriate limitation in the scope of work.
6. Indications that the client might be involved in money laundering or other criminal activities.
7. The reasons for the proposed appointment of the firm and non-reappointment of the previous firm.
8. The identity and business reputation of related parties.

(03 marks)
(Total 05 marks)

End of Section A



Suggested Answers to Question Five:***Chapter 7 – Audit Reporting*****(a)**

1. The building was being used from 1st March 2020. As per LKAS 16 the cost of the building should be transferred to building account from Capital WIP account. Rs. 1.5 Mn should be shown as buildings under PPE as at 31st March 2020.

Further, as per LKAS 16 the depreciation on the said building should be started when the asset is ready for use. Accordingly, the depreciation charge for the month of March of Rs. 125,000/- should have been recognized as an expense for the period ended 31st March 2020. Since, the depreciation charge of Rs. 125,000/- is lower than the materiality threshold of Rs.500,000/- this would not make a significant impact on the auditors' report.

2. As per LKAS 2, inventory should be recognized at cost or Net Realizable Value whichever is low. Therefore, the company should have adjusted the amount of Rs. 5 Mn from the inventory and which is higher than the materiality level set for the audit. Since this is an adjusting event for the financial statements for the year ended 31st March 2020.
3. As whole misstatements are material to the financial statements and if the management is not willing to rectify them, the auditor needs to modify his opinion.

(07 marks)**(b)**

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

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

Suggested Answers to Question Six:

(A)

Chapter 4 – Assurance Engagements and Related Services

Matters to consider before taking a decision to accept an engagement

- i. The proposed auditor should inquire the reasons why the predecessor auditor refuses the acceptance of the engagement and reasons for resignation, whether this is due to a dispute with the management of YP or due to an ethical issue. Hence, it is important that ethical clearance of the predecessor auditor is obtained.
- ii. The integrity of the management of YP – why the management did not want to disclose the current litigation against the Company. Whether the auditors have to work with a client having integrity issue (e.g. reputational damage)
- iii. The auditor needs to inquire or need to obtain the status and details of the legal case.
- iv. A short time period is available to provide the auditor’s report. It is worth to access the deadline set by the management as whether there is a real requirement for it.
- v. The ability of the auditor to provide the expected service of the YP, as this is a tight dead line and the auditor has a limited resource as there are other deadlines which need to be managed by the existing partners. Two partners are busy and seniors are seconded to an overseas office and therefore, it is important that the auditor assess the availability of required staff and the time that can be committed for this deadline.
- vi. Before accepting the engagement, the firm shall determine whether the acceptance of the engagement would create any threats to compliance with the fundamental principal.

(06 marks)

(B)

Chapter 8 – Ethical Requirements

Threats to independence

1. Financial Interests
2. Loans and Guarantees
3. Business Relationships
4. Family and Personal Relationships
5. Employment with an Audit Client

(04 marks)

(Total 10 marks)

Suggested Answers to Question Seven:

Chapter 6 - Audit Evidences

(A)

(a) Weaknesses in the external confirmation process

The auditor has adopted the negative confirmation request. Due to the following reasons, this cannot be used by the auditor;

- I. Auditor could have simply used positive confirmation request since smaller number of debtors with large values are existing.
- II. The assessed risk of material misstatements over existence of trade receivables is high. Therefore, it is important that auditor calls for positive confirmations.
- III. The confirmation process is the sole substantive audit procedure to test the existence of trade receivables
- IV. CEO has requested auditors to not to send a letter to confirm the balance of a nominated customer.

(04 marks)

(b)

- I. Inquire the reasons for the refusal, and seek audit evidence as to their validity and reasonableness
- II. Evaluate the implications of management's refusal on assessment of the relevant risks of material misstatement, including risk of material misstatement due to fraud, and on the nature, timing and extent of other audit procedures
- III. Perform alternative audit procedures designed to obtain relevant and reliable audit evidence.

(02 marks)

(B) Inquiries made by the management

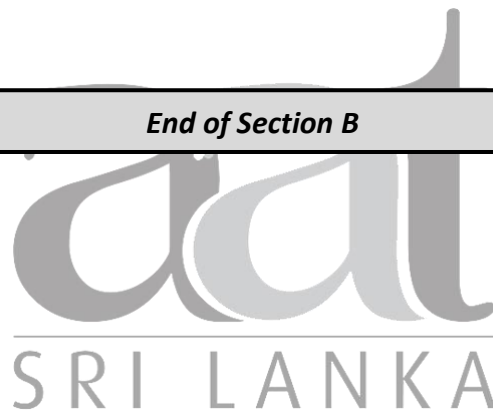
- Whether new commitments, borrowings or guarantees have been entered into.
- Whether sales or acquisitions of assets have occurred or are planned.
- Whether there have been increases in capital or issuance of debt instruments, such as the issue of new shares or debentures, or an agreement to merge or liquidate has been made or is planned.
- Whether any assets have been appropriated by government or destroyed, for example, by fire or flood.
- Whether there have been any developments regarding contingencies.
- Whether any unusual accounting adjustments have been made or are contemplated.
- Whether any events have occurred or are likely to occur that will bring into question the appropriateness of accounting policies used in the financial statements
- Whether any events have occurred that are relevant to the measurement of estimates or provisions made in the financial statements

- Whether any events have occurred those are relevant to the recoverability of assets.
- Reading minutes of the meetings of the entity's owners, management and those charged with governance that have been held after the date of the financial statements and inquiring about matters discussed at any such meetings for which minutes are not yet available.
- Reading the entity's latest subsequent interim financial statements.
- Read the entity's latest available budgets, cash flow forecasts and other related management reports for periods after the date of the financial statements.
- Inquire, or extend previous oral or written inquiries, of the entity's legal counsel concerning litigation and claims.
- Consider whether written representations covering particular subsequent events may be necessary to support other audit evidence and thereby obtain sufficient appropriate audit evidence.

(04 marks)

(Total 10 marks)

End of Section B



Suggested Answers to Question Eight:***Chapter 3 - Internal Control Systems and Business Processes*****(A)****(a) Internal Control Weaknesses**

1. No delegation of authorities since the MD's wife involves in invoicing and following up on outstanding collection process.
2. There are no material purchase records and supporting documents.
3. Lack of knowledge in accounting functions among the existing personal.
4. Books of records have not been updated and Financial Statements have not been prepared by the company for last 3 years.
5. MD is involved in procuring the materials and other supplies.

(03 marks)**(b)**

Control Type	Explanation	Example
Operational control	Operational controls refer to controls that reduce the risk of losing efficiency or effectiveness in business operations	Maintain machinery according to the instructions given in users manuals
		Implement physical safeguards such as access controls in stores
		Security guards or CCTV cameras can be occupied in the entrance of the factory premises
Financial controls	Financial controls are implemented to reduce the risks of errors or fraud in accounting systems and financial reporting.	All invoices must be recoded according to serial order
		All payment vouchers should be recorded in serial order to avoid failure to document or account any payments
		Payment vouchers should be supported with purchase orders, GRNs and other external supporting documents
		Cheques should be signed by 2 authorities
		Implementation of system controls to avoid duplicates

		Approval for the staff claim should be mandatory to perform the payment.
Compliance controls	Compliance controls are the controls which reduce the risk of non-compliance with laws or regulations. These controls vary with the nature of industry in which the business organization operates	Whether the company's food processed in accordance with the stipulated health regulations
		Whether date of manufacturing and expire dates etc. are clearly displayed as accounting to local authority rules

(06 marks)

(c) Key Business Processes

1. Cash Management Process
2. Procurement Process
3. Invoicing Process
4. Financial Statement preparation Process
5. Inventory Management Process
6. Payroll Process
7. Property, Plant and Equipment Process

(04 marks)

(d) Purpose of IT General Controls and IT Application Controls

General IT Controls

The purpose of general IT controls is to establish a framework of overall control over the computer information system's activities to provide a reasonable level of assurance that the overall objectives of internal controls are achieved. They include controls over access security, data center and network operations, software acquisition, change and maintenance, and application system acquisition, development and maintenance. They are sometimes referred to as supervisory, management or information technology controls.

Application Controls

The purpose of application controls is to establish specific control procedures over accounting applications in order to provide reasonable assurance that all transactions are authorized and recorded, and are processed completely, accurately and on a timely basis. Application controls include data capture controls, data validation controls, processing controls, output controls and error controls.

(03 marks)

(B)

(a) There may be deficiencies in internal controls due to various inherent limitations in controls. These include;

- Ineffective design of the controls
- Ineffective implementation where the control is designed adequately
- Human errors or oversight
- Fraud

Therefore, even after having an internal controls system it will not eliminate the errors entirely due to the above weaknesses discussed and your friend's statement is incorrect.

(04 marks)

(b) System of Internal Control

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

(03 marks)

(c) Components of internal control system as per COSO

- Control Environment
- Risk Assessment
- Control Activities
- Information and Communication
- Monitoring

(02 marks)

(Total 25 marks)

Suggested Answers to Question Nine:

(A)

Chapter 5 – Risk Assessment and Audit Process
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(a) Areas need special attention

1. Investments
2. Inventory
3. Revenue
4. Bonus
5. Related party transactions
6. Property, plant & equipment
7. Net profit

(04 marks)

(b) Conditions to be considered when revising the terms of the letter of engagement

- Any indication that the management has misunderstood the scope and objective of an audit
- Any revised or special terms of the audit engagement
- A significant change in the ownership
- A recent change in Senior Management
- A significant change in size or nature of the entity
- A change in laws or regulations
- A change in Financial reporting framework adopted in the presentation of the financial statements
- A change in other reporting requirements

(03 marks)

(c) Areas where auditor should exercise professional judgment in planning and performing an audit.

- Materiality & Audit risk
- Nature, Timing and extent of audit procedures
- Evaluation of whether sufficient appropriate audit evidence has been obtained
- Drawing conclusions based on the audit evidence obtained
- Evaluation of management's judgments in applying the entity's applicable financial reporting framework

(03 marks)

(d) Significant Risk

Significant risks are those that require special audit consideration. As part of the risk assessment, the auditor shall determine whether any of the risks are significant risks. The following factors indicate that a risk might be significant.

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

Since the CEO's bonus is determined based on the achievement of sales and profits, there is a tendency in increasing the revenue which is a significant risk for this engagement.

(04 marks)

(e) Audit procedure relating to sales

1. Analyze the current year revenue with last year revenue
2. Check whether revenue related transactions for the period have been occurred
3. Check whether the company uses pre-numbered invoices and check a sample of invoices
4. Check whether there are significant sales returns subsequent to the period end.
5. Perform cut –off procedures
6. Check whether the transactions relating to revenue have been considered for the period
7. Check whether amounts and other data relating to record revenue transactions and events are recorded appropriately
8. Revenue recognition point – check delivery notes to ensure that revenue is recognized once the risk and rewards passed to the buyer and properly accounted
9. Check the price list of items sold by the company

(04 marks)

(B)

Chapter 6 – Audit Evidences

(a) Financial indicators on the going concern

- i. Net liability or net current liability position
- ii. Fixed-term borrowings approaching maturity without realistic prospects of renewal or repayment
- iii. Indications of withdrawal of financial support by creditors
- iv. Negative operating cash flows (historical or prospective)
- v. Adverse key financial ratios
- vi. Substantial operating losses or significant deterioration in the value of assets used to generate cash flows
- vii. Arrears or discontinuance of dividends
- viii. Inability to pay creditors on due dates
- ix. Inability to comply with terms of loan agreements
- x. Change from credit to cash-on-delivery transactions with suppliers
- xi. Inability to obtain financing for essential new product development or other essential investments

(03 marks)

(b) Audit procedures to be performed when conditions to going concern are identified

1. Analyze and discuss cash flow, profit and other relevant forecasts with management
2. Analyze and discuss the entity's latest available interim financial statements (or management accounts)
3. Review the terms of debentures and loan agreements and determine whether they have been breached
4. Read minutes of the meetings of shareholders, the board of directors and important committees for reference to financing difficulties
5. Enquire of the entity's lawyer regarding litigation and claims
6. Confirm the existence, legality and enforceability of arrangements to provide or maintain financial support with related and third parties
7. Assess the financial ability of such parties to provide additional funds
8. Consider the entity's position concerning unfulfilled customer orders

9. Review events after the period-end for items affecting the entity's ability to continue as a going concern
10. Confirm the existence, terms and adequacy of borrowing facilities
11. Obtaining and reviewing reports of regulatory actions
12. Determining the adequacy of support for any planned disposals of assets

(04 Marks)

(Total 25 Marks)

End of Section C

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