

CA



THE INSTITUTE OF
CHARTERED ACCOUNTANTS
OF SRI LANKA

SUGGESTED SOLUTIONS

**KC4 – Corporate Governance, Assurance &
Ethics**

June 2017

SECTION 1

Answer 01

Relevant Learning Outcome/s:
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.
4.1.2 Advise on the need to change the audit approach for a given scenario.
Study text reference: Pages 257, 266 – 272, 596

(a) Answers to parts (i) and (ii) are given in the following table.

(i) Risk	(ii) Mitigating plan
<p>Financial risk</p> <p>Changes in the economic environment of the country such as changes in exchange rates, inflation and interest rates have an impact on the performance of the company. For example, in the case of a rise in inflation, visits of local tourists will fall and foreigners will also see the country as a costly place to spend holidays. Hence, inflation has an impact on revenues, expenses and profits of the company.</p>	<p>Continuous monitoring of changes in the macroeconomic environment and developing corporate plans based on these changes (e.g. consider the changes in tariffs etc.).</p>
<p>Maintaining market share and aggressive competition</p> <p>Competitive pressure → new entrants are there, and also due to capacity expansions there are new models like apartments and other home-like environments. Tourists will be attracted to these and there will be price completion, and under-occupancy of accommodation.</p>	<p>Enhance product delivery and service offerings to customers/tourists by offering value added services that will attract them.</p>
<p>Shift in the traditional markets (from European markets to China and India)</p> <p>There is a shift in global wealth profiles, and there is a risk that the company will not be able to respond effectively to market dynamics and customer needs. This will result in a decrease in the market share of the company.</p>	<p>Customising service levels to cater to emerging market customer expectations, and being alert to industry trends and accordingly responding to the needs of the customers (e.g. introduce Indian food to cater to Indian tourists etc.)</p>

(i) Risk	(ii) Mitigating plan
<p>Maintenance of service quality and operational efficiency</p> <p>Operational efficiency has an impact on profits, as it will affect the costs of the business. Further, if quality standards are not met, there will be an impact on customer satisfaction leading to reputational issues. Poor quality of food could result in health hazards. This too will have an adverse impact on the reputation.</p>	<p>Continuous improvement of the systems, products, processes, and provision of training to the employees.</p>
<p>Changes in the needs of customers</p> <p>Due to demographical changes, needs would change (e.g. recreation activities, entertainment, health concerns). If the company is unable to respond to these changes, there will be an impact on revenue.</p>	<p>Analyse the changes in the needs of customers, and proactively respond to these changes. The company can use satisfaction surveys and analyse the comments/suggestions obtained from customers.</p>
<p>Suppliers may not be able to provide the required supplies (e.g. vegetables, fruits, and other resources required to run the business)</p> <p>Inability to have supplies on time will have an adverse impact on the business operations, which will result in a fall in revenue from restaurants etc.</p>	<p>Have formal supply contracts with suppliers and periodically evaluate the performance of them, and take appropriate actions such as seeking new reliable suppliers etc.</p>
<p>Financial losses</p> <p>Risk of financial losses due to breakdown of internal controls.</p>	<p>Introduce clearly defined systems and procedures.</p>
<p>Human resources related risk</p> <p>Attraction of skilled employees and retention → new competitors will enter and attract trained and skilled employees from existing hotels through the use of attractive remuneration packages. The loss of employees will have an impact on the business operations of the company, as it will be unable to provide the required services etc., at the desired level of quality.</p>	<p>Identify skilled employees and have career planning, which should be supported with adequate remuneration and the provision of overseas training opportunities.</p>

(i) Risk	(ii) Mitigating plan
<p>Environmental risk</p> <p>Sea erosion, destruction of coral deposits, dumping of solid waste etc. would negatively impact the surrounding environment. This would result in adverse publicity as well.</p>	<p>Educating the villagers/residents who live close by to the hotel and working closely with local authorities.</p>
<p>Natural disasters</p> <p>Natural disasters (cyclones, floods, tsunamis etc.) will impact the hotel buildings and there will be a disruption to business activities. As a result, the company may have to incur additional costs.</p>	<p>Obtain adequate insurance coverage, and review this periodically and renew where required.</p> <p>Have a disaster recovery plan for the company.</p>
<p>Technology and data protection risk</p> <p>Failing to keep pace with developments in technology could impair the competitive position and operations.</p>	<p>Introduce new applications and IT controls.</p>
<p>Compliance risk</p> <p>Implications that arise due to non-compliance with regulatory requirements will result in high costs and also adversely impact reputation.</p> <p>(10 marks)</p>	<p>Regularly review statutory compliance by the key management personnel.</p> <p>(5 marks)</p>

(b) Answers to parts (i) and (ii) are given in the following table.

Item	(i) Impact on/changes required to the audit strategy	(ii) Further considerations
<p>1(a)</p> <p>Monthly accounts receivable and inter-company reconciliations</p>	<p>Initially the auditors had determined to rely on the controls over accounts receivable and the inter-company reconciliation process. However, these controls do not seem to operate effectively as reconciliations were not done on a consistent basis (they are supposed to be done on a monthly basis). Therefore, the auditor will not be able to rely on these controls, and instead substantive tests should be done in this area. Further, existence of differences and not following up on such discrepancies could indicate irregularities in the transactions. It may also indicate a risk of fraud, especially in the area of related party transactions.</p>	<ul style="list-style-type: none"> • Design substantive audit procedures to test the transactions (age analysis and impairment testing). • Expand the sample for calling confirmations from debtors. • Design unpredictable procedures in the related party transaction area, if a risk of fraud exists.
<p>1(b)</p> <p>System configuration on recognition on sales</p>	<p>Since the sales are on a FOB basis and there are delays from the date of raising the invoice to the date of delivery, there is a possible cut-off issue towards the year-end.</p> <p>As a result the auditor will not be able to effectively rely on the controls, and instead substantive tests should be done in this area.</p>	<ul style="list-style-type: none"> • Additional substantive testing should be designed to ensure there is no cut-off issue at the year-end. • The auditor also needs to have management controls in place to address this cut-off risk. E.g. check whether management does any reconciliation at the year-end to see whether all invoices raised in March have in fact been delivered over the ship's rail.
<p>2</p> <p>Misplaced assets</p>	<p>The theft of assets was not considered by the auditor as an area susceptible to fraud until they came to know about the complaints regarding the misplaced assets.</p>	<ul style="list-style-type: none"> • The auditor could design some testing regarding the nature of the unpredictability in this area, as there is a risk of fraud.

Item	(i) Impact on/changes required to the audit strategy	(ii) Further considerations
	Therefore, the auditor has to now consider this as an additional area susceptible to fraud.	<ul style="list-style-type: none"> • The auditor can assess the management controls to address the risk. • The auditor can increase the sample size for inspecting recorded assets and ensure all material aspects are verified.
3 Dissatisfaction of buyer	This buyer contributes to over 50% of the sales of the company, therefore dependency on this buyer is high. Discontinuation of orders by this buyer will have an impact on business continuation. The auditor has now identified a new risk that will have an impact on the going concern of the company. (5 marks)	The auditor needs to obtain additional audit evidence in this area, including: <ul style="list-style-type: none"> - Management negotiations with this buyer - Any other business plans to address this risk (seeking new buyers etc.) Accordingly, the auditor needs to assess the appropriateness of the going concern assumption. (5 marks)

(Total: 25 marks)

Answer 02

Relevant Learning Outcomes/s:
5.1.1 Evaluate factors relevant in accepting and agreeing the terms of new engagement for audit, review and related services.
Study text reference: Page 353 – 355

(a) **List of things to consider**

When assessing the potential risks associated with an engagement and deciding whether the firm can manage the risks effectively, consider the following:

- Whether the partners and staff are, or can reasonably become, sufficiently competent to undertake the engagement (this would include knowledge of the industry and subject matters, and experience with the regulatory or reporting requirements).
- Identification and availability of the individual assigned to perform the engagement quality control review (if required).
- Any proposed use of another auditor's or accountant's work.
- The ability to meet the engagement's reporting deadline.
- Whether there are any actual or potential conflicts of interest.
- Whether there are any identified independence threats, or they have the ability to have safeguards applied and maintained to reduce the threats to an acceptable level.
- The quality of the (potential) client's management, as well as those charged with governance, and those who control or exert significant influence over the entity, including their integrity, competence, and business reputation (consider any lawsuits or negative publicity surrounding the organisation), together with present and past firm experience.
- The attitude of these individuals and groups towards the internal control environment and their views on aggressive or inappropriate interpretations of accounting standards (including consideration of any qualified reports that have previously been issued and the nature of the qualifications).
- The nature of the entity's operations, including its business practices and the fiscal health of the organisation.
- Whether the firm expects any scope limitations.
- Whether there are any signs of criminal involvement and political exposure.
- Consideration of the reliability of the work done by the preceding firm and how this predecessor has responded to communications (this would include knowledge of the reasons why the client left the previous firm).
- Specific client identification such as compliance with law on money laundering.

(10 marks)

(b)

Chandra is required to establish policies and procedures for the acceptance of Outgrowers PLC as an audit client to provide reasonable assurance. CPA does not appear to have such policies or procedures in place. Chandra should establish policies and procedures to ensure that:

- The firm is competent and has the capabilities including time and resources
- The firm can comply with ethical requirements
- The firm takes steps to consider the integrity of the client

In the given scenario:

- Outgrowers PLC is a listed entity, and the audit would require a degree of skills and competency. CPA only has seven staff members who just have a part-qualification.
- The firm has experience and skills in small and medium audits, but not in listed companies.
- Chandra may place a greater emphasis on fee generation rather than formulating an effective process that personnel are able to consistently adopt when approaching new, potential client engagements.
This can lead to the firm undertaking riskier engagements that are driven by the size of the fee rather, than applying professional standards
- CPA should identify and evaluate circumstances and relationships that create threats to independence. In the given scenario, Chandra has known Ranil for some time and he (Chandra) has resolved all matters in relation to the Inland Revenue Department. Chandra also places a great emphasis on fee generation.
- CPA must formally consider integrity of the client prior to the commencement of the engagement. In this scenario, Ranil has a questionable reputation.
- CPA should set out a policy in quality control to investigate new client applicants through enquiries of referred sources and others in the community, and websites.
- CPA should consider the reliability of the work done by the preceding firm and the reasons why the previous auditor left.

(12 marks)

(c) **Matters to be formalised**

- Formalise by drafting and approving, policies and procedures for acceptance and continuance
- Establish a quality control manual and set out a policy for investigating new clients.
- Establish an appropriate HR policy in the area of staff training.

(3 marks)

(Total: 25 marks)

Answer 03

Relevant Learning Outcomes/s:
<p>1.10.1 Advise on the ethical issues and safeguards applicable to provision of non-assurance service.</p> <p>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 SME.</p> <p>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.</p> <p>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 audit and external audits -Conflict of interest.</p> <p>3.3.1 Propose further audit procedures to address identified risk of material statement.</p>
Study text references: Pages 108, 205 – 213, 331, 428, 436 – 439

(a) Answers to parts (i) and (ii) are given in the following table.

Professional service sought	(i) Evaluation	(ii) Recommendations
Lead the key owners of SSPL in connection with the investment decision to undertake technological improvements in line with the proposed expansion	<ul style="list-style-type: none"> Leading the owners beyond defining the investment can amount to active involvement in the management activities of the audit client. The auditor cannot get involved with management activities and at the same time audit the financial statements. Being involved in the client’s decision-making process in connection with the expansion will create a self-review threat, as the auditor is involved in the making of management decisions. 	<ul style="list-style-type: none"> Defining the scope to include specific activities to be done, that does not amount to engagement in management activities. Not provide decisions to the client, or not taking part in decision-making. Providing a list of recommendations from which the client can choose, based on their judgment. Involving an additional professional accountant to review the work done or otherwise advise as necessary. Insisting competent senior employees of the client to make

Professional service sought	(i) Evaluation	(ii) Recommendations
	<p>Getting involved in deciding which technological improvements are to be done, hampers the auditor's objectivity when auditing the financial results of the decision. For example, impairment of assets.</p>	<p>managerial decisions along with recommendations and get it documented.</p>
<p>Advise and implement the changes required for internal controls as the group finance director has already mentioned to the owners that, "presently the company relies on the integrity of personnel rather than having assurance from a control-based environment".</p>	<ul style="list-style-type: none"> • Undefined advice or vague scope can confuse the objectivity of the auditor. • Implementation of controls is a management activity that can hamper the auditor's ability to audit the controls, as they have been implemented by the auditor himself. • A self-review threat is created as the controls are the ones that are decided and implemented by the auditor. <p>May create a situation of "auditing the own work/results of controls", as the auditor will have to express his opinion on financial numbers that result from implemented controls.</p>	<ul style="list-style-type: none"> • Define a clear scope regarding the involvement in internal controls. • Not propose internal controls, but indicate risks that could arise due to the situation. • Recommend a list of suitable controls, out of which suitable ones can be chosen by the client. • Not being a part of the implementation activity of internal controls. • Training staff on how to implement general controls, but not specifically. • Using different partners and engagement teams with separate reporting lines for the provision of non-assurance services to the assurance client.
<p>Identify the level of opportunity and risk that SSPL should consider when assessing the strategic options as explained in the pre-seen.</p>	<ul style="list-style-type: none"> • Being involved in strategy is clearly a management responsibility. Hence, getting involved in this can confuse the role and objectivity of the auditor. 	<ul style="list-style-type: none"> • Define a scope that is not involved with the strategy of the company. • Assist clients to identify and define risks facing the business, but not get involved in the management's decisions.

Professional service sought	(i) Evaluation	(ii) Recommendations
	<ul style="list-style-type: none"> • Identifying opportunities and risks does tread on management activities. • Identifying the level of opportunities and risks requires assessing them as applicable to the client's management and business environment. • May create a self-review threat. <p style="text-align: right;">(6 marks)</p>	<ul style="list-style-type: none"> • Conduct primary and secondary research on the sector, market and ecosystem, in general. • Develop a trend analysis to help the client understand the relevant impacts of these trends on the business. <p style="text-align: right;">(5 marks)</p>

(b) **Key audit risks**

- Quality of the inputs and related impairment of inventory.
- Use of old machinery in coffee production and the quality of products can cause impairment of inventory.
- High cost of production of coffee powder can cause losses and also affect the NRV of inventory.
- Old machinery and losses can raise impairment issues for the machinery.
- Distribution and network of branches → effectiveness of controls at locations
- Significant “long outstanding” and “beyond credit period” debtors causing impairment.
- Sales documentation that originates at the network of branches not matching with the invoices raised at the shared service center.
- Sales not recorded due to missing documents between the network of branches and the shared service center.
- Delay in invoicing and timely revenue recognition.
- Non-preparation of group financial statements.
- Soap segment results are volatile, causing impairment of inventory.
- Soap segment impairment of assets due to the volatile market.
- Transfer pricing risks causing complexities in tax provisions.
- Intention by the HK investor to install new machinery, causing impairment issues on existing machinery.
- Internal controls not properly established.
- Cash loss in one outlet and the risk that it is prevalent in others too.
- Reputation risk, which could impact the going concern ability of the company (negative social media comments and customer complaints).

- Risks associated with the new ERP system and its performance.
 - Revenue declined by 3% – understanding the reasons
 - GP declined by 15%, and the GP ratio declined from 24% to 21% – understanding the reasons
 - Other income increased by 80%
 - Distribution expenses not in line with the sales drop
 - Net finance income reduced
 - Significant actuarial loss
 - Significant intangibles increase
 - AFS increase and FV calculations
 - Inventories drop
 - Disclosures around related party transactions
 - Trade receivables → debtors day ratio increased significantly
 - High bank OD and positive cash position simultaneously
 - Actuarial valuation of employee benefits
 - Significant increase of trade payables
 - Auditing segmental disclosures

(12 marks)

(c) **Areas to be included in the internal audit testing on quality control of inputs and raw materials**

- Assessing the supplier registration process and ensuring suppliers undergo evaluation on quality aspects.
- Mandating minimum raw material quality certifications to be obtained by suppliers.
- Performing surprise quality checks at supplier premises.
- Ensuring mandatory quality checks for compliance with specifications on quality, are carried out by the QC department on all receipts of raw material.
- Auditing areas of storage, the quality of storing and expiry dates.
- Auditing areas of quality aspects of the production process and compliance with internal and external quality specifications.
- Auditing areas such as pest control, waste control and disposal, and personal hygiene of workers.
- Auditing the transportation process with focus on the transporting mechanism used to deliver and compliance with quality of products.
- Understanding and accumulating data on customer complaints and making sure matters are attended to appropriately based on the QA process established.

(9 marks)

(d) An effective audit committee can bring the following benefits to SSPL:

- Improve the quality of financial reporting, by reviewing the financial statements on behalf of the Board.
- Create a climate of discipline and control, which will manage fraud risks.
- Enable the non-executive directors to contribute to an independent judgment and play a positive role.
- Help the finance director, by providing a forum in which he can raise issues of concern, and one which he can use to get things done which might otherwise be difficult.
- Strengthen the position of the external auditor, by providing a channel of communication and forum for issues of concern.
- Provide a framework within which the external auditor can assert his independence in the event of a dispute with management.
- Strengthen the position of the internal audit function, by providing a greater degree of independence from management.
- Increase public confidence in the credibility and objectivity of the financial statements.

(9 marks)

(e) **Note: Marks are given for each area separately**

Area 1: Data extraction

Evaluate the effectiveness of processes by which source data is extracted prior to conversion as well as how it is preserved and protected post-conversion

- Test the existence of well-defined business requirements, rollback plans and stakeholder signoffs.
 - Conduct interviews with key personnel to gain an understanding of the extractions process.
 - Review documentation of business requirements and rollback plans.
 - Test that all signoffs were collected before extraction and were given by stakeholders.
- Test the preservation and security of source data after extraction.
 - Review documentation related to preservation and protection procedures.
 - Test evidence of data preservation after extraction (e.g. time stamps, log file etc.).
 - Test evidence of security measures taken after preservation (e.g. archive/cut-off date, data access limitation etc.)

Area 2: Data transfer

Evaluate the controls in place to verify that data is transferred accurately and loaded completely between the source and destination.

- Test the design of controls in place that help to ensure accurate and complete transferring and loading of data.
 - Conduct interviews with key personnel to gain an understanding of the process by which data is transferred and loaded between the source and destination.
 - Test controls in place that help to ensure data integrity during the transfer and loading process (e.g. total counts, check sums, date and time stamps).
 - Test the existence of completed mapping of data between source and destination.
 - Test the controls in place that identify, communicate and resolve fallouts.
 - Test the controls in place that ensure business stakeholder signoffs.
- Test the integrity of data between the source and destination data stores.
 - Extract a population of data from the source and destination systems.
 - Import the data into a data analysis tool and test the data integrity between the two data sets.
 - Document any discrepancies found and discuss with key process owners to determine the validity of the results.

Area 3: Data accuracy

Evaluate the effectiveness of processes by which design, testing and approvals are performed on converted data and the underlying processes.

- Test change management procedures associated with the automated extract, transform and load (ETL) process and evaluate the effectiveness of the control design.
 - Conduct interviews with key personnel in order to gain an understanding of the change management process.
 - Test the operating effectiveness of the change management process and controls, as it relates to the automated ETL process.
 - Discuss any discrepancies with the process owners to confirm the issues and identify root causes.

(9 marks)

(Total: 50 marks)

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