SRI LANKA

Association of Accounting Technicians of Sri Lanka

Level III Examination - January 2025

Suggested Answers

(303) FINANCIAL CONTROLS & AUDIT (FCA)

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THE ASSOCIATION OF ACCOUNTING TECHNICIANS OF SRI LANKA

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(303) FINANCIAL CONTROLS & AUDIT

SUGGESTED ANSWERS

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

Suggested Answers to Question One:

Chapter 01

1. **Inflation**
   Inflation significantly affects Sri Lanka's construction industry, influencing project costs, investment, labor availability, and overall industry stability. This has caused customer affordability to reduce as savings are impacted.

2. **Foreign Exchange Rates**
   The foreign exchange rate significantly impacts Sri Lanka's construction sector, especially in a country reliant on imported materials, equipment, and foreign investments. Depreciation of the Sri Lankan Rupee against major currencies like the USD can negatively affect the construction industry.

3. **Global Economic Factors**
   Global economic factors, such as supply chain disruptions and rising interest rates, negatively affected Sri Lanka's construction sector resulting in reduced export revenue of the country and the dependents of such income and thereby impacting the businesses such as **Sewana Homes**.

4. **Interest Rates**
   With the recorded high interest rates, the customers were not able to secure a mortgage loan to purchase capital assets such as houses. Further, due to high interest rates the investors opt to earn high returns by depositing money in banks rather than investing in capital assets such as property.

5. **Taxation**
   Higher tax rates have impacted the affordability of the customers and impacted the savings. Hence, no investments / purchase of properties / houses.

6. **Unemployment**
   The increase in unemployment impacted the affordability impacting the businesses such

as **Sewana Homes.**

(05 marks)

Suggested Answers to Question Two:

Chapter 02

1. **Compliance Risk**
   The company has failed to comply with the quality control (production) standards. Hence the company may lose SLS certification and will have to pay fines. Litigations will be initiated by relevant authorities for non-compliance with food safety regulations.

2. **Reputation risk**
   Providing low-quality products leads to a loss of customer base and market share. Also, the company claims that Coco oil is premium quality. If the news on poor quality products appears on media, the Company will lose the reputation as virgin coconut oil is used by health conscious customers who are extremely focused on quality of goods for the premium price they pay.

3. **Operational risk**

(05 marks)

Suggested Answers to Question Three:

Chapter 06

Audit Procedure	**Explanation**	**Example**
Inspection	Inspection involves examining records or documents, whether internal or external, in paper form, electronic form, or other media, or a physical examination of an asset.	• Inspection of bank statements • Inspection of loan agreements • Inspection of sales invoices • Inspection of title deed of a land
Observation	Observation consists of looking at a process or procedure being performed by others.	• Observe physical stock verification • Observe internal control system of an entity
External Confirmations	An external confirmation represents audit evidence obtained by the auditor as a direct written response to the auditor from a third party (the confirming party), in paper form, or by electronic or other medium.	• Debtors/Creditors confirmations • Bank confirmations for current account balances, investments and loans. • Confirmation for inventory held by parties. • Confirmations from legal advisors

Recalculation	Recalculation consists of checking the mathematical accuracy of documents or records. Recalculation may be performed manually or electronically.	• Calculate depreciation of the year • Calculate the loan interest
Re-performance	Re-performance involves the auditor's independent execution of procedures or controls that were originally performed as part of the entity's internal control.	• Reperformance of Bank reconciliations • Reperformance of reconciliations between individual supplier balances with supplier statements • Reconciliation of debtors' sub ledger accounts with control ledger account
Inquiry	Inquiry consists of seeking information of knowledgeable persons, both financial and non-financial, within the entity or outside the entity.	• Inquiry from Stores Manager • Inquiry from internal auditor
Analytical Procedures	Analytical procedures consist of evaluations of financial information through analysis of plausible relationships among both financial and non-financial data.	• Comparable information for prior periods • Anticipated results such as budgets and forecasts • Comparison of similar industry information

(05 marks)

Suggested Answers to Question Four:

Chapter 09

(a)

1. Leadership responsibilities for quality within the firm
2. Relevant ethical requirements
3. Acceptance and continuous client relationship
4. Human Resources
5. Engagement Performance
6. Monitoring

(02 marks)

(b)

1. Performing work that complies with professional standards and applicable legal and regulatory requirements.
2. Processes for complying with the firm's quality control policies and procedures as

applicable.

3. How engagement teams are briefed on the engagement to obtain an understanding of the objectives of their work.
4. Processes of engagement supervision, staff training and coaching.
5. Methods of reviewing the work performed, the significant judgements made and the form of report being issued.
6. Appropriate documentation of the work performed and of the timing and extent of the review.
7. Processes to keep all current policies and procedures.

(03 marks)
(Total 05 marks)

End of Section A

(Total 30 Marks)

SECTION - B

Suggested Answers to Question Five:

Chapter 06

(a)

1. **Net Current Liability position:** The total of the current liabilities are higher than the current assets of the entity. In that case, the suppliers may not want to continue with the affairs of the company and might be in default position.
2. **Continued Losses:** The company has incurred losses in previous years and also in the current year. This may indicate there are difficulties in business operations and may have a concern over the going concern of the Company.
3. **Accumulated losses and possible serious loss of capital:** The net liability position is a limitation of serious loss of capital situation as per the Companies Act, No.7 of 2007 in Sri Lanka. The company is not generating adequate return on its investments.
4. **Negative operational cash flows:** Having fixed administration cost and less income indicates negative operational cash flows which raise a significant doubt about the going concern ability of the entity.
5. **Downward Trend in the construction industry:** The entity engages in an industry which is not functioning or growing. Hence, it makes a significant doubt in generating funds to run the company.
6. **Receivable from related parties:** While the company has a considerable amounts of current liabilities, its current assets include LKR 10 million from related parties.

(04 marks)

(b)

1. Check the loan agreement of the loan
2. Independently calculate the interest for the year
3. Check subsequent payments made on loan
4. Obtain balance confirmations from BCC.
5. Review prior year working papers for names of known related parties
6. Review minutes of meetings of shareholders and directors
7. Review other relevant statutory records such as the register of directors' interests.
8. Review accounting records for large or unusual transactions or balances, in particular transactions recognized at, or near, the end of the financial period.
9. Enquire as to the affiliation of directors and officers with other entities.
10. Review the share register to determine the names of principal shareholders.
11. Review invoices and correspondence from lawyers for indications of the existence of related parties or related party transactions.

(03 marks)

(c)

1. Related party transactions have taken place without charge.
2. Related party transactions are not self-evident to the auditors.

3. Transactions are with a party that the auditors could not reasonably be expected to know is a related party.
4. Active steps have been taken by management to conceal either the full terms of a transaction, or that a transaction is, in substance, with a related party.
5. The corporate structure is complex.

(03 marks)
(Total 10 marks)

Suggested Answers to Question Six:

Chapter 08

(a)

1. **Self Interest threat:** A member of the assurance team having a direct financial interest in the assurance client. Accepting a gift will create a self-interest threat as this gift is of a material value to **Sachin.**
2. **Self-Review threat: Sachin** helped with the calculation of income tax and deferred tax provision recorded in the financial statements and then it will be reviewed by him and **Tissera** will rely on that review in signing the audit opinion. Tax computations are of estimate nature, reviewed by tax authorities and therefore, material nature. This creates a self-review threat.
3. **Self-Familiarity threat** : This seems that there is a long or close relationship with the client. Therefore, familiarity threat has arisen.

(06 marks)

(b)

1. Rotating senior assurance personnel.
2. Having professional accountants who were not involved with the non-assurance services.
3. Using different partners and engagement teams with separate reporting lines for the provision of non-assurance services to an assurance client
4. Disclosing to those charged with governance of the client the nature of services provides an extension of fees charged
5. Advise Sachin not to accept the gift. If accepted by Sachin, explain the consequences and inform the relevant professional body on the non-compliance.
6. Sachin should not get involved with reviewing tax computations. Another person conversant with tax computation is required to review tax computation and related working papers. The issue is to be discussed with TCWG of management.
7. Promotion of services: Advise staff on firm's policy on promotions and nature of allowed promotions and approval process before any promotional activities.
8. Leadership of the firm that stresses the importance of compliance with the fundamental principles.
9. Leadership of the firm that establishes the expectation that members of an assurance team will act in the public interest.
10. Policies and procedures to implement and monitor quality control of engagements.
11. 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.

12. Documented internal policies and procedures requiring compliance with the fundamental principles.
13. Policies and procedures that will enable the identification of interests or relationships between the firm or members of engagement teams and clients.
14. Policies and procedures to monitor and, if necessary, manage the reliance on revenue received from a single client.
15. Policies and procedures to prohibit individuals who are not members of an engagement team from inappropriately influencing the outcome of the engagement.
16. Timely communication of a firm's policies and procedures, including any changes to them, to all partners and professional staff, and appropriate training and education on such policies and procedures.
17. Designating a member of senior management to be responsible for overseeing the adequate functioning of the firm's quality control system.
18. Advising partners and professional staff of assurance clients and related entities from which independence is required.
19. A disciplinary mechanism to promote compliance with policies and procedures.
20. Published policies and procedures to encourage and empower staff to communicate to senior levels within the firm any issue relating to compliance with the fundamental principles that concerns them.

(04 marks)
(Total 10 marks)

Suggested Answers to Question Seven:

Chapter 07

(a)

1. Material Misstatement in Inventory Valuation

- As per **LAKS 2 - Inventories**, inventory should be measured at the lower of **cost or net realizable value (NRV)**. The company's draft financial statements reflect inventory at cost **(Rs. 74,125,300/-)**, whereas the NRV has been assessed at **Rs. 41,260,415/-**.
- This results in an **overstatement of inventory by Rs. 32,864,885/-** (Rs. 74,125,300 - Rs. 41,260,415).
- If unadjusted, this leads to an **overstatement of profit** by the same amount, given that cost of goods sold (COGS) is understated.

2. Materiality Considerations

- Materiality for the audit has been determined based on profit before tax, which is **Rs. 1.2 million**.
- The misstatement of Rs. 32,864,885/- is significantly **higher than the materiality threshold**, making it a **highly material misstatement**.

- Since reported profit is **only Rs. 8,560,210/-**, adjusting the inventory would result in a **significant loss**, which directly impacts the financial statements.

3. Management's refusal to Adjust the Financial Statements

- The **Managing Director refuses to adjust the financial statements** due to concerns about reported performance and future banking facilities.
- This indicates **management bias** and a potential **risk of intentional misstatement** (fraud risk).
- If management continues to refuse the adjustment, the financial statements **will not provide a true and fair view**, leading to a modified audit opinion.

4. Impact on the Audit Opinion

Given the **magnitude of the misstatement** and its **pervasive impact on the financial statements**, the auditor must consider the appropriate audit opinion:

Conclusion

Since management **refuses to adjust** the financial statements for the material inventory overstatement, per SLAuS 705, the auditor should issue an **Adverse Opinion**, stating that the financial statements **do not give a true and fair view** due to material and pervasive misstatements.

(06 marks)

(b)

1) Title
2) Addressee
3) Auditor's Opinion
4) Basis for Opinion
5) Going Concern
6) Key Audit Matters
7) Other Information
8) Responsibilities for the Financial Statements
9) Auditor's Responsibilities for the Audit of the Financial Statements
10) Other Reporting Responsibilities
11) CA Sri Lanka Membership Number of the Engagement Partner
12) Signature of the Auditor
13) Auditor's Address
14) Date of the Auditor's Report

(04 marks)
(Total 10 marks)

End of Section B

(Total 50 Marks)

SECTION - C

Suggested Answers to Question Eight:

Chapter 03

(a)

1. Inventory Management Process
2. Procurement Process
3. Payroll Process
4. Property Plant and Equipment Process
5. Cash Management Process
6. Revenue Process

(04 marks)

(b)

(i) Control Weaknesses (4 marks)	***(ii) Recommendations (4 marks)***
a) Production samples were not inspected by a qualified quality assurance professional.	Implement a formal quality assurance process by ensuring that all production samples are inspected by a qualified quality assurance professional. Conduct regular training sessions for staff and establish clear quality control procedures to maintain product standards.
b) Recording only inventory quantities in the inventory management system.	Enhance the inventory management system by incorporating additional details such as item descriptions, batch numbers, expiration dates, and supplier information. Implement periodic audits to ensure data accuracy and completeness.
c) Inclusion of large quantities of expired coconut powder stock in the inventory	Establish a robust inventory control system with automatic alerts for approaching expiration dates. Implement a first-in, first-out (FIFO) inventory management method to minimize stock obsolescence. Conduct regular inventory checks and dispose or return of expired items promptly to prevent contamination or misuse.
d) When making payments to suppliers, some purchase orders did not match the corresponding invoices.	Strengthen the procurement and payment verification process by implementing a three-way matching system (purchase order, invoice, and goods receipt). Ensure proper review and approval of all payments, and conduct regular reconciliations to prevent discrepancies

e)	Inventory Valuations are maintained manually	Inventory valuations can be automated. Focus on the proper setup of automatic inventory valuation which ensures journal entries in accounting / application match with and stock valuation updates in inventory applications.
f)	When payments are made on suppliers, some purchase orders did not agree with the invoices	All payments must be released after rechecking the source documents relevant to each transaction.
g)	All staff of Finance Division can access to all systems and database using a single user's account to maintain records. Inadequacy of process and IT controls.	• Establish sound controls over accuracy of input to system. • Limited access to authorized personal. • Prevent unauthorized amendments to data files • Prevention or detection of unauthorized changes to programs. • Password protection • User identification control such as passwords, restricted entry, etc.
h)	Purchasing from unregistered suppliers	• Organization should maintain registered suppliers and purchase must be done through the registered suppliers.

(b)

	Control Activity	Description
1.	**Arithmetical and Accounting Controls**	To check the correct and accurate recording and processing of transaction. Eg: Reconciling between the system balance and general ledger
2.	**Physical Control**	To prevent unauthorized access Eg: Using Biometric controls to enter stores
3.	**Authorization and Approval**	Approval of actions prior to being processed. Eg: When a payment is made, it should be approved by the higher management.
4	**Segregation of Duties**	Assigning the work responsibility for recording transactions, authorizing transactions and maintaining custody of assets to different employees to minimize the risk of fraud and error.

5	**Management Controls**	Management Performance Review. Eg: Manager can compare budget against actual
6	**Supervision Controls**	Supervision / Observation of activities performed by the employees.
7	**Organizational Controls**	Controls are provided by organization structures, such as lines of reporting, lines of authority, authority and responsibility for managers in each position in the organization.
8	**Personnel Controls**	Attention should be given to selection, training and qualifications of personnel, as well as personal qualities. The quality of the system will depend on the competence and integrity of the people attached to the process.

(06 marks)

(d)

i. Segregation of duties.
ii. Password protection of programs so that access is limited to computer operation staff.
iii. Restricting access to the system as necessary (Eg: by locking doors)
iv. Virus check on software. Use of anti-virus software and policy prohibiting use of non-authorized programs or files.
v. Back-up copies of programs being taken and stored in other locations.

(04 marks)

(e)

i. Evidence of ineffective features or elements in the control environment
ii. The absence of a risk assessment process for identifying, analyzing, and evaluating risk
iii. Evidence of an ineffective response to identified significant risk
iv. Misstatements in the draft financial statements that have been detected by the external auditors' procedures and that were not prevented, or detected and corrected by the organization's internal controls.
v. Risk events that have happened and are attributable partly to a failure in controls

(03 marks)

(Total 25 marks)

Suggested Answers to Question Nine:

Chapter 05

(a) Key Areas Requiring Special Attention in the Audit of Malcom PLC

i. **Existence and Accuracy of Trade Receivable**
ii. **Revenue Recognition and Potential Fraud Risk**
iii. **Related Party Transactions and Disclosure Compliance**
iv. **Audit Risks Due to the High-Risk Profile of the Client**

Alternate answer

- Debtors
- Sales
- Commission Payments
- Compliance with listing rules
- Loan Covenants.

(05 marks)

(b)

Difference between Reasonable and limited assurance	
Reasonable assurance	**Limited assurance**
The practitioner gathers sufficient appropriate evidence 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.
Gives a high level of assurance	Gives a moderate or lower level of assurance than that of audit (Reasonable assurance)
Performs very thorough procedures to obtain sufficient appropriate evidences – Test of controls and substantive audit procedures	Performs fewer procedures – mainly enquiries and analytical procedures

(04 marks)

(c) Adequate planning benefits the audit of financial statements in several ways, including the following;

- Helping the auditor to give appropriate attention to important areas of the audit.

- Helping the auditor identify and resolve potential problems on a timely basis.
- Helping the auditor properly organize and manage the audit engagement so that it is performed effectively.
- Assisting in the selection of engagement team members with appropriate levels of capabilities and competence to respond to anticipated risks and the proper assignment of work to them.
- Facilitating the direction and supervision of engagement team members and the review of their work.
- Assisting in the coordination of work done by auditors of components and experts.

(04 marks)

(d)

(i) Fraudulent financial reporting involves intentional misstatements including omissions of amounts or disclosures in financial statements to deceive financial statement users which mainly includes the following;

- Manipulation, falsification, or alteration of accounting records or supporting documentation from which the financial statements are prepared.
- Misrepresentation in or intentional omission from the financial statements of transactions.
- International misapplication of accounting Principles.
- Recording fictitious journal entries.
- Inappropriately adjusting assumptions and judgments used on accounting estimates.
- Concealing facts that could affect the amounts in the financial statements

(02 marks)

(ii)

The primary responsibility for the prevention and detection of fraud is with those charged with governance and the management of Malcom PLC. This is implemented by having a commitment to create a culture of honestly and ethical behavior and active oversight by those charged with governance. The management should take actions to avoid conditions/ events which increase the risk of fraud.

(04 marks)

(e)

Matters to be communicated to the management of Malcom PLC are mainly included below areas

Communication Area	Details
The Auditor's Responsibilities in relation to the about the Financial Statement Audit	The auditor shall communicate with those charged with governance the responsibilities of the auditor in relation to the financial statement audit, including that the auditor is responsible for forming and expressing an opinion on the financial statements that have been prepared by management with the oversight of those charged with governance.
Planned Scope and	The auditor shall communicate with those charged with

Timing of the Audit	governance an overview of the planned scope and timing of the audit.
Significant Findings from the Audit	• Interest income over statement is clearly insignificant as it is below 407,500/-. • Amount of RPT is clearly insignificant but material by nature. Therefore, this will have an impact on opinion if the management disagree to make the disclosure in the financial statements. • Total misstatements (14,350,000 + 2,050,000) = 16,400,000/-. • Misstatements are not material individually, but aggregate misstatements may be higher than the materiality level. Therefore, either the management shall make adjustments on such misstatements noted or failure in which the auditor shall consider the impact of it on the auditor's report, i.e. most likely a qualified opinion shall be issued considering the materiality.
Auditor Independence	In the case of listed entities, the auditor shall communicate with those charged with governance: • A statement that the engagement team and others in the firm as appropriate, the firm, and, when applicable, network firms have complied with relevant ethical requirements regarding independence. • All relationships and other matters between the firm, network firms, and the entity that, in the auditor's professional judgment, may reasonably be thought to bear on independence. This shall include total fees charged during the period covered by the financial statements for audit and non-audit services provided by the firm and network firms to the entity and components controlled by the entity. These fees shall be allocated to categories that are appropriate to assist those charged with governance in assessing the effect of services on the independence of the auditor. • The related safeguards that have been applied to eliminate identified threats to independence or reduce them to an acceptable level.

(06 marks)
(Total 25 marks)

End of Section C

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