KC 4 – Corporate Governance, Ethics & Assurance

Suggested Answers and Marking Grid

Section 1

Question 1

Basis for allocation of marks
a) Total 10 marks **Leadership responsibility (6 marks)** • 2 marks for referring to the requirement of SLQC 1 on promoting an internal culture. • 2 marks for explaining the impact of partner's time allocation and cost pressure on the quality of the audit. **Ethical issues (4 marks)** • One mark for each of the four points.

a)

Learning outcomes
1.2.1 Advise the effectiveness of a board, in the perspective of governance, including: - unitary and two-tier board structures - division of powers (Ceoand chairman) - Board composition - Types of directors - role of independent non-executive directors - financial acumen - responsibilities of the board

Leadership responsibilities for quality within the Firm

Leadership responsibilities require **promotion of an internal culture** which recognizes that quality is essential in performing engagements. The promotion of a quality-oriented internal culture depends on clear, consistent and frequent actions and messages that emphasize on audit quality.

Absence of an internal culture that recognizes the importance of quality is reflected in the following actions of the Firm:

- The leadership has not set examples recognizing the importance of audit quality. Partner's involvement only at the final stage of an audit is not adequate. Rewarding audit staff who complete audits delivers the massages that audit quality is not an important aspect of the work.
- It appears that commercial pressure to attract clients has diverted the Firm from its commitment to audit quality. Quoting lower fees and the resultant pressure to keep the audit cost low jeopardizes the quality of the audit work since sufficient resources may not to be allocated to complete the audit according to the applicable technical standards. This increases the risk of non-detection of material misstatements. Further, in case of failures of the client, the Firm's quality control system may be subject to scrutiny by regulators and action could be taken against the Firm for professional negligence.

Ethical issues

The Firm is likely to deviate from the following ethical requirements applicable to auditors' independence.

Pricing

A self-interest threat to professional competence and due care is created if the fee quoted is so low that it may be difficult to perform the engagement in accordance with applicable technical and professional standards for that price.

Fee size

The Firm's strategy may result in the total fees generated from an audit client representing a large proportion of the total fees of the Firm. The dependence on that client creates a self-interest or intimidation threat.

Non-assurance services

The provision of non-assurance services to audit clients may result in a self-review threat which could affect the independence of the Firm. In particular, many non-audit services such as preparation of financial information, valuation, tax services, etc. are restricted to listed entities.

Compensation and evaluation policies

A self-interest threat is created when a member of the audit team is evaluated on or compensated for selling non-assurance services to that audit client. The code specifically provides that key audit partners shall not be evaluated on or compensated based on that partner's success in selling non-assurance services.

Question 1 (b) (i) & (ii)

<u>Basis for allocation of marks</u>

b) 15 marks

i) Proposed audit adjustments (8 marks)

- 2 marks for referring to the requirements of SLAuS 450 in evaluating misstatements.
- 4 marks on ESOP. 2 marks for explaining the requirement of SLFRS 2 and the balance 2 marks for its application and explaining the impact on the financial statements.
- 2 marks for explaining that a provision cannot be recognized for the estimated cost of the new water treatment plant.

(ii) Impact on the audit report (7 marks)

- 2 marks for explaining that an adverse opinion may not be suitable.
- 2 marks for explaining the meaning and requirement of SLAuS 706 in relation to emphasis of matter.
- 1 mark for clarifying the requirements of LKAS 37 in relation to a contingent liability.
- 2 marks for an appropriate conclusion that a qualified opinion is to be revisited in light of the omission of the disclosure and that the audit report should be structured according to SLAuS 705.

Question 1 (b) (i)

Learning outcomes
4.2.1 Evaluate the effect of identified misstatements on the audit and the effect of uncorrected misstatements, if any, on financial statements.

According to SLAuS 450: Evaluation of misstatements identified during the audit, the auditor shall determine whether uncorrected misstatements are material individually or in aggregate. In making this determination, the auditor shall consider the size and nature of misstatements both in relation to particular account balances, classes of transactions or disclosures and the financial statements as a whole, and the particular circumstances of their occurrence.

SLAuS 450 further requires consideration of the effect of uncorrected misstatements related to prior periods.

Proposed adjustments

ESOP

The proposed adjustment on account of ESOP represents 10% of profit before tax and is material to the financial statements. It is assumed that this adjustment had been derived based on the fair value of the share option at the grant date and the number of eligible options. SLFRS 2: Share-based payment, requires an expense and a corresponding entry to equity to be recognised over the vesting period of a share-based payment scheme.

In determining the value of a share option many variables are taken into account. Share price and its expected volatility are considered as variables in valuation models used to determine option prices. In this context, the finance director's argument is not valid as the basis for non-recognition of share-based payment. Further, a letter of representation cannot substitute for the failure to comply with SLFRS 2. Therefore, management should be requested to make the necessary adjustment to recognise the expense and entry to equity.

Provision - water treatment plant

The estimated cost of the new water treatment plant does not meet the definition of a provision in terms of LKAS 37. The entity does not have an obligating event, i.e. an event that creates a legal or constructive obligation that results in an enterprise having no realistic alternative to settling that obligation. Because the Company can avoid the future expenditure by its future actions, for example by upgrading the water purifying system, relocating the factory, etc, no provision is recognized. This adjustment is not individually material but should be accumulated with other misstatements.

<u>Question 01 (b) (ii)</u>

Impact on auditor's report

In aggregate, the misstatements have a net effect of LKR 10 million which represents 7% of profit before tax. This is however less than 1% of the total assets. If these adjustments are not made, the financial statements could be materially misstated. However, these adjustments are unlikely to be considered as having a pervasive impact on the financial statements so as to require an adverse audit opinion in terms of the amounts and number of elements involved. Therefore, a qualified opinion may be expressed, with the auditor stating in the opinion that except for the effects of the matters described in the "basis for qualified opinion" paragraph, the financial statements show a true and fair view.

The effect of the litigation

The impact of the litigation has been included after the audit opinion as an emphasis of matter. According to SLAuS 706: Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report, emphasis of matter refers to a matter appropriately presented or disclosed in the financial statements that, in the auditor's judgment, is of such importance that it is fundamental to users' understanding of the financial statements.

If it has been established that the litigation is a contingent liability because of the uncertainty of the future outcome which is not wholly within the control of the enterprise (possible obligation), or because of the inability to reliably assess the outcome, the entity should provide appropriate disclosures on the contingent liability.

The inclusion of an emphasis of matter paragraph in the auditor's report does not affect the auditor's opinion. An emphasis of matter paragraph is not a substitute for disclosures in the financial statements that the applicable financial reporting framework requires management to make. The auditor should re-evaluate the appropriateness of the qualified opinion in light of the significance of this issue along with other issues noted in (ii) above. If the auditor concludes that omission of the disclosure is fundamental to the user's understanding and is pervasive, an adverse opinion may be expressed.

The audit opinion should be supported by a basis for an adverse/qualified opinion paragraph. The basis for such adverse/ qualified opinion paragraph should be placed immediately before the opinion paragraph and should contain a description of the matters giving rise to the modification. This should include a description and a quantifying of the financial effects of the misstatement / details of the omission.

Question 2

Basis for allocation of marks
a) Risk based internal audit (10 marks)
• 1 mark for referring to applicability of IIA performance standards.
• 2 marks for explaining the engagement objectives in relation to the case.
• 2 marks for explaining the scope in relation to the case.
• 5 marks for case-specific planning considerations.
b) Business plan (7 marks)
• 1 mark for clarifying that the auditor cannot certify information so as to provide an absolute assurance.
• 6 marks divided equally for explanation of suitable engagements on prospective financial information and un-audited financial information.
c) Key audit matters (8 marks)
• 2 marks for explaining the meaning of key audit matters and the judgement involved.
• 2 marks for identifying any of the 3 considerations in determining key audit matters.

(a)

Learning outcomes
2.7.1 Advise the approach to managing an internal audit engagement in a given scenario relating to the main business process of an entity

The Institute of Internal Auditors' (IIA's) International Standards for the Professional Practice of Internal Auditing (Standards) is essential in meeting the responsibilities of internal auditors and the internal audit activity. IIA performance standards provide high level guidance on planning and performing an internal audit. The section below explains the main considerations in relation to the risk based procurement audit in light of the requirements of IIA performance standards.

Engagement planning

Internal auditors must develop and document a plan for each engagement, including the **engagement's objectives, scope, timing, and resource allocations**.

Engagement objectives

IIA standards specify that:

- Internal auditors must conduct a preliminary assessment of the risks relevant to the activity under review. Engagement objectives must reflect the results of this assessment.
- Internal auditors must consider the probability of significant errors, fraud, non-compliance, and other exposures when developing the engagement objectives.
- Adequate criteria are needed to evaluate governance, risk management, and controls.

It appears that the main objective of the risk based internal audit on procurement is to evaluate the effectiveness of internal controls in achieving related business objectives over procurement. The entity's procurement policies and established control procedures could be used as criteria to evaluate governance, risk management, and controls in relation to the procurement process.

A detailed review of the management's risk assessment and mitigation plans will be a starting point for the preliminary assessment of the risks.

Engagement scope

IIA standards specify that the the established scope must be sufficient to achieve the objectives of the engagement. The scope of the engagement must include consideration of relevant systems, records, personnel, and physical properties, including those under the control of third parties.

In the procurement process IT general controls and application controls play an important role in achieving management controls. Therefore, the internal auditor should be equipped with IT experts to conduct testing on IT controls and extracting relevant data for the detailed analysis.

Key planning considerations in accordance with IIA performance standards on engagement and their applicability are discussed below

- The significant risks to the activity, its objectives, resources, and operations and the means by which the potential impact of risk is kept to an acceptable level.
- The objectives of the activity being reviewed and the means by which the activity controls its performance.
- The adequacy and effectiveness of the activity's governance, risk management, and control processes compared to a relevant framework or model; and
- The opportunities for making significant improvements to the activity's governance, risk management, and control processes.

Applying planning consideration

- Given the made-to-order business model, procurement decisions are order specific and may be complex. The main risks highlighted are the risk of excessive purchases and misappropriation of stocks.
- Discussion should be held with key management personnel making procurement decisions, to understand high level business objectives, risk and risk mitigation strategies.

- Walk-through procedures could be used to document the full transaction and decision flow at each sub-process to identify risk and related controls at each process.
- Adequacy and effectiveness of risk management and control processes could be evaluated in light of the Company's policies, control procedures and industry best practices.
- Significant improvements can be included in the internal auditor's report to the audit committee.

(b)

Learning outcomes
5.1.2 Advise on suitable engagements in a given scenario, considering the requirements of intended users and the assurance framework, including following areas: - Special purpose audits - Assurance engagements - Review of financial statements - Related services

The Firm may not be able to certify the accuracy of information included in the business plan. This is because certification implies an absolute level assurance which is not practically attainable.

Suitable engagements on the financial information included in the business plan.

Subject matter	Engagements
Forecasted profit and cash flow for the next 3 years.	This could be undertaken as a separate engagement using SLSAE 3400: The examination of prospective financial information. This includes forecasted profit and cash flow derived on the basis of management assumptions. Given the future oriented and speculative nature of information, the auditor may not be able to provide a reasonable assurance; however, limited assurance could be provided.
Un-audited financial information for the last 6 months	There may not be adequate time to perform a full scope audit on un-audited financial information. Therefore, a review engagement could be undertaken in terms of Sri Lanka Standard on Review Engagements to provide a limited assurance on the un-audited financial statements. Alternatively, if the bank requires a reasonable assurance on a single financial statement or on specific elements, SLAuS 805 could be used to conduct a special purpose audit.

(c)

Learning outcomes
5.1.3 Advise on the impact of current topics relevant in performing an assurance engagement.

Key Audit Matters or "KAM" are those matters that, in the auditor's professional judgment, were of most significance in the audit of the financial statements of the current period. KAM should be specific to the entity and the audit that was performed in order to provide relevant information to users. Therefore, ISA 701 includes a judgment-based decision-making framework to help auditors determine which matters are KAM. This decision-making framework was developed to focus auditors on areas about which users have expressed the most interest.

As an initial step in determining KAM, ISA 701 requires the auditor to determine, from the matters that were communicated with TCWG, those matters that required significant auditor attention.

ISA 701 provides robust guidance to support the decision-making framework in determining the relative significance of a matter communicated with TCwG and whether such a matter is a KAM, noting the following considerations, among others, may be relevant:

- The nature and extent of communication with TCwG about the matter, because the auditor may have had more in-depth, frequent or robust interactions with TCwG on more difficult and complex matters.
- The importance of the matter to intended users' understanding of the financial statements as a whole; in particular, its materiality to the financial statements.
- The nature of the underlying accounting policy relating to the matter or the complexity or subjectivity involved in management's selection of an appropriate accounting policy compared to other entities within its industry.
- The nature and materiality, quantitatively or qualitatively, of corrected and accumulated uncorrected misstatements due to fraud or error related to the matter, if any.
- The nature and extent of audit effort needed to address the matter, including the extent of specialized skill or knowledge needed to apply audit procedures to address the matter or evaluate the results of those procedures, if any, and the nature of consultations outside the engagement team regarding the matter.
- The nature and severity of difficulties in applying audit procedures, evaluating the results of those procedures, and obtaining relevant and reliable evidence on which to base the auditor's opinion, in particular as the auditor's judgments become more subjective.
- The severity of any control deficiencies identified relevant to the matter.

Section 2

<u>Question 3</u>

(a)

Learning outcomes
1.2.1 Advise the effectiveness of a board, in the perspective of governance, including: - Unitary and two-tier board structures - Division of powers (CEO and chairman) - Board composition - Types of directors - Role of independent non-executive directors - Financial acumen - Responsibilities of the board
1.3.1 Evaluate an audit committee charter including the key aspects of an audit committee, such as: - Role of "the audit committee" - Membership and meetings - Financial and management information reporting - Internal controls - Internal audits and external audits - Conflict of interest

(i)

<u>Basis for allocation of marks</u>

Each point carries 3 marks (3*4), equally divided for the explanation of the governance issues and for the proposals.

1. Balance of power and authority

Mr. Marasinghe appears to play a dominant role in running the business and in making significant board decisions of the Company. In the event the Chairman and CEO are the same person, the board should appoint one of the independent non-executive directors to be the "Senior Independent Director" (SID). The senior independent director should make himself available for confidential discussions with other directors who may have concerns which they believe have not been properly considered by the board as a whole and which pertain to significant issues that are detrimental to the Company. Further, this risk of dominance of the board could be counterbalanced by having an appropriate board balance as explained below.

2. Board balance and independence of non-executive directors

The number and calibre of non-executive director should be adequate for their views to carry significant weight in the board's decisions. This does not seem to be the case for MCLP as the board is dominated by the CEO/ Chairman and other executive directors. If Mr. Marasinghe continues to be the chairman, non-executive directors should comprise a majority of the board. In MCLP, the two non-executive directors cannot be seen as independent in terms of the corporate governance code:

- Mr. Gamlath is a family member of Mr. Marasinghe and has been employed by a subsidiary as the CEO; and

This may require appointment of additional members to the board who are independent of management and free of any business or other relationship that could materially interfere with the exercise of their unfettered and independent judgment. Two or one third of non-executive directors appointed to the board of directors, whichever is higher, should be 'independent'.

3. Remuneration committee

At MCLP, remuneration of the board is determined by a committee comprising all board members. This may result in lack of transparency and bias in determining the remuneration package for executive directors.

MCLP should set up **remuneration committees of independent non-executive directors** to make recommendations to the board. Remuneration committees should consist **exclusively of non-executive directors who are independent of management** and free from any business or other relationship which could materially interfere with the exercise of their independent judgment. Remuneration committees should have a chairman who should be appointed by the board.

4. Audit committee

The mandate of MCLP's audit committee has been restricted to the discussion of internal audit reports and KPIs and has not addressed other key areas of an audit committee's responsibilities identified in the code on audit committee best practices.

According to the code on best practices for audit committees, the main role of an audit committee should be to **oversee the financial reporting system** of the company, with a view to safeguarding the interests of the shareholders and all other stakeholders.

Other areas recommended in the code on audit committee best practices

- Management of business risk and management of internal controls,
- Reporting conflicts of interest,
- Compliance with laws and company polices,
- Assessing independence of external auditors and monitoring external audit function.

Alternative answers

Internal audit

The internal audit function at MCLP is not independent as the audit reports are first discussed with Mr. Marasinghe who has the power to exert pressure over the findings included in audit reports. Further, it is not appropriate to bring the internal audit function under the oversight responsibility of the CFO who has a vested interest in the subject matter of internal auditors.

The head of internal controls should report directly to the audit committee.

Nomination committee

As a listed company, MCLP does not have a formal and transparent procedure for the appointment of new directors to the board and there may be bias in selecting appropriate members to the board.

A nomination committee should be established to make recommendations to the board on all new board appointments. The majority of the membership of the committee should be non-executive directors together with the chief executive.

(ii)

Learning outcomes
1.4.2 Evaluate the ethical behavior in a given scenario.

Criticise the ethical behaviour of Amal Fernando

The investigation report of the Central Environmental Authority on contaminated water caused by the Company's operation should be viewed as a source of uncertainty affecting the operation of the plant and may result in penalties and other sanctions being imposed by the regulator. This may require **disclosure in the financial statements and the sustainability report**.

(1 mark)

Integrity

Amal's behavior in not disclosing the event clearly violates the fundamental principles of integrity. As a professional with integrity, Amal should have the highest levels of probity in all personal and professional dealings. According to the code of ethics, professionals should be straightforward and honest in all relationships, and never take part in anything that might undermine, or appear to undermine, the trust which society has placed in them. Amal is exposed to a conflict of interest situation where the request made by Mr. Marashinge is contradictory to his duty to uphold fundamental ethical principles and to act in the public interest.

(2 marks)

Inducement to objectivity

Without following the ethical guidelines on conflict resolution given in the code of ethics, Amal has acted on self-interest by accepting inducements to comply with Mr. Marashinge's request.

A significant increase in bonus made him disproportionately concerned with hiding information which is fundamental to stakeholders of the Company and this helped to cloud his judgment and reduced his objectivity as a professional. Amal should not have allowed bias, conflicts of interest or undue influence to cloud his judgment on professional decisions.

(2 marks)

(b)

i. Change in risk appetite

Learning outcomes
2.1.3 Demonstrate the key concepts in enterprise risk management including risk appetite, risk analysis, risk mitigation and risk monitoring

Basis for allocation of marks
1 mark for explaining high risk-taking behavior in general.
3 marks for explaining specific strategic decisions reflecting a high risk-taking behavior.

With the aggressive management style of Mr. Marasinghe, MCLP appears to be to be more risk-seeking than risk-averse.

The following strategic decisions/changes could be considered to be high risk and would have contributed to increase the risk appetite of the group.

- Acquiring the controlling interest of Modern Ceramic Limited (MCL) and transferring current orders without adequate assessment of MCL's ability to meet the quality standards of the Company.
- Joint venture with Chinese partner without a proper study on potential conflicts (due diligence assignment should have been undertaken).
- Derivative trading including commodity contracts - the Company may not have experience in derivative trading and could be exposed to high risk arising from the complexity of such instruments. Further, this is not part of the Company's core business and could change the risk profile of the Company.

(4 marks)

ii) Appropriate structure for implementation of ERM

Learning outcomes
2.2.1 Demonstrate the roles and responsibilities relating to enterprise risk management including the role of chief risk officer.

<u>Basis for allocation of marks</u>

- **2 marks for explaining the lapses in the current structure.**
- **3 marks for the discussion of an appropriate structure for assigning roles and responsibilities, including the roles of CEO and management, board and audit committee.**

Main lapse in current structure

Implementation of Enterprise Risk Management (ERM) at MCLP is vested with a committee comprising the CFO, head of internal audit and head of marketing. Furthermore, a risk assessment had been carried out based on the knowledge of the committee members Such a committee, which is not integrated to the business, may not take a holistic view of the risk and may not be aware of the risk appetite of the board, strategic decisions, and uncertainties arising from the internal and external environments which affect the business.

Role of CEO and management

Under the leadership of the CEO, the senior management team should identify the risks associated with high level business objectives and strategies. Periodic meetings between the CEO and senior management team enable the review of risk status and risk mitigation plans. For emerging risk, strategy implementation which indicates potential misalignment with risk appetite, the CEO will take necessary actions to re-establish alignment or discuss with the board.

MCLP should assess in light of the size and complexity of the business and breadth of the scope of the function, whether it should establish a centralized coordinating point to facilitate ERM and create the position of "Chief Risk Officer".

Role of the board

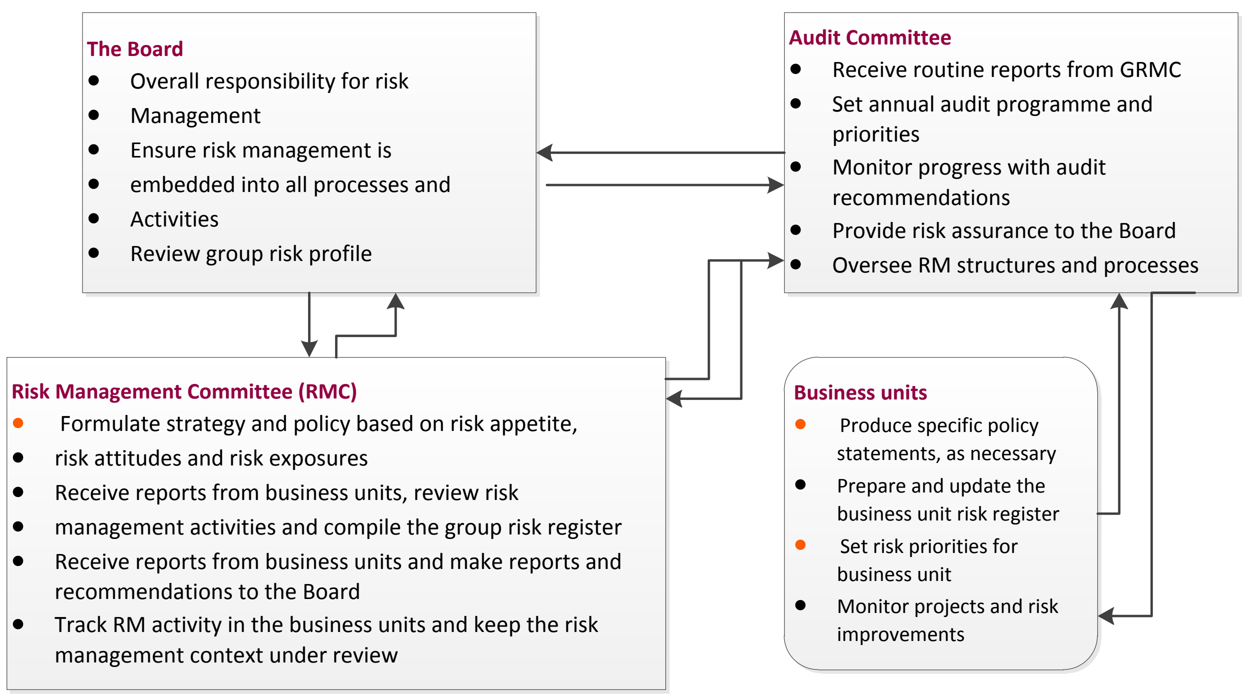
By definition, ERM is a process applied in strategy setting to identify potential events that may affect the entity and manage risk to be within its risk appetite. As a part of the internal environment, the board set the tone and provides an oversight with regard to the enterprise risk management process. The board should be involved in formulating risk management policies, establishing risk appetite and the process of risk management. This is because ultimate responsibility for governance lies with the board of directors.

Board committees consisting of independent non-executive directors could be established to focus attention on various elements of ERM. E.g. risk management committee to drive the process and audit Committee to monitor the effectiveness of the risk management process with the involvement of internal audit.

Audit Committee

The main role of the audit committee is to ensure the effectiveness of risk management framework and the processes including the risk mitigation plans. The audit committee may review periodic risk reports and may act as an independent monitoring mechanism. Most of these works could be accomplished through internal audit function.

Risk management roles and responsibilities (illustration purpose only)



iii) Appropriateness of risk identification and risk evaluation documented in MCLP's risk grid including the adequacy of coverage and appropriateness of risk score.

Learning outcomes
2.4.1 Evaluate, in a given scenario, the risk arising from internal and external environment in terms of likelihood, consequence and other risk criteria

Basis for allocation of marks
• **1/1/2 marks for explaining the risk not included in the risk grid (½ for identifying four risks and 1 mark for the explanation). (6 marks)** • **1 mark for explaining 3 risks which are within the risk appetite with a lower score and could be shifted upwards with a higher score.**

Risk not included in the risk grid

Due to the flaws in the structure of risk management and its lack of integration with other functions of the organization, MCLP has not been able to identify risk events arising from its strategic initiatives to achieve its objectives. In a robust risk management system, management should take a proactive approach to identify potential risk.

The table below shows the risk events which relate to the Company's strategic initiatives which had not been identified in the risk grid.

(Any of the points listed below are acceptable; alternative answers could be considered).

Strategic Initiative	Risk events
Review the contracts with dealers	Increased sales returns, cost of warranty and inappropriate rebates arising from flexible terms and conditions introduced. There may be incentive pressure for regional managers to manipulate sales.
Producing customized tiles by investing in digital ceramic printing technology	This is a new business model which could give rise to a set of new business risks such as inadequate demand, increase in stock write-off, product returns, etc.
Joint venture with a Chinese company	The Chinese company fails to enforce terms and conditions of the joint venture agreement; potential conflict of interest.
Mining raw materials	Inability to comply with regulatory requirements applicable for mining.
Use of derivatives	With commodity trading, derivatives have been used beyond the hedging of the Company's interest rate and currency risk exposure. Excessive losses from inappropriate use of derivatives without a proper control framework.

Risk which should move beyond risk appetite with a higher risk score

Note: Answer does not take into account the impact of risk mitigation plans on the risk assessment.

1 mark for each valid comment

- Compliance violation has also been marked as <u>a low risk</u> but the Company has failed to implement adequate risk mitigation plans to address <u>environmental regulations</u>. Further, it seems to have violated the law applicable for mining. These suggest that inability to comply with the law is a likely risk and should move beyond the risk appetite.

- Given the plan to sub-contract orders and the partnership with the Chinese supplier, the Company should have expected quality issues and taken preventive measures. This has also been rated low.
- Supply chain issues have resulted in losing customer orders. This is a likely risk with a relatively higher impact and could move beyond the risk appetite

(9 marks)

(c)

Learning outcomes
3.2.1 Evaluate financial information and non-financial information relating to economic, industry and business matters to identify risk of material misstatements, including the financial statements of a group and an SME.

1. Revenue recognition

Despite the pressure from competition, the Company has increased revenue by 24%. Remuneration of regional sales managers is related to revenue targets set in the budget. According to SLAuS 240: Auditor's responsibilities relating to fraud in an audit of financial statements, this is an indicator where the management could inappropriately overstate revenue to increase their incentive payments. **(1 ½ marks)**

Revenue recognition in the current period is subject to differing interpretations with the review of dealer's contracts. The risk is further evident by the significant increase in the volume of sales returns after the year end. These non-standard clauses have brought added complexity to revenue recognition and there is a risk of overstatement of revenue e.g. premature revenue recognition, recognition of higher sales during the period and the subsequent reversal of such sales. **(1 ½ marks)**

2. Recognition of intangible assets

According to LKAS 38, expenditure on research (or on the research phase of an internal project) shall be recognised as an expense when it is incurred. It shows that the digital ceramic printing project is still at the research stage and has not met all the criteria required to be identified as an internally developed intangible asset which is at the development stage. **(1 ½ marks)**

The Company is yet to establish the technical feasibility of the project as the initial trial had failed to meet the identical customer specifications and required quality standards. Furthermore, the entity's ability to generate probable future income economic benefit from this project is affected by the competitor's initiative to launch a similar product. **(1 ½ marks)**

3. Inappropriate recognition of long-term investments

According to SLFRS 10, an investor controls an investee when it is exposed, or has rights, to variable returns from its involvement with the investee and has the ability to affect those returns through its power over the investee. The essential part of the definition is that control can be established by the investor's ability to exercise power so as to affect its return.

(1 mark)

In case of MCL, although the Company has less than 50% shareholding (voting rights), it has the power over relevant activities through the management contacts so as to affect its variable return from MCL. E.g. purchasing, financing and sub-contracting orders at a margin determined by the Company. Therefore, recognizing MCL as an available-for-sale (AFS) financial asset is not appropriate. Further analysis is required to determine whether MCL should be consolidated with MCLP. **(2 marks)**

Other valid points

(a) **Measurement uncertainty associated with fair valuation of** non-quoted and non-trading investments. Determination of fair value of unquoted investments involve subjective judgements and use of unobservable data.

(b) SLFRS 12 requires an entity to disclose information that enables users of its financial statements to evaluate:

- the nature of, and risks associated with, its interests in other entities; and
- the effects of those interests on its financial position, financial performance and cash flows.

4. Inappropriate treatment of joint venture in the consolidated financial statements

MCLP has used proportionate consolidation in accounting for Bath Specialist Limited. According to SLFRS11: Joint arrangements, a joint arrangement is an arrangement in which:

– the parties are bound by a contractual arrangement; and

– the contractual arrangement gives two or more of those parties joint control of the arrangement.

It is mentioned that the two parties have joint control over the net assets of the Company.

(1 mark)

According to SLFRS 11, such parties having rights to the net assets of the arrangement are parties to a **JOINT VENTURE** and **a** party to a joint venture should account for the investment in the arrangement using the equity method. Therefore, use of proportionate consolidation is not appropriate and this may have a pervasive impact on the financial statements.

(2marks)

Other valid points

SLFRS 12 requires an entity to disclose significant judgements and assumptions made by the entity in determining:

(i) that it has joint control; and (ii) if structured through a separate vehicle, whether the arrangement is a joint operation or a joint venture

5. Inappropriate accounting policy on derivatives

MCLP has accounted for all derivatives in OCI; this contradicts with LKAS 39: Financial instruments recognition and measurement. According to LKAS 39, all derivatives should be valued at fair value and any gain or loss should be directly recognized in profit and loss.

Gain or loss on derivatives could be accounted in OCI only if the company has designated derivatives as a hedging instrument in an effective hedging relationship, which is unlikely to be the case for MCLP. Hence, the loss on derivatives should be accounted in profit and loss.

(2 marks)

Commodity contracts (1 mark)

Whether commodity contracts are within the scope of LKAS 39 depends on the intention of the company. If the contracts had not been entered for the purpose of physical receipts of a commodity (executor contracts) such as jet fuel, copper, etc., the contracts could meet the definition of derivatives and should be accounted for accordingly.

Other valid points about derivatives

Valuation and measurement of derivatives are highly complex and subjective in nature. The appropriate valuation model should be used for the valuation of such contracts.

- Another concern regarding the recognition of financial instruments is the detailed disclosures required by SLFRS 7: Financial instruments - Disclosure.

The following answers which are risks of material misstatements at assertion level could also be considered as valid.

1. Weak control environment

Control environment at MCLP appears to be weak due to the following issues.

- According to SLAuS 550: Related parties, Mr. Marasinghe can be identified as a related party with dominant influence who could inappropriately influence the selection and application of aggressive accounting policies as indicated in the case. He had exerted pressures on the CFO. This increases the fraud risk at financial statement level, due to management override of controls.
- Resignation of the experienced CFO would also affect the financial statements in relation to application of accounting policies on subjective and complex areas.

2. Key management personnel holding shares

- Mr. Marasinghe is one of the key management personnel and holds a 15% stake in the entity. Transactions between him and the entity should be identified and separately disclosed.