THE INSTITUTE OF CHARTERED ACCOUNTANTS OF SRI LANKA

SUGGESTED SOLUTIONS

KC4 – Corporate Governance, Assurance & Ethics

December 2017

Answer 01

Relevant Learning Outcomes/s;
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 audit – Assurance engagements – Review of financial statements – Related services 5.3. 1 Propose areas that are important in undertaking an engagement quality control review for a given engagement. 4.1.2 Advise on the need to change the audit approach for a given scenario.
Study text reference: Page, 414, 596, 343, 736

(a) **Audit areas to be reviewed by the engagement quality review partner**

The engagement quality review partner (EQRP) shall be involved in reviewing the significant judgmental areas of the audit of Lak Power PLC. These areas include:

- During the last two years the company was not able to meet the revenue target set out in the power purchase agreement (PPA). This may impact on the going concern of the company. Therefore, how the auditor has evaluated this issue and the auditors conclusion on the matter. The quality review partner should check how the auditor evaluated the repayment capacity of the loan as a result of falling revenue.

- The given information suggests that there is an issue on the depreciation assessment of the power plant as this power plant does have significant components which require periodical replacement. Presently the entire plant is depreciated over 30 years which is not appropriate considering the significant components of the power plant. Therefore, management is required to assess the significant components and the impact on the financial statements after considering the significant components. Accordingly, it is required to determine the period over which those components shall be depreciated. This again is a judgmental area as the evidence needs to be gathered as to the significant components and the period over which they should be depreciated. Hence, EQRP shall review this area as there is an accounting issue and is a judgmental area of the audit.

- As per the given information, the company is facing issues due to the technical failures in the power plant. As a result, the expected power has not been generated and there had been shut downs in the plant (decreased revenue, increase in losses are also noted). This is the second year of business operations since commissioning of the plant. Such early technical faults / break downs in the plant may indicate the need for impairment of the plant which is a judgmental area. EQRP therefore shall ensure whether the judgments made by the engagement team in this area are appropriate (e.g. if the engagement team concludes that there will be no impairment, assessing whether the evidence obtained to that extent is appropriate or not. If the engagement team decides the need for an impairment assessment, the evaluation of appropriateness of judgments made by the management is critical. Hence, EQRP's review of this area will be vital.

- Other significant areas of this engagement will be assessing the net realizable value of inventories held at the balance sheet date. Given the break downs and increase in coal quantities might suggest that the NRV of those items may be lower. Assessing of NRV involves estimates (e.g. selling prices, costs to complete). Hence, will become a judgmental area and the EQRP shall review the appropriateness of audit evidence gathered in this area.

- There had been a warning letter from the Environmental Authority. Failure in adhering to the regulatory requirements may result in adverse consequences to the entity. These need to be evaluated by the engagement team and it is important that EQRP will also review the evidence obtained and the appropriateness of the judgments made in this area up to the date of audit report. (E.g. A provision for penalty is required to be made in the financial statements or whether the failure of the regulations will have an impact on the continuation of the business operations, if so the impact to the audit report of the company etc.). This also suggests the importance of reviewing the financial statements and the audit report of the entity by the EQRP.

- **Engagement quality review partner should assess the adequacy and appropriateness of the audit testing carried out on significant risks identified on revenue recognition and management override of controls.**

  [Candidates are not expected to write other judgmental areas such as determination of materiality, firm's independence, consultation, uncorrected misstatements, communication with those charged with governance as this question focuses on specific judgmental areas related to the entity]

(b) The initial audit plan has identified two significant risks. However, the given information and subsequently known information suggests that other risks also exist (e.g. impairment, going concern, component depreciation etc.). Therefore, these might suggest modifications are required to the initial risk assessment of the company as detailed testing is to be carried out in many audit areas.

The auditor has planned to rely on controls over other areas (except revenue and management override of controls). However, issues have been noted on other areas such as component depreciation, estimates and impairment. These may suggest that the engagement team needs to consider more substantive testing in this area given the increased risks and the changes in the control environment. Further, the walk through procedures on the purchasing process also indicates that the auditor may not be able to rely on certain controls. Therefore, the initial audit plan should be modified to this extent.

(c) (i) **Assurance services**

Before providing an assurance service, the auditor shall consider whether the following elements of assurance engagements are in existence for this service:

- Three-party relationship
  - The professional accountant (i.e. SMP)
  - Responsible party (in this case management is responsible for the non-current assets details or schedule)
  - Intended user (Chinese investor)
- Subject matter – Non-current assets which is an element of financial position of the company
- Suitable criteria – In this case, noncurrent assets can audited to ensure whether they are recognized, measured and disclosed in accordance with LKAS 16, which is the suitable criteria.
- Terms of Engagement – Whether the SMP can gather appropriate and sufficient audit evidence to evaluate whether fixed assets have been accounted as per LKAS 16
- Conclusion – whether an assurance report can be issued for the said purpose and whether it is supported by an appropriate auditing standard.

Since the elements of an assurance engagement are present for the proposed engagement, SMP Associates will be able to undertake the assurance engagement. SMP however, has to comply with the requirements of SLAuS in undertaking this work. This engagement therefore can be undertaken as per SLAuS 805 - *Audits of single financial statements and specific elements, accounts or items of a financial statement.*

(c) (ii) SLAuS 805 emphasises that the auditor must consider whether there are adequate disclosures according to LKAS 16 to enable users to understand the information conveyed in the financial statements or elements and the effect of material transactions in the information conveyed. This may mean considering whether additional disclosures are required beyond those required by the Financial Reporting Framework being used.

If the statement or element on which the auditor is reporting is published together with the Financial Statement on elements is sufficiently differentiated from the Financial Statements and must report separately on that.

Since SMP is the auditor of the financial statements of the company, it should be clearly communicated to the readers that this is not an audit on the entire financial statements but only an element of the financial position of this company. It is important that the element of the financial statement, including the related notes, in view of LKAS 16, provides adequate disclosures to enable the intended users to understand the information conveyed in the element of the financial statements**.**

The report shall also make a specific reference that these special purpose financial statements are not suitable for general use and it is prepared only for the use of a specific user and in this case the user could be mentioned. (the potential Investor use purpose only).

Accordingly, SMP shall include the "Restriction on Distribution" paragraph clearly stating the purpose of the report and restrictions on distribution of the report for use other than the specified purpose considered in preparing the report. This paragraph shall be added after the "Opinion" paragraph in the auditor's report.

(Total: 25 marks)

Answer 02

Relevant Learning Outcomes/s;
2.6.1 Explain the role of the internal auditor in enterprise risk management. 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. 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.
Study text reference: Page 318-319,264-270,325-333

(a) **Contribution of the internal auditor in risk management**

If the company wishes to employee an internal auditor, the internal auditor can contribute in many ways in risk management process of Lora.

- The internal auditor can assess the present processes for risk management at Lora (which may not be a formal process) and whether it is capable of identifying risks on a timely basis. If the present process is not adequate the internal auditor can advise on the gaps in the process and the appropriate actions the management of Lora could take.

- Internal auditors will attempt to confirm whether the present risk management processes and controls operate to mitigate risks and ensure that the management receives accurate information. If the present internal controls do not support the management in obtaining accurate information, the internal auditor can bring those to the attention of the management.

- Internal auditor will be able to assess the adequacy of internal controls in Lora, any weaknesses might be indicative of non-consideration of certain risks. The internal auditor can bring such weaknesses to the attention of the management.

- With the active involvement of the internal auditor on testing the internal controls and with timely reporting to the management, the internal auditor will be able to enhance risk management and the control culture.

The following points can also be considered.

- The internal Auditor can check the adequacy of the existing processes related to risk management especially processes for identifying, assessing, managing and responding to risks.
- Internal Auditor through his/her work will be able to establish a proper risk management and control culture.
- The Internal Auditor can assess the appropriateness of internal controls in operation to manage risks.
- The operation and effectiveness of the risk management processes including internal controls.

- Internal auditor can facilitate risk identification and evaluation and coaching management on risk identification, assessment and mitigation.
- Internal auditor can provide assurance on risk management.

(b) (i) & (ii)

Risk (i)	**Nature of the risk (i)**	**Impact to the operations (ii)**	**Mitigation plan (ii)**
1. Inventory – theft / pilferage	Almost certain due to the nature of the products as it can be easily taken out by outsiders / employees	Will have moderate or major impact if it is frequent and due to the high values of the branded products	Monitor through CCTV cameras Weekly / monthly / periodic inventory count and comparison with the records and investigate any differences and take appropriate action. Insurance coverage
2. Expiration of products and risk of selling those to the customers	Possible as the products carry an expiry date.	Selling of expiry goods has an adverse impact on the reputation of the company and might have an impact on the franchise agreement as well. If it happens it will have a severe impact on the company	Regularly monitor products nearing expiry and remove from the shelves in the shops. Before expiring do a product promotion and sell at a discounted price (50% off or 75% off etc.)
3. Theft of cash	Possible as the company's sales are done mainly on cash basis.	This will have a major impact if the cash theft happens frequently. The company's financial position will be negatively impacted as the products are priced at a high range	Cash in transit – insurance Monitor through CCTV cameras
4. Misappropriation of cash by employees	This is possible as there will be cash without being deposited at the end of the day	Impact depends on the frequency.	Surprise cash counts by internal auditor Daily reconciliation of cash collection and cash deposited by the head office and investigate any differences.

Risk (i)	**Nature of the risk (i)**	**Impact to the operations (ii)**	**Mitigation plan (ii)**
5. Availability of non-branded products in the market	This is almost certain as presently the company is facing this threat due to substitutes available at a lower price	The impact will be major if the market responds to the substitute products. The sales will be negatively impacted	Brand promotion Product promotion highlighting the advantages and safety of use (health concerns)
6 High costs due to inflation and increased exchange rates, high taxes	This is almost certain as the country is presently facing a similar situation	The impact will be major as this will result in increased costs and to recover the costs prices need be increased and demand may decrease.	Forward exchange rate contracts with the banks Find out possible untouched markets / customers who are ready to buy the products and may not have access. Then reach out those customers.
7. Lessor my discontinue the lease agreements after expiry	Since the shops are in prime locations, the demand for the property is high.	Since the company has already invested in the leased building by branding, shifting to another location and finding a similar location will be difficult.	Build up a good relationship with the lessor and safeguard the building leased out to the company Target alternative locations, if it is certain the lessor will not renew the lease agreements
8.Products are not appropriately stored at the proper temperature and safely	Possible as the environment under which the products are located have an impact on the quality and safety of the products	The impact will be major if the entity will not be able to ensure product quality and safety	Regular maintenance of the AC and assess the appropriateness of storage facilities
9. Risk of Increase government levies/ taxes on import products, remittances and local operations.	As the government policy is to increase the tax revenue and focus on economic growth this is possible.	This will result in increased costs of imports, local tax expenses and high cost on remittances.	The company can engage in an effective dialog with the relevant government authorities and demonstrate their existing tax payments and other contributions for social development.

Risk (i)	Nature of the risk (i)	Impact to the operations (ii)	Mitigation plan (ii)
10 Risk of non-compliance with new and changes in laws and regulations. (custom laws, health & safety laws, tax l	This is possible if the company is unable to comply with the new changes.	Non-compliance will have a significant impact as the company may have to incur penalties and increases in cash outflows. Further, in the case of non-compliance the company is exposed to reputational risk.	Assign the responsibility to an officer to ensure compliance with existing and new laws and regulations.
11.Cancellation of franchise agreement.	If the Company has not complied with the terms of the agreement.	Cancellation of dealership. Discontinuation of business activities.	Assign a person to check whether the terms and conditions of the agreement are adhered to by the Company.

Internal Control Testing

Inventory Management

The internal Auditor can test the following

1. Test the inventory movement i.e. Receipts, issuances are properly supported with appropriate documents.
2. Test whether all inventory have been accurately recorded with reference to quantities received/issued.
3. Observe and evaluate the existence of proper segregation of duties in the activities related to inventory receipts, recording etc.
4. Test the adequacy and appropriateness of security measures in place to safeguard the inventories.
5. Review the documentation used for recording inventories.
6. Review the procedure in place for inventory recording and handling.
7. Test the procedures in place to ensure the same quantities of items dispatched to each location have been received by the respective shops.
8. Test on a sample basis, any inventory reconciliations carried out by the management.

Cash management – internal controls

- Reconciliation of daily sales with cash deposited, cash in hand and receipts and credit card sales documents / slips. Any discrepancies shall be inquired from the officer in charge**.**
- Conduct regular surprise cash counts at shops and agree the cash in hand with the cash sales made during the day.
- Observe the existence of proper segregation of duties in handling cash.
- Review any reconciliations prepared by management with respect to cash. (Ex. Bank Reconciliation)
- Test whether payments have been authorized and recorded accurately and completely.
- Test whether all receipts are recorded on a timely basis, and accurately in the books of accounts of the Company.

(Total: 25 marks)

Answer 03

Relevant Learning Outcomes/s;
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 audit – Assurance engagements – Review of financial statements – Related services 1.7.1 Advise on ethical issues faced by a professional accountant in an enterprise for a given scenario. 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 4.2.1 Evaluate the effect of identified misstatements on the audit and the effect of uncorrected misstatements, if any, on financial statements. 1.5.1 Advise on the process of ethical conflict resolution 1.2.1 Advise on the effectiveness of a board on 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
Study text reference: Page 662,185,379,591,161,88

a)

i.

- There is no direct SLAUS that can be used to provide the "certified" 5 year forecast.
- Audits or reviews are not suitable as 5 year forecasts are not historical financial information
- SLSAE 3000, 3400 and 3420 may be referred to formulate an engagement to meet with the requirement.

ii.

- Determine a suitable applicable criteria, under which pro-forma five year financial data is compiled as given in QPL.
- Determine if the applicable criteria is suitable, given the objective, of "certified" information for the loan agreement of the bank,
- Set appropriate materiality, having understood the user as the bank that grants the loan and what is important to the decision of granting the loan. Such can be operating cash flow, EBITDA, or interest cover, etc. of QPL.
- Understand how proforma information is compiled by QPL, and determine if appropriate notes are given, to describe the basis, and assumptions,

– Obtain evidence on sources of information, for the compiled proforma information such as expected GP ratios, cost relationships, to other areas admin cost and selling expenses composition, and drivers, of such costs, tax expectations of QPL.

b)

- Although Kasun is a member of AAT he has to take steps to ensure that the entity complies with Laws and regulations (NOCLAR) as he is the chief regulatory officer and as an accountant in business.
- Kasun must first discuss the matter with the immediate supervisor if supervisor seems to be involved inform those who are charged with governance (1 mark) to obtain their concurrence regarding appropriate action to take to respond to the matter and to enable them to fulfill their responsibilities.
- If the management does not respond effectively Kasun may disclose it to a public authority.
- Comply with the legal provisions governing the reporting of the matter to an appropriate authority. The standard enables Kasun to set aside the principle of confidentiality when there is a strong public interest reason.
- Rectify, remediate or mitigate the consequences of the noncompliance - Reduce the risk of reoccurrence and seek to deter the commission of noncompliance
- Maintain appropriate documentation of the matter including –
  - results of discussion & responses received.
  - course of action considered, judgments made and decisions taken.
- If management does not respond effectively, Kasun is enabled to disclose it to a public authority
- The Standard enables Kasun to set aside the principle of confidentiality when there is a strong public interest reason

c)

i. Shops are in various locations. Therefore, it is important to understand the level of controls (centralised or not) and intended reliance
ii. Being a family company, there is an increased possibility of management overriding the control, this matter should be addressed in formulating the audit strategy
iii. Contracts require better discussion in terms of revenue recognition
iv. Revenue recognition in terms of agency or principle aspects
v. Related party transactions- MDs wife and supplier link, MV is sold to MDs wife
vi. Intangible assets seem valued in contradiction to the existing SLFRS that prohibits accounting for own- brands
vii. ERP is internally developed- special focus on IT application controls
viii. Covenants have been breached, where the debt to equity is beyond limit in the loan agreement. Being without remediation at the BS date
ix. Given the intended land sell off, there can be a residual that may require reclassification into non-current assets held for sale
x. Materiality to be set- low percentage on profits
xi. Significant increase in sales require better understanding of reasons
xii. GP ratio has increased to 44% from 32%. Understand the reasons and substantiate

xiii. Admin, selling and other operating costs seem to have increased significantly but not having any relationship mathematically with sales or costs. This require further analysis
xiv. Inventories increasing more than the apparent proportion in cost of sales
xv. Debtors increase disproportionately with sales
xvi. Capitalisation of borrowing cost, in line with LKAS
xvii. Exchange rate for conversion of imports and stocks, in line with LKAS
xviii. Deferred tax asset recoverability.
xix. Any other area with rationale

It was proposed to include the following points

- Capitalisation of borrowing cost, in line with LKAS
- Exchange rate for conversion of imports and stocks, in line with LKAS
- Deferred tax asset recoverability

d) .

- <u>Setting off</u> the assets under lien is <u>not correct</u> as <u>the risk and rewards of it still flows to the company</u>.
- <u>D</u>ebt to equity ratio before and after setting off are as follows:
    - Before -debt to Equity = (interest bearing loans/stated capital)= 65.7+19.9 Mn : 15.Mn= 5.71 = Covenant is breached
    - After -debt to Equity = (interest bearing loans/stated capital)= (65.7+19.9) Mn – 8.9-16.9 Mn = 59.7Mn : 15Mn= 3.98 = Covenant appears not breached
- In evaluating this misstatement, we need to <u>compare the error against the materiality</u>. The error is a significant misstatement.
- On the other hand the <u>breached covenant now appears not to have been breached</u> less than Debt : Equity of 4:1)
- Given that this is a material misstatement, financial statements are not presented fairly.

e)

Kasun faces three ethical dilemmas

- Firstly **-** <u>conflict of interest </u>as Lasantha asked him to <u>keep the takeover a secret</u>**,** but considering <u>job security </u>at QPL and not knowing whether to tell Malik or not.
- Second, Lasantha is asking Kasun to <u>deceive the other main shareholder</u>**.** Deception is <u>unprofessional behavior </u>and will <u>break your ethical guidelines</u>**.** Therefore the situation is presenting you with two conflicting demands.
- It is worth remembering that no employer or owner should ask to break ethical rules.
- Finally, the request to break Kasun's <u>own ethical guidelines constitutes unprofessional behavior by Lasantha</u>. Kasun should consider <u>reporting him to the relevant body.</u>

f) The following matters can be proposed in the discussion process and documentation at board level meetings.

- High-quality board documentation
- Obtaining expert opinions if necessary
- Allowing time for debate and challenge, especially for complex, contentious or business-critical issues
- Achieving timely closure of discussions
- Providing clarity on the actions required and timescales and responsibilities

(Total: 50 marks)

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1. to provide a detailed example of a suggested solution to an examination question; and

2. to assist students with their research into the subject and to further their understanding and appreciation of the subject.

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