THE INSTITUTE OF CHARTERED ACCOUNTANTS OF SRI LANKA

SUGGESTED SOLUTIONS

KC4 – Corporate Governance, Assurance & Ethics

June 2018

Answer 01

Relevant Learning Outcomes/s;
3.1.1 Develop an overall audit strategy for an audit engagement, including an audit of the financial statements of a group and an SME. 3.4.1 Propose further audit procedures to address complex areas relating to financial reporting issues (including audit of fair value measurements and estimate derivatives, related parties and the use of the work of an expert). 4.1.1 Evaluate the sufficiency and appropriateness of audit evidence gathered, and identify changes to plan further audit procedures.
Study text reference: 361-366, 424-425,497-510,602-609

(a) **Appropriateness of benchmark used for materiality**

The entity is a newly established entity and its main investor China Company does not expect to generate profits within the first 3 years. As it is in the development stage of its' activities, use of 'loss before tax' will not be a good benchmark. However, as described in the given scenario, this is the first period of the audit, and the 'value of assets' is a significant item in the Balance Sheet. Therefore, 'Assets' may **be considered to be** an appropriate benchmark, in the determination of materiality. The audit team however, based on their audit strategy and approach, may rationalize other appropriate benchmarks (e.g. total expenses). If materiality is to be determined based on 'loss before tax', it will result in a low materiality level, which will require performing detailed testing.

(b) **Risks to be considered**

- **Assets transferred –** Management has taken into consideration, the existence of the assets and the depreciable period. Management needs to consider the lower of the economic life of each component of the asset or the lease period, in calculating depreciation/amortization of leasehold assets.

- **Functional currency** – It appears that the financial statements have been prepared using USD, and it must be determined whether this is the appropriate functional currency for this company, based on the primary economic environment in which it operates.

- **Contingencies from employment compensation** – Consider whether employment compensation and benefits will result in a material contingency which requires disclosure in the financial statements.

- **Related party transactions –** identification of related party relationships and proper disclosure of related parties and the occurrence of related party transactions
- **Capitalization of borrowing costs –** Consider whether borrowing costs have been incurred prior to commencing construction, and if so, whether the classification of such borrowing costs would have a significant impact on the financial statements.

- **Any deferred tax impact arising due to tax holiday period.**

  [If the candidates have written below, consider giving marks]

  As per SLAuS there is a rebuttable presumption that fraud in revenue recognition is a significant risk**. Hence if the engagement team does not consider rebutting this risk, it can be considered as a key risk area, given that the revenue is generated mainly from related parties.**

(c) **Audit procedures to be performed on related parties and related party transactions**

- Understand the entity's controls over the identification of related parties and maintenance of a complete List of Related Parties.
- Review minutes of meetings of shareholders and directors and other relevant Statutory Records such as the Register of Directors' Interests.
- Enquire of Management and Directors as to whether transactions have taken place with related parties that are required to be disclosed by the disclosure requirements that are applicable to the entity.
- Review accounting records for large or unusual transactions or balances, in particular transactions recognized at or near the end of the financial period.
- Review confirmations of loans, receivables and payables and confirmations from banks. Such a review may indicate the relationship, if any, of guarantors to the entity
- Review the Register of Interests in Shares to determine the names of principal shareholders.
- Enquire as to the affiliation of Directors and Officers with other entities.
- Obtain direct confirmations from Related Parties.
- Review agreements, invoices and other correspondence to identify indicators of RPs and RPTs.
- Obtain written representation from Management indicating that they have disclosed all RPTs.
- Obtain relevant audit evidence to confirm that the related party transactions have taken place at arm's length.
- Perform substantive procedures relating to related parties and their transactions with the entity, by making inquiries from third parties. (Legal Counsel)

(d) Although the auditor's opinion is based on the financial statements of a particular year end, the auditor shall be aware of the events that have occurred since the year end, to the date of signing the audit report, to assess any subsequent events which may have an impact on the financial statements. SLAuS 560 Subsequent Events deals with this requirement. LKAS 10 Events after the Reporting Period identifies two types of events i.e. adjusting and non-adjusting events. Accordingly, the auditor needs to assess the impact of any subsequent event to determine whether a particular event is an adjusting or a non-adjusting event.

(Total: 25 marks)

Answer 02

Relevant Learning Outcomes/s;
5.2.1 Evaluate the system of quality control of a firm and recommend improvements under SLQC1. 5.2.2 Evaluate quality control procedures in place to ensure that audit engagements are performed in accordance with applicable laws and regulations and the reports issued are appropriate. 5.3.1 Propose areas that are important in undertaking an engagement quality control review for a given engagement. 4.2.1 Evaluate the effect of identified misstatements on the audit and the effect of uncorrected misstatements, if any, on financial statements.
Study text reference: 405-410,415,597-599

(a)

(i) **Quality control matters**

- **Leadership –** The issues as described at R&L, indicates that the leadership at R&L had not taken adequate measures to establish and maintain the firms system of quality control. The commitment of leadership to quality is in question, per the given facts in the scenario.

- **Monitoring –** despite the regulator identifying deficiencies in engagement quality issues, no corrective action appear to have been taken.

- **Human Resources/Assignment of engagement teams –** inexperienced members have been assigned to the audit.

- **Engagement performance –** There seems to have been insufficient supervision, review and direction and also the misleading of engagement teams, by providing inappropriate direction re the audit.

- **Client acceptance procedures –** Accepting any client without considering the client's background would ultimately have an adverse impact on the reputation of the audit firm.

- **Consultation –** Darshika had not sought proper consultation from a subject matter expert, for complex transactions, such as hedging

- **No appointment of a quality control reviewer –** Although this is a Listed Company, no process appears to have been in place, to appoint a quality control reviewer.

- **Ethical requirements/Independence related issues** - Auditors' Independence Requirements do not appear to have been considered, before undertaking the work (e.g. Ashan the External Audit Manager is not independent of the client, as his brother is the Finance Manager of Ocean Ltd.)
- **Documentation –** Dharshika had verified the accounting entries relating to the hedging transaction. However she had not provided any working papers to support the work performed.

(ii) **Measures to be taken at the Firm Level**

- Per the given facts, in performing the engagements, certain quality issues had been identified. These have been noted and communicated by the Regulator as well. The Leadership of R&L are required to take the responsibility for the quality of the engagements, and this should be communicated to all in the Firm. Thereby the Firm will 'set the tone' at the top.

- R&L Leadership should hold the Engagement Leaders responsible for the assignment of suitable staff to its engagements, and ensure that the work is performed by competent & experienced staff, and not junior staff members, to ensure high quality standards are maintained, at all times.

- Anomalies had been noted, in accepting clients & engagements, as some clients had been accepted by the Firm without performing adequate background checks and certain engagements accepted, without considering the impact on the independence levels expected of auditors. Therefore, it is essential that R&L should have a formal process of accepting clients and engagements. The policies and processes should be communicated to all partners and staff.

- All Listed Entities are required to appoint an Engagement Quality Reviewer. Per the scenario described, an Engagement Quality Review Partner had not been nominated for the audit of this Listed Entity. The Firm should review all engagements / clients and identify those for which an Engagement Quality Review Partner needs to be appointed. This should be communicated to the relevant staff and the partners.

It is essential that R&L should monitor the Quality Control System of the Firm and assess the impact of problems related to time sheet completion and 'time charge out' and other relevant issues, on the quality of its assurance work, as well as adherence to the Policies and Procedures established by the Firm.

- There appear to be issues needing expertise on technical matters. There is no indication of availability of a Technical Consultant in the Firm. Therefore, a policy should be formulated and implemented, mandating consultation with a Technical Expert on accounting & other issues relating to the audit.

(iii) **Quality Control Reviewer – areas to be reviewed**

- I will review all significant matters identified by the Engagement Team performing the audit of Dairy Lanka PLC, including the evidence gathered to support such matters, and the conclusions derived based thereon.

- At the completion stage, I will review the financial statements prepared by the Engagement Team as well as the proposed audit report and ensure that the audit report is consistent with the work performed / concluded, by the Engagement Team.

- If the Audit Team is involved in computing deferred tax impairment, it gives rise to an independence issue; which would come under the purview of the Quality Control Reviewer. I will seek evidence of review of the audit work performed on these areas by a senior person (e.g. engagement manager). In particular, per the given information, hedging is considered to be a key area of judgment as it involves fair valuation and estimates. Hence, this and any other such key areas of judgment in the audit, will be reviewed, as the Engagement Quality Review Partner.

- Also, will review how the engagement team has assessed the independence of the Firm and of its Team Members, and whether appropriate safeguards have been put in place, to cover the threats to independence, and that these safeguards are properly documented.

- Given the complexity of accounting for the hedging transaction (a complex financial instrument), I will check whether there has been appropriate consultation and documentation in concluding the review of work performed in this area.

- I will select key audit areas for review (e.g. revenue, journal entry testing etc.) and assess whether the audit documentation reflects the work performed in relation to significant judgments and whether such documentation supports the conclusion reached by the Audit Engagement Team.

- The judgments made by the Engagement Team, in determining the materiality and significant risks, significance of corrected and uncorrected misstatements etc. would also be reviewed by me.

- I would also assess whether the Engagement Team has appropriately identified the issues that should be communicated to those charged with governance.

(b) The net impact of the unadjusted differences appears to be above the overall materiality level determined for this engagement. However, any adjustments arising from prior year adjustments, (e.g. debtors impairment. Inventory valuation), should first be adjusted, to assess the final impact. If the differences are still of material significance, Management should make the necessary adjustments. If no such adjustments are made, cover the impact of this in the Auditor's Report.

(Total: 25 marks)

Answer 03

Relevant Learning Outcomes/s;
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. 1.3.1 Evaluate an Audit Committee Charter including the key areas to be covered by 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 1.4.1 Recognise the role of ethical behavior and stages of morality development in "Kohlberg's Model", in shaping a professional accountant. 1.1.1 Evaluate "rules" and "principles" based approaches to Corporate Governance. 1.2.1 Advise on the effectiveness of a Board in the perspective of Governance 2.2.1 Demonstrate the roles and responsibilities relating to enterprise risk management including the role of chief risk officer. 2.6.2 Explain the role of internal auditor in enterprise risk management.
Study text reference: Page 330 -332,111,40-41,78-89,250-251, 328-329,150-155

(a)

(i) **Criteria to bear in mind when identifying areas for investigation:**

- **Financial**
  The volume and size of income and expenditure transactions, or the value of assets.

- **Internal control**
  The existence or otherwise of controls.

- **Probity**
  Whether there is any evidence of past inaccuracies or fraud.

- **Business goals**
  Whether the organization has laid down explicit objectives and policies against which its achievements can be measured.

- **Business effects**
  Whether the business generates any consequences, internal or external, which need to be investigated

- **Value for money**
  Whether there is likely to be any waste which can be eliminated.

- **Special investigations**
  Whether management has requested the internal audit department to undertake any specific tasks.

(ii)

	Areas identified for investigation/focus	**Reason for identifying the specific area as a focus area/Evaluation of the facts to identify key focus area /application of the criteria**
	Related party transactions Design and operational effectiveness of controls in place to address the **higher level of risks** arising from related party transactions.	Facts indicate that the ETD Group engages in material **volume** of related party transactions with David Fernando's family owned transport company, Transporters Pvt Ltd., and Health Care (Pvt.) limited owned by spouse of Edward.

		Further an impairment of related party receivables amounting to Rs. 24.068 million from Health Care (Pvt) Ltd has also been reported**.** A shareholder has already raised concern that if those transactions are carried at arm's length (as per anonymous letter), this in turn would affect the return they would receive for their investments.
	Inventory management – Design and operational effectiveness of controls in place over inventory management at showrooms and monitoring of controls in place.	Inventories held at showrooms are material in terms of volume and value. MTD PLC owns 320 showrooms, as well as over 12 supreme showrooms The Company has identified that retail activities are the main contributor to group profits, and that sustaining current growth momentum is going to be a challenge- [**Indicator of impact of business goals]** Auditor (KV Associates), has reported many quantity discrepancies/shortages and noted the existence of obsolete items which were not classified as obsolete in identified showrooms (based on their sample)-
	Taxes and duties Focusing on appropriateness of actions taken by Management and the process in place to identify probable impact, required revisions to related systems, and actions to be taken to mitigate the level of resulting adverse effects.	The facts of the case indicate changes in macro-economic environment which impact **business goals**: i.e. Changes to VAT on Construction Sector, as Construction is a major line of the Group's business – [**Value for money]** The facts of the case also indicate changes to customs duty structures

		which impact the company's main line of business – import of luxury electronic and electrical items. New developments may require changes to existing controls – [**Internal controls]** Extracts of Board Minutes indicate that the Board of Directors has made a special request to focus on this area. – [**Special investigations]** Facts also indicate that the IRD has challenged the deductibility of certain expenses – **[presence of probity]**
	Granting of Loans & Provisioning for non- performing loans- ET Finance Plc	Non-performing loans, if properly classified, will have a significant impact on the bottom line – [**Financial effect (volume & size)]** Facts also indicate that ET Finance PLC has a need for expansion and promotional campaigns, but tight controls imposed by the Authorities would prevent them from doing so – [**Presence of higher level of risk would impact business goals].** Probability of intentional violation of relevant accounting standards and regulatory directions exists (as suggested by FD). [**Business effects]**
	IT Design and operational effectiveness of existing controls over designing, implementing and upgrading existing information systems	As per pre-seen materials, IT System Risk; Information Technology has evolved as a source of competitive advantage. The ERP system of ETD is a Core Competence enabling them to maintain a leadership position in the industry. Any failure in the ERP system, IT infrastructure or IT

		security may severely affect the business. The IT System had been upgraded by professionally qualified staff in the internal IT division. Further, The Board has noted that the competitor's web based sales system is gaining popularity The above facts indicate criticality of IT systems to the **business and significance of impact on business goals, and that therefore IT is an investigation/focus worthy area.**
	Clearance of imported goods – risk of non-compliance in ethics & business impact due to undue delays in getting items cleared	Importing branded electrical and electronic items is a core activity of the Group – **Financial impact - higher volume and size** The Board indicated that they were concerned about the indirectly requested unauthorized payments – [**business effects /conflict with Company's values]** **[Probable non –compliance with laws]** Group is likely to incur losses due to giving unauthorized payments and penalties for non-compliance if found to be guilty of making such payments to government officials -**Loss of value for money for investors/increased level of reputation risks**

b)

Composition of the Audit Committee

ETD PLC's Audit Committee consists of <u>3 Non-Executive Directors</u> which is the <u>suggested minimum</u> for an Audit Committee as indicated below, (as per the facts given in pre-seen and unseen text):

1.
   i. Mr. Nihal Kulatunge – Independent Director*(i.e. NED) – Chartered Accountant

   ii. Dr. Ajith Perra - Independent Non-Executive Director (i.e. INED).

   iii. Mrs. Dabare – Retired Banker who does not get involved in management activities (i.e. INED)

   * *Nihal Kulatuge's independence related matter is dealt with separately in point No. 2 below, given fact that he is an Independent Director is quoted above only in order to indicate he is an executive director.*

2. The Audit Committee should be chaired by an Independent Non-Executive Director. For a Director to be independent, such Director should be free from <u>other relationships</u> that could materially interfere with the exercise of their unfettered and independent judgment. Nihal Kulatunge (i.e. current Chairman of the Audit Committee) becoming son-in-law to the Chairman, may also be perceived to be a relationship that would interfere with his unfettered and independent judgment in the local context. Accordingly, the Board should assess if he still maintains independence of status.

3. ETD PLC's Audit Committee clearly <u>consists of the required minimum number of</u> <u>**independent directors**</u> given the fact that Dr. Ajith Perera and Helena Dabare are independent directors of ETD PLC.

4. The Board should satisfy itself that **at least one member** of the audit committee has recent and relevant experience in financial reporting and control. Mr. Nihal Kulatunge, Chairman of the Audit committee of ETD PLC is a Chartered Accountant who has had recent and relevant experience in financial reporting and control.

Audit Committee Meetings

Specimen Audit Committee Charter implies that the Audit Committee shall meet at a minimum on a quarterly basis, or more frequently as circumstances dictate. As per the additional facts given (in the unseen content), it appears that the Committee has failed to meet for 2 quarters consecutively, which raises doubt about the operational effectiveness of the Committee.

The Audit Committee may meet Auditors periodically. However, it appears that the Audit Committee has failed to meet the Auditors, even though the Auditors were awaiting a meeting with the Audit Committee.

(c) (i)

Advantages of having a principles-based Code for Corporate Governance.
1. **Avoid legislation** It avoids the need for inflexible legislation that companies have to comply with even if the legislation is not appropriate
2. **Less costly** It is less burdensome in terms of time and expenditure. A principles based approach avoids the need for costs arising from provision of information management & reporting and complex monitoring and support structures, which can be expensive.
3. **Appropriate for company** A principles based approach allows companies to develop their own approaches to corporate governance, as appropriate to their circumstances within the limits laid down by stock exchanges.
4. **Flexibility** A principles based approach can allow for transitional arrangements and unusual circumstances. **Example:** if one Director leaves the Board suddenly, there may be a period of non-compliance until the Director is replaced. However most Shareholders would be satisfied, provided this non-compliance issue is explained. Principles based approaches allow such flexibility.
5. **Emphasis on explanations** Enforcement of 'comply or explain' means that a business can explain why they departed from a specific provision, if they felt it was appropriate. **Example:** Code (Principle A.2 & A2.1.) suggest that it is considered 'best practice' that two separate individuals take on the role of Chairman and CEO. If the Board had decided to combine the roles of Chairman and CEO, in one position, that should be justified and highlighted in the Annual Report.
6. **Emphasis is on investor decisions** A principles based approach accompanied by disclosure requirements, puts the emphasis on investors, enabling them to make up their mind about what a business is doing and whether the degree of departure from the code is appropriate.
7. **It prevents professionals interpreting legal requirements narrowly** to get around ethical issues. It can be true that rules engender deception, whereas principles encourage compliance.

(ii) **Extent of Compliance:**

Principles relating to The Board of Directors (BOD)	**Answer**
Principle A .1 Every public company should be headed by an effective Board, which should direct, lead and control the Company.	Based on facts given in pre-seen and unseen materials, ETD PLC's Board Composition is as follows; 1. **David Fernando**–<u>Executive</u> Director (it is implied David is involved in Management) Chairman – Lawyer. 2. **Joseph Emmanuel –** <u>Executive</u> Director (it is implied that he is involved in Management. E.g.: David & Joseph built up the business from inception. Joseph has requested the Board to approve his new Business Plan involving fashion and footwear.) 3. Ajith Perera – Has a doctorate – <u>Non-Executive</u> *Independent* Director 4. **Helena Dabare –non-executive** *Independent* Director–Retired Banker 5. Nihal Kulatunge **–non-executive** *Independent* Director and Chair of Audit Committee – Chartered Accountant As per Extracts from the Minutes of Meetings of the BOD, it is evident that the Board meets regularly & aspects such as Risk from competitors, Compliance with laws and regulations etc. have been discussed. As per the Chairman's briefing (pre-seen content), the Board appears to have considered the probable impact of macroeconomic issues on their business – e.g. from policy instability, revised tax law etc.

	Further the Board has emphasized the importance of IT & new technologies such as digitalization. Risk management & internal control processes section as pre-seen, illustrates the Board's focus on risk and controls. Financial strategies section of the pre-seen – illustrates that the Board closely monitors leverage and alternative financing. **Above facts as per the pre-seen and unseen materials, indicate the existence of effective Board Control at ETD PLC.**
Principle A.2 There are two key responsibilities of Top Management of every Public Company - conducting of the business of the company and facilitating executive decisions in managing the company business. There should be a clear division of responsibilities among Top Management, which will ensure a balance of power and authority, such that no one individual has unfettered power to make decisions. A decision to combine the roles of Chairman and CEO in one position should be justified and highlighted in the Annual Report.	The extracts quoted below from Pre-seen indicate that ETD PLC has a separate individual in the role of CEO**.** "Norman also reported the following financial information requested by the CEO of ETD PLC. or "CEO also mentioned that the Board of Directors of ETD PLC had considered declaring a 20% dividend in the future"
Principle A.4 – Financial Acumen The Board should ensure the availability within it, of those with sufficient financial acumen and knowledge to offer guidance on matters of finance.	Two Board Members clearly possess the required financial acumen & knowledge - a Chartered Accountant (Nihal Kulatunge) and experienced Banker (Mrs. Dabare) – as stated
Principle A.5 – Board Balance It is preferable for the Board to have a balance of executive and Non-executive directors such that no individual or small group of individuals can dominate the Board's decision taking.	The Board consists of 7 members. Dr. Ajith, Mrs. Dabare and Mr. Nihal Kulatunge are non -executive directors. (3 or 1/3 of 7 – approx. 3) ETD PLC is in full compliance with A5.5 & A5.1 is met)

A 5.1 The Board should include Non-executive directors of sufficient calibre and number for their views to carry significant weight in the Board's decision. The Board should include at least three non-executive directors or such number of non-executive directors, equivalent to one third of total number of directors which is higher.	

(d) **Benefits of having a separate Risk Committee**

At present Risk Management responsibilities are within the remit of Audit Committee. Hence students are expected to discuss and compare the benefits of having a separate Risk Management Committee.

1. **Staffing**

The Risk Management Committee can be staffed by Executive Directors who have more insight into business operations, whereas an Audit Committee, according to best practice in corporate governance, should be staffed by Non-Executive Directors.

At present, the Audit Committee oversees the risk management activities, and consists of 3 Non -Executive Directors, including members with accounting background and prior experience in banking.

Given the fact that Retail, which is the core business of the group is currently facing a number of challenges such as the probable loss of sole local dealerships, heavy competition from innovative competitors such as X logic, and the business' higher susceptibility to technological obsolescence, it may be prudent for the Board to create a separate Risk Committee, including Executive Directors with relevant experience in this sector.

Further, given that its IT systems are one of the Group's competitive advantages, and that failure of the ERP system may severely affect the business (as per pre-seen), managing IT risk related to core operations is a must, in addition to establishing an IT Risk related financial reporting system. As related risk may be aggravated by competitor activity, such as X logic's innovative IT solutions, this shouldn't be ignored. Hence establishing a separate Risk Committee will allow ETD PLC to involve an Executive Director with related exposure and experience.

2. **Breadth of remit**

As a key role of the Audit Committee would be to liaise with the External Auditors, much of their time could be focused on financial risks.

The Board should acknowledge the fact that the Audit Committee –being financial experts- would already have many responsibilities focused on financial reporting, as it is, in effect, the last line of defense, for financial reporting risk.

Given the diverse nature of the group, (i.e. businesses in retail, electrical, construction, finance etc.) and the size of the business (few listed and unlisted subsidiaries & J/Vs) it would be prudent to have a separate Risk Committee.

Additionally, the rapidly changing business environment & the expectation of significant emerging risks, such as evolving technology innovations, might find a separate Risk Committee of immense value.

3. **Leadership**

A Risk Management Committee can take the lead in promoting awareness and driving change in practice, whereas an Audit Committee will have a purely monitoring role, checking that a satisfactory Risk Management Policy exists.

Given that a Risk Committee can include Executive Directors with exposure and experience in identified high risk areas, and that they get involved in day to day operations, embedding a risk awareness culture within the organization, would become easy.

4. **Investigations**

A Risk Management Committee can carry out special investigations, particularly in areas not related to the accounting system.

For example the Risk Committee will be in a better position to assess the emerging market risk from competitors, and suggest proactive risk management measures, to face innovators in IT, like X Logic PLC.

5. A separate Risk Committee will be in a better position to identify dysfunctional behavior in company culture that could undermine the effectiveness of the risk management process, and lead to inappropriate risk taking, e.g. the nature and balance of the compensation structure (fixed in consultation with a compensation committee) has the potential to encourage inappropriate risk taking.

(e)

Six [6] imperatives for high performance in an internal audit function.

	Description of imperative
1	**Strategic stature within the organization** An Internal Auditor should ensure priorities align with the wishes of the Audit Committee and Management and should be a trusted advisor to Key Stakeholders. To gain credibility across the organization, internal auditors must have the courage to tell stakeholders the truth, whether they want to hear it or not. This means internal audit must be prepared to handle conflict. Ex: The FD had stated that he wants to re-formulate the financial strategies, to manage the supply chain of the group using the existing ERP system, without further investment. If this proposal is adopted by the Board, prioritizing the internal audit work around the resulting impact on controls and resulting risk, may best align the output from the IA function, with the expectations of the Board. Ex: External Auditors have reported issues relating to inventory held at branches. As a matter affecting the core business, identifying control lapses and implementing remedial actions would be a high priority of the Board. Accordingly, prioritizing internal audit work covering this areas may allow Internal audit to align its work with management expectations, and reinforce its position as trusted advisor.
2	**Development and update of Strategic Plan aligned with Objectives and Stakeholder Expectations** The plan should indicate how Internal Audit will develop, and be organized to deliver service, suggesting specific goals or strategic initiatives, to bridge capability gaps. Initiatives developed should focus on future risk management practices. Towards this end, divisional or business heads in would be consulted, in addition to discussions with the Audit Committee. Failure to update plans frequently may put Internal Audit at risk of overlooking important changes in the business environment. A lack of alignment with strategy can make it difficult for Internal Auditors to demonstrate the value they add to their organizations. E.g. The given facts indicate that changes are expected in tax legislation and customs duty structures. IA would need to devise their action plans covering these developments. E.g.: The Company had received intimation letters challenging the deductibility of certain expenses for 2015/16. This would be a priority for the Board as its continuance may impact the results of the following years.

	Internal Audit could priorities their work to include these areas, thus aligning their work with stakeholder's expectation.
3	**Communication with key stakeholders** In particular there should be regular dialogue with the Audit Committee Chairman (AC) and External Auditors. Frequent communications with the Audit Committee will help maintain the independence of the internal audit function (IA), as committee members will be less inclined to serve self - interest and divert internal audit's attention away from priority areas for the business. AC will therefore help IA to ensure that their work remains responsive to changing stakeholder needs.
4	**Align HR strategies with enterprise and stakeholder needs** This means that Internal Audit must ensure that skills gaps, arising due to emerging technologies, are bridged. E.g. As per the pre-seen materials the Board believes IT systems; Risk Information Technology is a source of competitive strength of the Group. So IA should ensure that the Internal Audit function is adequately resourced with relevant audit skills to support these areas.
5	**Focus continually on enterprise risks** As well as testing controls, Internal Auditors ought to focus on the risks themselves, keeping Management informed about risk exposure and conducting an annual enterprise-wide risk assessment, which feeds into the Audit Plan. Risk Assessment needs to be transparent, aligned with business units and involve External Audit as well as Internal Management. Technology risks are always evolving, and internal auditors need to keep pace with emerging trends.
6	**Integrated approach to IT audit** There should be an annual IT risk assessment, which addresses risks within business processes and seeks to enhance IT audit capabilities. Given the fact that the operations of the group are highly dependent on IT, this aspect should not be ignored by IA.
7	**Use of technology to improve efficiency, effectiveness and quality.** This includes automating tracking and reporting, testing populations automatically and using technology to conduct 'real time' reviews. Technology now allows internal auditors to analyze complete data sets instead of samples, and to improve efficiency and sophistication, in auditing data-rich areas. E.g. The Group is engaged in a financing and leasing business via ET Finance Plc. Given the fact that a finance company's operations involve voluminous transactions, of which a significant volume would be system generated data,

	use of IT audit tools could enhance the efficiency and effectiveness of internal audit procedures, in ET Finance Plc.
8	**Development of knowledge management plan** The aim of this plan should be to disseminate internal audit knowledge and expertise to other internal auditors and business unit & enterprise management. Internal auditors cannot rely only on their employers for training. A recent survey shows training programs in the smallest internal audit departments often are not fully developed. Technical skills and knowledge of the business or organization, are of critical importance to successful IA. E.g. ETD group operates in diversified fields such as Finance, Engineering / Construction, Retail, Electrical etc. Hence Industry knowledge in these areas would be key to conducting an effective internal audit. Hence the IA should consider compiling and training his staff with specialized knowledge relating to those fields.
9	**Commitment to continuous quality assurance** There should be a quality improvement program and an external assessment of performance and benchmarking A strong quality assurance and improvement program demonstrates a group-wide commitment to quality. Internal audit can contribute by going above & beyond generic programs, with activities targeting specific areas, thus adding value to the organization.
10	**Link performance measures to strategic goals** IA should use a balanced scorecard approach to track performance against the strategic plan and Recruit, motivate, and retain great team members**.** Getting the right mix of skills into the internal audit department is important. Many organizations are using bonuses as motivation and retention techniques, which should be considered by ETD PLC.

(f) Mr. Norman mentioned that though ET Finance PLC has earned profits in past years; there are non-performing loans which have not yet been classified as non-performing assets in the balance sheet. He had stated that whilst it is significant, this should not be highlighted in this year's financials statements, as the impact on the bottom line would be significant, and would badly reflect on group performance.

Mr. Norman, being a chartered accountant, is well aware of the fact that incorrect identification, classification of accounts and non – disclosure, is a violation of Sri Lanka Accounting Standards, Regulatory directions as well as the Code of Ethics. He is well aware that he is duty bound to comply with these regulations. . <u>However he seems not to have attempted to comply with known ethics or related law.</u>

He also appears not to have paid attention to the rights of wider stakeholders of financial statements, who would need to know of the said irregularity. Wider universal ethical principles have been ignored.

Hence it is hard to believe Mr. Norman's thought processes reflected level 3 – i.e. Post conventional.

As a chartered accountant, he would be well aware of the fact that his immediate circle (other members of CA, work mates etc.) would only consider him to be of high integrity if he acts in accordance with what they believe is right, and hence are likely to consider his decision as bad and unethical. However, he seems to have not considered this aspect, in arriving at his decision.

Hence it is hard to argue that Mr. Norman's thought processes reflected level 2 – i.e. conventional.

It appears he has only considered his own best interests, as benefits derived from this action will flow through to him via the wellbeing of the entity he is associated with. He would likely have thought about the negative impact that he as finance director would face, if the non-performing loans are duly accounted for and disclosed. He is also most likely to have thought about the benefits that will accrue to him, with the financials reflecting better performance.

The above facts indicate that Mr. Norman's thought processes mostly reflect self-interest i.e. at stage

(Total 50 marks)

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