



Association of Accounting Technicians of Sri Lanka

Level III Examination – July 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 - July 2021

(303) FINANCIAL CONTROLS & AUDIT

SUGGESTED ANSWERS

(Total 20 Marks)

SECTION - A

Suggested Answers to Question One:

Chapter 4 - Assurance Engagements and Related Services

(a) Difference between Reasonable Assurance Engagement and Limited Assurance Engagement

Reasonable Assurance Engagements	Limited Assurance Engagements
The practitioner gathers sufficient appropriate evidences to be able to draw reasonable conclusions.	The practitioner gathers sufficient appropriate evidences to be able to draw limited conclusions.
Concludes that the subject matter conforms in all material aspects with identified suitable criteria.	Concludes that the subject matter, with respect to identified suitable criteria, is applicable only to the circumstances.
Gives a positively worded assurance opinion.	Gives a negatively worded assurance opinion.
Performs very thorough procedures to obtain sufficient appropriate evidence – Test of controls and substantive audit procedures.	Gives a moderate or lower level of assurance than that of an audit – Performs fewer procedures.

(03 marks)

(b) Assurance Engagements

- 1) Assurance on special purpose financial statements
- 2) Review of Financial Statements
- 3) Assurance over strength of internal controls
- 4) Assurance over environmental matters
- 5) Assurance over regulatory compliances
- 6) System reliability reports
- 7) Assurance over corporate governance
- 8) Assurance over risk management

(02 marks)

(Total 05 marks)

Suggested Answers to Question Two:

Chapter 1 - Business Environment and Governance Framework

Difference between Agency Theory & Stewardship Theory

Agency occurs when one party, the principal, employs another party, the agent, to perform a task on his behalf. Agency theory focuses on relationships between parties where one delegates some decision-making authority to the other. The agent is responsible for maximizing the principal's investment in exchange for a fee based on the decision making authority delegates by the principal.

Stewardship is the responsibility to take good care of resources of the organization. A steward is a person entrusted with management of another person's property, for example, when one person is paid to look after another person's property, while the owner goes abroad on holiday. Therefore, this is a framework which argues that people are intrinsically motivated to work for others or for organizations to accomplish the tasks and responsibilities with which they have been entrusted.

(05 marks)

Suggested Answers to Question Three:

Chapter 5 - Risk Assessment and Audit Process

(a) Risk in operations

Risk in operations are the uncertainties and hazards a company face when it attempts to do its day-to-day business activities within a given field or industry. Leisure sector is badly affected due to the Covid 19 pandemic. Since AB PLC engages in the leisure sector there is a high risk of operations for the entity.

- Significant liquidity and cash flow risk from ceased operations during peak season and expectation of slow recovery.
- Deferred CAPEX could impact long-term growth prospects.
- Extensive travel restrictions resulting in booking cancellations.
- Increase in staff and guests' health and safety measures
- Supply chain disruption.
- Unexpected labour shortages due to self-quarantines.
- Low revenue would affect the payment of staff salaries and which in turn affect the skilled labour turnover.
- Operates below the normal occupancy ratio due to the government health regulations and inability of utilizing the banquet hall facilities.
- Pressures on cash management due to low revenue.
- Reduced investments and restrictions in obtaining borrowings for the company.

- Stricter food safety guidelines and requirement for additional staff personal protective equipment (PPE).
- Increasing operating costs (payment of minimum wage, rates, rent, food supplies).
- Interdependence with, and codependence on other sectors (aviation, logistics and distribution, tour operators).

(b) Compliance Risk

The risk of failure to comply with an important law or regulation. A consequence of noncompliance with regulations may be losses from the cost of fines. There are some industries which are bound by specific regulations due to the significant risks involved in that industry.

- Nonpayment of loan installments in due date in line with the terms and conditions.
- Delay or default in income and other tax payments.
- Comply with employee related payments (EPF ad ETF).
- Company is bound by new rules , regulations and guidelines on health issues.
- Laws on environmental protection.

(05 marks)

Suggested Answers to Question Four:

Chapter 9 - Requirements for an Audit of Financial Statements
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(a) Quality of engagement performance.

- 1) How engagement teams are briefed on the engagement to obtain an understanding of the objectives of their work.
- 2) Processes for complying with applicable engagement standards.
- 3) Processes of engagement supervision, staff training and coaching.
- 4) Methods of reviewing the work performed, the significant judgments made and the form of report being issued.
- 5) Appropriate documentation of the work performed and of the timing and extent of the review.
- 6) Processes to keep all policies and procedures current

(02 marks)

(b) Matters to be considered when reviewing the audit work

- 1) Whether the work has been performed in accordance with professional standards and applicable legal and regulatory requirements.
- 2) Whether significant matters have been raised for further consideration.
- 3) Whether appropriate consultations have taken place and the resulting conclusions have been documented and implemented.
- 4) Whether there is a need to revise the nature, timing and extent of work performed.
- 5) Whether the work performed supports the conclusions reached and are appropriately documented.
- 6) Whether the evidence obtained is sufficient and appropriate to support the report.
- 7) Whether the objectives of the engagement procedures have been achieved.

(03 marks)

(Total 05 marks)



End of Section A

Suggested Answers to Question Five:

Chapter 8 - Ethical Requirements

(a)

1 Self-interest Threat

Contingency Fee - Managing Director has agreed to increase the audit fee by 20% upon succeeding to find a potential investor for the intended private placement to be held in the next year.

2 Advocacy Threat

Promoting shares in an audit client - The audit manager of Suraj & Company has agreed to find a potential buyer for the new share issue.

3 Familiarity Threat

- **Long term relationship** - Suraj & company and senior have been conducting the audit for 25 years and 6 years respectively. This long term relationship with the client FTL, Suraj & company will be too sympathetic to their interests or too accepting of their work.
- **Accepting gift vouchers** - FTL has offered gift vouchers for 2 day stay at a five star hotel to the audit team to celebrate the silver jubilee.

(06 marks)

(b) Firm wide safeguards to be implemented

- 1 The leadership of the firm must stress the importance of the compliance with the fundamental principles.
- 2 Document policies and procedures to be established to identify the fundamental principals, evaluate on regular basis and apply to safeguard threats.
- 3 The firm should obtain a declaration on independence from the team members.
- 4 The policies and procedures to rotate the team members from same engagement.
- 5 Establish policies and procedures on quality control of engagements and monitoring on regular basis.
- 6 Develop internal controls policies and procedures requiring compliance with fundamental principals.
- 7 Establish procedures to access and monitor the reliance on revenue received from a single client at the time to initial acceptance and continuance of the engagement.
- 8 Implement the policies to ensure the independence between assurance and non-assurance services to client.
- 9 Policies and procedures to prohibit individuals who are not members of an engagement team from inappropriately influencing the engagements and it's results.
- 10 Making awareness on the firms policies and procedures and developments to the entire team.

- 11 Implement disciplinary mechanism to promote compliance with policies and procedures.
- 12 Establishing whistle blower policy in the firm.

(04 marks)
(Total 10 marks)

Suggested Answers to Question Six:

Chapter 8 - Ethical Requirements

(a) Audit procedures to be followed before accepting the engagement

- 1) Ensure professionally qualified to act - Consider whether they could be disqualified on legal or ethical grounds
- 2) Ensure existing resources are adequate - Consider available time staff and technical expertise
- 3) Obtain References - Make independent enquiries if directors are not personally known
- 4) Communicate with present auditors - Enquire whether there are reasons / circumstances behind the change which the new auditors ought to know, also as a courtesy.

(04 marks)

(b) Primary Purpose

Primary objective of audit documentation is to provide evidence of the auditor's basis for a conclusion about the achievement of the overall objectives of the audit and to provide evidence that the audit was planned and performed in accordance with SLAuSs and applicable legal and regulatory requirements.

(03 marks)

(c) Content of Working Papers

- 1) Information obtained in understanding the entity and its environment, including its internal control, such as the following:
 - Information concerning the legal documents, agreements and minutes.
 - Extracts or copies of important legal documents, agreements and minutes.
 - Information concerning the industry, economic environment and legislative environment within which the entity operates.
 - Extracts from the entity's internal control manual.
- 2) Evidence of the planning process including audit programs and any changes thereto.
- 3) Evidence of the auditor's consideration of the work of internal audit and conclusions reached.
- 4) Analyses of transactions and balances.
- 5) Analyses of significant ratios and trends.
- 6) Identified and assessed risk of material misstatements.
- 7) A record of the nature, timing, extent and results of audit procedures.

- 8) Evidence that the work performed was supervised and reviewed.
- 9) An indication as to who performed the audit procedures and when they were performed
- 10) Details of audit procedures applied regarding components whose financial statements are audited by another auditor.

(03 marks)
(Total 10 marks)

Suggested Answers to Question Seven:

Chapter 7 - Audit Reporting

(a) Matters to be communicated to the management and those charged with the governance

- 1) An authorized person has not reviewed the bank reconciliation statements for the months September 2020 to February 2021. This will lead to misapplication of cash. Hence, auditor should satisfy as to the absence of any rectifications actions carried out by the management since same observation had communicated in the last year as well.
- 2) HR manager has not reviewed the Payroll prepared by the executive and this will lead to make payments to dummy employees.
- 3) The company has constructed a qualified asset i.e. an office building. This has funded through borrowings and the interest paid on the said loan has charged to income statement without capitalizing. This needs to be communicated to the management.

(04 marks)

(b)
Borrowing cost

Borrowing cost on building - The misstatement is above the materiality threshold and hence there is a significant impact on the audit.

As per LKAS 23, an entity shall capitalize the borrowing on building are capitalized in the books of accounts with the qualifying assets when it is certain that it will have future economic benefits.

Accordingly, 5Mn borrowing cost incurred on constructing the building is a material misstatement. Since it is above the materiality threshold of Rs. 0.9 Mn and if any case management refuses to adjust the financial statements, the impact to the financial statements to be evaluated.

The total of the uncorrected misstatement is Rs 5 Mn which resulted in reducing the profit for the year ended 31st March 2021 and which is material to the overall financial statements. The auditor needs to communicate the unadjusted 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.

(06 marks)
(Total 10 marks)

End of Section B

Suggested Answers to Question Eight:***Chapter 3 - Internal Control Systems and Business Processes***

(a)

Elements of control activities	Examples	Recommendations (b)
Segregation of Duties	<ul style="list-style-type: none"> ▪ Preparation of monthly payroll and related adjustments are done by HR Assistant based on manual attendance record. ▪ Job schedules and output of the factory are prepared by the Factory Supervisor. ▪ Salary transfers are accounted and changes to the GL is done by the Accounts Executive. ▪ Payroll related entries are posted to ledger accounts by Accounts Executive. 	<ul style="list-style-type: none"> ▪ Finger print machines should be installed at the entrance to record attendance. ▪ Amendments made by HR assistant should be approved by HR manager. ▪ Payroll entries must be posted to the ledger with the approval of the Finance Manager.
Physical Controls	<ul style="list-style-type: none"> ▪ Payroll records are kept at a common area in the Finance department. ▪ Employee attendance records are kept at the common area in finance department. 	<ul style="list-style-type: none"> ▪ Payroll records need to kept under proper custody in a safer and secure place. ▪ Finger print machine should be installed at the entrance to record attendance.
Authorization and Approval	<ul style="list-style-type: none"> ▪ Payroll related entries are posted to the ledger by Accounts Executive. ▪ Payroll amendments' are done by HR Assistant. 	<ul style="list-style-type: none"> ▪ A person with proper delegation should be approved such amendments to GL. ▪ Payroll related amendments should be done by a person who is above HR Assistant category who has proper authority to do so.

a- (06 marks)***b- (03 marks)***

(c)

1) Helping protect assets, prevention and reduce the possibility of fraud.

The physical assets can be prevented from stealing, misusing or accidentally destroying by implementing adequate controls. Some internal controls help to stop potential errors before it happens.

2) Improving efficiency and effectiveness in operations.

Effective controls help to use resources efficiently and effectively to optimize the organizational goals.

3) Increasing reliability and integrity in financial reporting.

It is the responsibility of the management to prepare the financials to meet the stakeholders' requirements. Sound internal controls help to provide reliable information for the users of such financials.

4) Ensuring compliance with laws and statutory regulations.

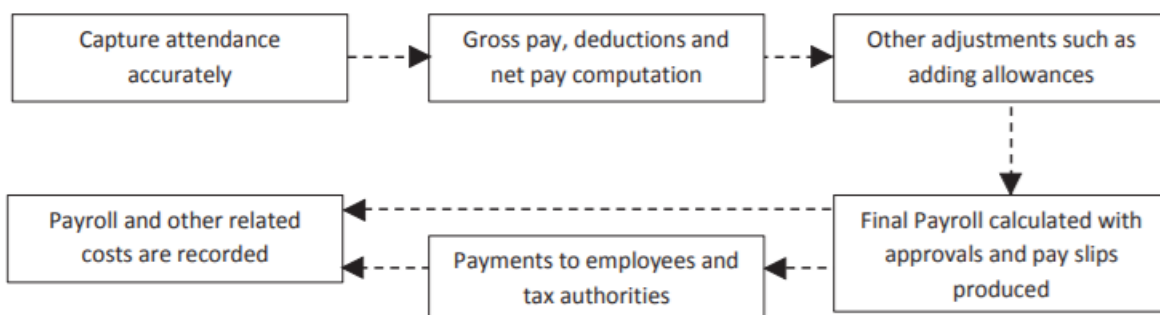
The entities need to comply with a number of rules and regulations and have to follow the rules those are directly related to financial reporting. Non-compliance with those rules may affect the going concern ability of the entity as well.

5) Establishing monitoring procedures.

The deviations from the implemented internal controls can be easily identified and this helps to monitor the effectiveness of the entire operations of the organization.

(06 marks)

(d) Payroll Process



(04 marks)

(e) Controls over prevention or detection of unauthorized changes to programs

- 1 Segregation of duties.
- 2 Password protection of programs so that access is limited to computer operation staff.
- 3 Restricted access to central computer by locked doors.
- 4 Virus check on software.
- 5 Use of anti-virus software and policy prohibiting use of non-authorized programs or files.
- 6 Back-up copies of programs being taken and stored in other locations.

Controls to prevent unauthorized amendments to data files

- 1 Physical security over remote terminals
- 2 Limited access to authorized personnel
- 3 Firewalls
- 4 User identification controls such as passwords
- 5 Encryption of Data

(06 marks)
(Total 25 marks)

Suggested Answers to Question Nine:

Chapter 6 - Audit Evidence

(a) Obtaining further audit evidence

- Revenue
- Property , Plant and Equipment
- Trade receivables
- Bank Loans
- Trade Payables
- Inventory
- Other payables
- Revenue
- Expenses

(05 marks)

(b) Audit procedures

Procedure	Example
Observation	<ul style="list-style-type: none">• Observe physical stock verification.• Observe internal control system of an entity to determine effective application of those controls.
Inspection	<ul style="list-style-type: none">• Inspection of a bank statement confirms the bank balance shown in the bank reconciliation which intern confirms the cash book figure for the financial statements.

	<ul style="list-style-type: none"> • Inspection of a loan agreement to confirm the terms and repayment details. • Inspection of sales invoices to ensure the correct customer has been invoiced and correct amounts have been taken into books of accounts. • Inspection of title deed of a land belonging to a business organization.
Re-calculation	<ul style="list-style-type: none"> • Recalculation consists of checking the mathematical accuracy of documents or records. Recalculation may be performed manually or electronically.
Re-performance	<ul style="list-style-type: none"> • Reperformance of Bank reconciliations. • Reperformance of reconciliations between individual supplier balances with supplier statements. • Reconciliation of debtors' sub ledger accounts with control ledger account.
External confirmations	<ul style="list-style-type: none"> • Debtors/Creditors confirmations. • Bank confirmations for current account balances, investments and Loans. • Confirmation for inventory held by third parties. • Confirmations from legal advisers.
Analytical procedures	<ul style="list-style-type: none"> • Comparable information for prior periods. • Anticipated results such as budgets and forecasts. • Similar industry information.

(06 marks)

(c) Audit Procedures for PPE

- 1 Select a sample of items in PPE register Perform physical inspection on the selected items to ensure the existence of PPE.
- 2 Vouch the details and documents relating to PPE.
- 3 Check the accuracy of the capitalized cost is in line with LKAS.
- 4 Review the client's depreciation method to evaluate whether it is in accordance with the applicable accounting standards.
- 5 Examine the useful life of PPE to evaluate whether the client's estimate is reasonable, e.g. by comparing with industry standard. Professional judgment is required and very important here.
- 6 Perform recalculation on the depreciation of PPE and compare the result of recalculation to the client's figures.

- 7 Select a sample of PPE items in the register examine the title documents or title deeds of the selected items to ensure they really belong to the client.
- 8 Obtain confirmations for property title deeds held by lawyers or financiers for safe custody or as security.
- 9 Ensure the reasonableness of estimation of the useful life of the PPE.
- 10 Review the additions during the period fulfills the recognition criteria.
- 11 Review the reasonability of accounting policies adopted relating to PPE.
- 12 Peruse the board minutes for approvals relating to additions and disposals.

(05 marks)

(d) Audit Procedures for Related Party Transactions

- 1 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.
- 2 Review prior-year working papers for names of known related parties.
- 3 Review minutes of meetings of shareholders and directors and other relevant statutory records such as the register of directors' interests.
- 4 Review accounting records for large or unusual transactions or balances, in particular transactions recognized at, or near, the end of the financial period.
- 5 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.
- 6 Review investment transactions, for example purchase or sale of an interest in a joint venture or other entity.
- 7 Enquire as to the names of all pension and other trusts established for the benefit of employees and the names of their management and trustees.
- 8 Enquire as to the affiliation of directors and officers with other entities.
- 9 Review the register of interests in shares to determine the names of principal shareholders.
- 10 Enquire of other auditors currently involved in the audit, or predecessor auditors, as to their knowledge of additional related parties.
- 11 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.
- 12 Review invoices and correspondence from lawyers for indications of the existence of related parties or related party transactions.

(05 marks)

(e)

Chapter 7 – Audit Reporting

Emphasis of Matter Paragraphs in the Auditor’s Report

- 1) An uncertainty relating to the future outcome of exceptional litigation or regulatory action.
- 2) A significant subsequent event that occurs between the date of the financial statements and the date of the auditor’s report.
- 3) Early application (where permitted) of a new accounting standard that has a material effect on the financial statements.
- 4) A major catastrophe that has had, or continuous to have, a significant effect on the entity’s financial position.

(04 marks)

(Total 25 marks)



End of Section C

Notice:

These answers compiled and issued by the Education and Training Division of AAT Sri Lanka constitute part and parcel of study material for AAT students.

These should be understood as Suggested Answers to question set at AAT Examinations and should not be construed as the “Only” answers, or, for that matter even as “Model Answers”. The fundamental objective of this publication is to add completeness to its series of study texts, designs especially for the benefit of those students who are engaged in self-studies. These are intended to assist them with the exploration of the relevant subject matter and further enhance their understanding as well as stay relevant in the art of answering questions at examination level.



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