THE INSTITUTE OF CHARTERED ACCOUNTANTS OF SRI LANKA

No of pages: 11

Corporate Level

KC 4 – Corporate Governance, Ethics & Assurance

(Pilot Paper)

Instructions to candidates

(1) Reading time: 15 minutes

Time allowed for writing: 3 hours

(2) All questions should be answered

(3) Answers to questions should be in the answer booklet provided to you. Begin each answer on a separate page.

(4) All answers should be in English.

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June 2015

Question 01

(a)

Super Drive & Co commenced as a firm of chartered accountants in 2010. One of the key challenges faced by the firm during the first three years of its operation was attracting new clients. Therefore, the business strategy of the practice placed a particular emphasis on quoting lower fees for audit engagements and selling non-assurance services to audit clients. The rationale for quoting lower fees for new clients is the anticipated opportunities to render other services to clients for a higher fee. The business strategy is to compensate key audit partners on success in selling non-assurance services, the firm has been able to expand its client base during the last two years. However, the firm is under pressure to keep the cost structure low and to complete the audits within a shorter period of time and to the required quality standards. The engagement partners' involvement in the audit is limited to the final review of the engagement prior to signing the audit report.

Required:

> **Evaluate** the system of quality control of Super Drive in relation to leadership responsibilities and compliance with ethical requirements.

(10 marks)

(b)

The following information relates to the finalization of the audit of Suriya Limited, a recently accepted audit client. The Company is a major local player in stainless steel cookware and furniture manufacturing business. Suriya Limited has reported a net profit of Rs. 150 million for the year (2013: Rs 135 million) and its total assets as at 31st April 2014 amounted to approximately Rs. 1,250 million (2013: Rs. 1,150 million).

Saman Kumara, senior in charge of the audit has suggested the following audit adjustments and proposed changes to the audit opinion in relation to the audit of financial statements.

(i) **Evaluate** the effect of the suggested audit adjustments on the financial statements.

(You should briefly refer to the requirement of SLAuSs in relation to evaluating the effect of uncorrected misstatements)

(8 marks)

(ii) **Recommend** modifications and other changes required on the proposed audit opinion, clearly identifying issues with the proposed opinion.

(7 marks)

(Total 25 marks)

Proposed audit adjustments

These matters are yet to be discussed with the client.

(Figures in Rs. 000)

	Income Statement		Balance Sheet	
Proposed adjustments to Uncorrected misstatements	**Debit**	**Credit**	**Debit**	**Credit**
ESOP	15,000			15,000
Provision - Water treatment plant		5,000	5,000	
Total	15,000	5,000	5,000	15,000

1. In December 2013, the Company had offered an Employee Share Option Plan (ESOP) to the senior management for a quantum of 1% of issued shares. Given the declining trend of the share price, the finance director carried out an analysis and explained that the share option scheme should not be recognized in the financial statements. A letter of representation has been obtained from the Financial Director to rationalize the accounting treatment of the ESOP.

2. The provision represents the estimated cost of the new water treatment plant. This cost is expected to be incurred in light of the result of the environmental consultant's report which states that the two factories are releasing contaminated water to the environment.

Proposed audit opinion

In our opinion, b**ecause of the significance of the matter discussed in the basis for an Adverse Opinion paragraph**, the financial statements of Suriya Limited are **not presented fairly.**

Without qualifying our opinion we draw attention to the litigation against the Company by the Environmental Authority over the alleged release of contaminated water. According to the management the outcome of this litigation remains uncertain as at 31st March 2014. In our view, the details of this litigation should be disclosed in financial statements.

Question 02

(a)

Ridma PLC is a leading manufacturer of fashion garments which are exported to the US and Europe. The Company follows a "made to order" business model where ordering, manufacturing and delivery are based on confirmed customer orders. The main operational objective of the Company is to ensure that shipments will be delivered on time while ensuring that optimum stocks will be purchased and utilized to produce the customer order quantity. Purchase orders are automatically raised from the system (an integrated ERP system) based on the material requirement of customer orders recorded in the sales module. It had been reported in the risk report to the board that the Company has not established effective controls to reduce purchase of excess raw material and misappropriation of inventory. The audit committee has requested the internal audit department to perform a risk based internal audit of the procurement process.

Required:

Advise on the approach to be taken in planning the risk based internal audit of the procurement process, setting out engagement objectives, scope and planning considerations.

(10 marks)

(b)

In order to expand the Company's operations into commercial construction, the Company intends to apply for a bank loan. A detailed business plan had been requested by the bank as a part of the loan application. The bank has requested external auditors' certification of the following financial information included in the business plan.

- Unaudited financial information for the last 6 months; and
- Forecasted profit and cash flow for the next 3 years.

Advise on suitable engagements with their level of assurance, which the external auditor may undertake to report on the financial information included in the business plan.

(7 marks)

(c)

At the last audit committee meeting there was a detailed discussion on the external audit for the year ended 31st March 2014. One member of the audit committee stated that the auditor's report needs to be more informative – in particular, auditors should provide more relevant information to users based on the audit that was performed. The chairman of the audit committee responded that the new and revised auditor reporting standards lay the foundation for the future of global auditor reporting and improved auditor communications. He said that one of the major changes in the new standards is the section on key audit matters.

Advise the audit committee on the meaning of key audit matters and framework suggested in the new audit reporting standards to identify key audit matters.

(8 marks)

Total 25 marks

Section 02

<u>Question 03</u>

Unseen case materials

Following the board meeting held in January 2014, the board unanimously decided to respond to the risk highlighted and made some significant changes to its strategic directions. These changes include:

1. The need to increase production capacity to reduce the risk of losing customer orders during the peak period of sales.
2. Introducing new operating guidelines to regional sales managers to review the contracts with dealers in terms of warranty, product return policy and sales rebates. Each regional sales manager is incentivized based on the weekly sales target.
3. Producing customized tiles by investing in digital ceramic printing technology and a colour mixing machine that makes it possible to print any picture, design or pattern on floor or wall tiles based on customer preferences.
4. Entering into a joint venture with a Chinese company to produce bathware fittings. A separate legal entity, Bath Specialist Limited was formed for this purpose with joint control over the net assets of the company.
5. Investing in an energy saving project to discover new techniques of burning tiles as there is continuous pressure from increasing prices of electricity and fuel which account for approximately 40% of production costs.
6. Forming a treasury division with the objectives of mitigating interest rate and currency risk and maximizing returns from forward buying and selling of commodities.

Governance

Mr. Marashinge, the founder of the Company, is the CEO and chairman (group) and holds 15% of the shares. The board consists of four executive directors and two non-executive directors. Mr. Gamlath and Mr. Kamal are non-executive directors. Mr. Gamlath is the younger brother of Mr. Marashinge. He is the CEO of Migaya Bathware (Pvt.) Limited and was awarded the 'Entrepreneur of the Year' award. Mr. Kamal Nanayakara, a veteran banker, is the other non-executive director. Kamal is the CEO of Public Trust Bank and serves on the board of the top five listed companies in the country. Remuneration of the board is determined by a committee comprising all board members. The audit committee of MCLP consists of Mr. Kamal and Mr. Dimuthu Bandara, partner of a local firm of chartered accountants. The audit committee meets twice a year to discuss internal audit reports and to review the Company's KPIs.

Preparation of financial statements

Ranjith Fernando, FCA of the Institute of Chartered Accountants of Sri Lanka was responsible as finance manager for the preparation of statutory financial information including the consolidated financial statements and had led the finance team for five years. During December 2014 he left the Company over a disagreement with Mr. Marashinge. Mr. Marashinge recruited Amal Fernando, FCA and a Chartered Financial Analyst as the CFO. Amal's role also includes taking an oversight responsibility for risk management and internal audit and he reports directly to the board.

Internal audit and Enterprise Risk Management

The internal audit function is headed by Sumith Fernando, ACA. All internal audit reports are initially discussed with Mr. Marashinge and his recommendations are considered prior to tabling audit reports at audit committee meetings.
Enterprise-wide risk management is carried out by a committee headed by Amal Fernando. Other members of the committee are Sumith Fernando and head of group marketing, Wasantha Soysa. The committee identifies and assesses risk based on their understanding of the business and the risk grid is shared with business unit heads who are responsible for implementation of risk mitigation plans. The risk grid is presented to the Board on a quarterly basis.

Annual strategy review – June 2015

The following points relate to the last management meeting where there was a brainstorming session to review the Company's strategic initiatives and to prepare for challenges faced by the Company. The event was attended by all board members, regional sales managers, showroom managers, warehouse managers and other operational level staff.

1) Following the flexible terms of trade with dealers, there is a significant increase in sales returns and recovery issues.
2) Disputes between local management and joint venture partnership.
3) Several customer complaints were received from major construction companies due to poor quality standards of tiles produced by Modern Ceramic Limited.

Audit of financial statements of MCLP

The following information relates to the audit of financial statements of MCLP PLC.

(All of the matters listed below are considered as material to the consolidated financial statements of MCLP).

1. Long-term investments

(a) Modern Ceramic Limited (MCL)

This represents a strategic investment of 45% of the shareholding of Modern Ceramic Limited (MCL). During the previous year the Company had an investment of 20% and as part of the Company's aggressive growth Mr. Marasinghe decided to increase its investment in MCL and had entered into a management contract whereby the Company could play a key role in directing relevant business activities in order to strengthen the strategic position of MCL. These activities specified in the contract include changing raw material suppliers to those of the Company, sub-contracting the Company's order to MCL at a margin determined by the Company, and making financing decisions. The investment in MCL has been recorded as an Available for Sale financial instrument in the consolidated financial statements of MCLP.

Other long term investment consist of investments in non-quoted and non-trading shares.

Bath Specialist Limited (BSL)

BSL has been considered as a joint venture for financial reporting purposes and its financial information has been incorporated in the consolidated financial statements of MCLP using the proportional consolidation method.

2. Intangible assets

Intangible assets include cost incurred on two development projects. With the hiring of new designers and a Chief Innovation Officer (CIO), the Company has invested in digital ceramic printing technology and a colour mixing machine that makes it possible to print any picture, design or pattern on floor or wall tiles based on customer preferences. Although an initial trial failed to meet identical customer specifications and required quality standards, the CIO is working with the supplier to achieve a high degree of precision in capturing a given design. The project is expected to launch during 2015. It has also come to light that Ceramic Specialist Limited is already offering customized tiles and has a collaborative partnership with an established ceramic tile manufacturer in China.

3. Derivatives

The Company has mitigated the interest rate risk exposure on its variable rate borrowings by entering into an interest rate swap arrangement on 1st December 2014 under which it had agreed to pay a fixed rate of interest and to receive a variable rate which is linked to SLIBOR. Further, the Company has entered into foreign currency forward contracts and the fair values of all derivative contracts have been recognized in OCI. In addition, the companies have started commodity trading contracts for jet fuel and copper. These contracts are not included in the financial information as they do not fall within the definition of financial instruments.

Consolidated statement of comprehensive Income for the year ended 31st March 2015

		2015	**2014**
	Note	**Draft**	**Actual**
		Rs '000'	**Rs '000'**
Revenue		4,106,015	3,641,563
Cost of Sales		(3,026,511)	(2,512,679)
Gross Profit		**1,079,504**	**1,128,884**
Other income gains	2	3,782	4,232
Investment income		14,422	111,849
Administration expenses		(252,207)	(297,914)
Distribution expenses		(462,450)	(158,757)
Finance cost		(252,894)	(165,562)
Profit Before Tax		**130,157**	**622,732**
Income tax expense		(39,047)	(186,820)
Profit for the Period		**91,110**	**435,912**
Other Comprehensive Income			
Profit for the period		**91,110**	**435,912**
Loss on derivative contracts		(78,500)	-
AFS		51,747	65,149
Total Comprehensive Income		**64,357**	**501,061**

Subsequent events

Following repeated complaints made by villagers of Godakawela about the effluents released by the factory and its adverse impact on the quality of well water (pH), the Central Environmental Authority carried out an investigation. According to the results of the investigation which were released before the finalization of the Company's annual report, water pollution has been continuing from the inception of the plant in the year 2000 and had caused health issues for the people in the surrounding villages. The investigation report further states that the poor effluent treatment facility and lack of testing of treated water are factors which contributed to these issues.

It was discussed at the last board meeting that there is a significant threat to the continuity of the plant and the corporate image of the Company. Therefore, this information is to be withheld from the public as Mr. Marasinghe has already started lobbying on the matter with a top-level politician of the area. Mr. Marasinghe offered to substantially increase Amal's bonus if he would not discuss this issue in the sustainability report or in any other disclosures. Further, Amal was asked not to make board minutes available for the auditors and to ensure that the auditors will not have access to the investigation report and the correspondence with the Central Environmental Authority.

Eventually, through speaking to an anonymous Company source, a financial journalist discovered the whole story and included it in an article in a business magazine on the subject of "reality of corporate sustainability". The article also revealed information about illegal mining of mineral resources alleged to have been conducted by the Company.

You are required to:

(a)

(i) **Propose four key measures** that could be taken to strengthen the corporate governance of MCLP (You should explain the main weaknesses in the current governance structure)

(12 marks)

(ii) **Criticise** the behaviour of Amal Fernando, clearly identifying the fundamental ethical principles he has failed to meet.

(5 marks)

(b)

(i) **Explain** how the change in strategic direction of MCLP has changed the risk appetite of the group.

(4 marks)

(ii) **Evaluate** the structure for assigning Enterprise Risk Management roles and responsibilities, focusing on the roles of CEO and management, board and audit committee.

(5 marks)

(iii) In light of the changes to strategic direction of the group, **validate** the risk grid (a) identifying risks which are not included in the grid and (b) risks within the risk appetite which should have been rated with a higher score..

(9 marks)

(c) **Evaluate** the financial and non-financial information relating MCLP to identify five risks of material misstatements in relation to the audit of consolidated financial statements of MCLP for the year ended 31 March 2014.

(15 marks)

Total 50 marks