Association of Accounting Technicians of Sri Lanka
(303) FINANCIAL CONTROLS & AUDIT (FCA)
Model Paper - Answers

Prepared by: Nilantha Weerasinghe

Section A

Question 01

(i) Audit risk is the risk that the auditor gives an inappropriate audit opinion when the financial statements are materially misstated

(ii) **Inherent risk**

Inherent risk is the susceptibility of an assertion to a misstatement that could be material, either individually or when aggregated with other misstatement, assuming that there are no related controls

Control risk

Control risk is that a misstatement that could occur in an assertion and that could be material, either individually or when aggregated with other misstatement, will not be prevented or detected and corrected, on a timely basis by the entities internal controls

Detection risk

Detection risk is that the auditor will not detect such misstatement. Detection risk is a function of the effective of an audit procedure and of its application by the auditor.

Question 02

(i) 1. Another reason as to why a member should behave ethically is that unethical behavior may result in disciplinary action being taken by the professional body which may lead to expulsion from the membership. This situation may negatively affect a member's future career.

2. Ethical behavior includes compliance with the law of the country. If a member violates the law of the country he may be prosecuted and charged by law enforcing authorities. Such an outcome will have a negative impact not only on the particular member but also to other members of the profession.

(ii) Shamika is a member of CA Sri Lanka and therefore, as a professional accountant there is a high expectation in regards to his ethical behavior. Since he is dealing with the payment function of NPPL, he needs to ensure his duties are discharged as a professional accountant in a trustworthy manner. Money and the payment function are two aspects of the NPPL business where fraud and other crimes are most likely to occur. For instance there is a possibility of making fraudulent payments, excessive payments by oversight etc. Payments may be made for activities that are not ethical (bribe). Therefore, Shamika needs to consider these aspects and behave ethically in discharging his duties as his employer needs to be able to trust Shamika with their money. Identification of the risk why ethics are required.

Question 03

(i) Obtained from independent source outside the entity

Obtained directly by the auditor

It exits in the documentary form

(ii)

I. Bank balances & other information from bank

II. Accounts receivable balance

III. Loan from bank

IV. Accounts payable

V. From leasing companies

Section B

Question 05

I. What are the basic elements of an Auditor's Report?

- ✓ Tittle
- ✓ Addressee
- ✓ Introductory Paragraph
- ✓ Management responsibility for the financial statement
- ✓ Auditor's Responsibility
- ✓ Audit Opinion
- ✓ Other reporting responsibilities
- ✓ Signature of the Auditor
- ✓ Date of the Auditor's Report
- ✓ Auditor's Address

II. Errors in the audit report

- ✓ Report to be addressed to directors

  It should be addressed to shareholders

Report on the Financial Statements

- ✓ 1st sentence says "we have reviewed" burst it should be "we have audited"
- ✓ No mentioned of the cash flow statement in the Report on the Financial Statements paragraph
- ✓ Management responsibility paragraph missing

Auditor's responsibility

- ✓ The report status, we have conducted the audit in accordance with Sri Lanka accounting Standards, it should be "we have conducted our audit in accordance with Sri Lanka Auditing Standard"

Opinion

This paragraph says the financial statement gives a correct view of the company's state of affairs. It should be "The financial statements give a true & fair view "of the company's state of affairs.

- Audit report is not dated
- Auditors address is absent

Question 06

Audit issues

I. Value of trade debtors shown in the financial statement amounting to Rs 1,332,000 does not agree with the amount of Rs 1,197,000 as per age analysis. Difference is Rs 135,000

II. Supun Super market balance of Rs 412,000 as per total of age analysis does not agree with amounts as per age analysis of Rs 350,000 showing a difference of Rs 62,000

III. Balance due from Kadurata Ltd is over 365 days old. Recoverability od this balance is doubtful

IV. Total of age analysis amounting Rs 1,197,000 does not tally individually age analyzed, amount which amount to Rs 1,135,000 showing a difference of Rs 62,000

V. Cash paid amounting Rs 215,000 three months ago remained un identified. This unusual and needs special attention

Question 07

(a) General IT controls are different policies and procedures that support the effective functioning of applications controls. General IT controls usually cover the following areas.

(i) Operations in IT centers and networks
(ii) Access security/password controls
(iii) Changes to IT system and system maintenance/program change controls
(iv) General rules and procedures for acquiring, developing and maintaining of application IT systems
(v) System software acquisition

(b)

(i) Password protection of programs
(ii) Restricted access to server room
(iii) Maintenance of program logs
(iv) Storing of backup copies of files/programs
(v) Viral checks
(vi) Documentation and testing of program changes
(vii) Disaster recovery procedures
(viii) Segregation of duties
(ix) Testing procedure using test data
(x) Approval of new applications by users and management
(xi) Installation procedures
(xii) Password protection of programmes
(xiii) Backup copies of programmes
(xiv) Protection of equipment against fire and other hazards
(xv) Maintenance agreements and insurance.

(c) Application IT controls are those that operate at a business process level. They are either preventive **or** detective **in** nature. They relate to procedures at initial recording, processing and the reporting of transactions.

(d)

(i) Digit verification
(ii) Reasonableness test
(iii) Existence check
(iv) Character check
(v) Mandatory fields
(vi) Screen warnings
(vii) One for one checking
(viii) Manual checks to ensure input was authorized
(ix) Programmed matching of input to an expected input control file
(x) Permitted range (no transaction processed over or under a certain value)

Section C

Question 08

(a) **Key element of assurance engagement**

I. A three party relationship involving practitioner, responsible party and intended users
II. An appropriate subject matter
III. Suitable criteria
IV. Sufficient appropriate evidence
V. A written assurance report in the form appropriate to a reasonable assurance engagement or a limited assurance engagement

(b) Components of assurance engagement risk.

I. Inherent risk
II. Control risk
III. Detection risk

(c) In a reasonable assurance engagement, sufficient appropriate evidence is obtained as part of a systematic engagement process that includes obtaining an understanding of the engagement circumstances, assessing risks, responding to assessed risks by performing further procedures. However, in a limited assurance engagement, procedures performed are deliberately limited relative to a reasonable assurance engagement.

(d) substantive procedures

I. Test the additions and extensions of final inventory listings
II. Ascertain whether the method used to value inventories had been correctly applied in the valuation
III. Ascertain whether the method used for valuing inventory is an acceptable method of valuation under LKAS 2
IV. Ascertain if the method used for valuing inventory is consistent with the method used in the previous years and the entity's accounting policy

(e) Circumstances that may indicate fraud and/or error

I. Pressure on sales staff to achieve revenue target. This may lead to incorrect recognition of revenue.

II. Lack of segregation of duties due to the accountant performing work of the finance manager.
III. Ability, competence of the accountant to perform the tasks of the finance manager with the same due care.
IV. Revenue entries that are passed manually towards the year end.

Question 09 (A)

(a) **Test of controls vs. substantive procedures.**

Test of controls are tests of the effectiveness of internal controls to prevent misstatements in the financial statements. These are audit procedures designed to evaluate the effectiveness of internal controls in preventing or detecting and correcting material misstatements.

Substantive procedures consist of test of details and analytical procedures. These are performed to detect material misstatements in the figures reported in the financial statements.

The performance of only test of controls is not sufficient and substantive testing procedures for to pay key balances and transactions should also be performed.

If the auditor can rely on the effectiveness of internal controls the need for substantive testing is reduced.

However some substantive tastings are also required.

(a) - Re-performance
- Inspection
- Observation
- Inquiries

(b) Sequential order checks - Obtain a list of invoices and it should be checked to make sure the sequential order is always maintained.

Approval of invoices - Select a sample of invoices raised during the period and check the evidence of approval by sales manager.

(c) Substantive procedures on sales
- Sales cut-off
- Detailed checking of invoices with source documents
- Testing subsequent returns to make sure the sales during the year have in fact occurred
- Reconcile sales ledger with the general ledger
- Analytical procedure E.g. Ratio, trend analysis

Question 09 (B)

(i) objectives of the internal controls

✓ To ensure that all cash to which the entity is entitled is received.
✓ To ensure that all such cash is properly accounted for and recorded in the entity's records.
✓ To ensure that cash is adequately safeguarded.
✓ To ensure that all such cash is banked promptly and intact.

(ii) & (iii)

Control deficiency	Consequences	Suggested control
Cashier collects cash, updates cash book & sales ledger. This is weak segregation of duties.	Increased risk of fraud & error misuse of cash.	Cashier should update the cash book. Another clerk should update the sales ledger.
Receptionist opens the post unsupervised.	This could result in cheques being misappropriated.	An independent officer should supervise the opening of mails and sign-off the cheque register entries.
Cash and cheques are banked every few days.	Misappropriation of collection by staff.	Cash and cheques should be banked every day.
Any member of the finance team collects cash when cashier is absent.	Lack of accountability for collection could result in misappropriation.	One member of the finance team should be appointed to collect cash if the cashier is absent.
Cashier's password is shared with other clerks.	Difficulty in assigning responsibility for frauds & errors since computer systems identify the user based on login details.	Separate login account should be given to the nominated person to access the system.
Bank reconciliations are not reviewed by the Accountant consistently.	Errors in the cash cycle may not be promptly identified.	A responsible officer (accountant) should check & approve all bank reconciliations.

04. Limitation of Internal Controls

- Employees by-passing controls through collusion.
- Management override.
- Human error, judgment & misunderstanding could result in control failure.
- Internal control systems are not capable of dealing with non-routine transactions.
- Cost of implementing internal control systems may exceed benefits.

Question 11

A. factors that the auditor should consider in forming the audit conclusions

I. Whether sufficient appropriate audit evidence had been obtained

II. Whether uncorrected misstatements are material individually or in aggregate

III. Whether financial statements are prepared in all material respects in accordance with the requirements of applicable financial reporting framework

IV. Whether financial statements adequately refer to or describe the applicable financial reporting framework

B. important matters included in the introductory paragraph of an auditor's report

I. Identify the entity whose financial statements have been audited
II. State that the financial statements have been audited
III. Identify the title of each statement that comprises the financial statements
IV. Refer to the summary of significant accounting policies and other explanatory information
V. Specify the date or period covered by each statement comprising the financial statements

C.

I. There is a scope limitation on the work of the auditor. This may lead to a modification of the audit opinion.

II. Qualified opinion – auditor expresses an adverse opinion on a particular aspect of the accounts which is considered material but not pervasive.

Disclaimer – Auditor states he is unable to form an opinion on truth and fairness of the financial statements, if the impact is material and pervasive.

D. The auditor may modify the audit report by including an emphasis of matter paragraph to highlight a matter affecting the financial statements which is included in a note to the financial statements that more extensively discusses the matter.

Examples:

- To highlight a material matter regarding a going concern problem.
- When there is a significant uncertainty (other than going concern problem), the resolution of which is dependent upon future events and which may affect financial statements – outcome of exceptional litigation or regulatory action.
- Early application of a new SLAS that has had or continue to have a pervasive effect on the financial statements in advance of its effective date.

Note: Other matter paragraph may also be considered if explained properly.

Examples: - Disclosure about predecessor auditor.
- Restriction on distribution or use of the Auditor's report