THE INSTITUTE OF CHARTERED ACCOUNTANTS OF SRI LANKA

SUGGESTED SOLUTIONS

KC4 – Corporate Governance, Assurance & Ethics

December 2018

SECTION 1

Answer 01

Relevant Learning Outcomes/s: 2.4.1 and 5.2.2
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. 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.
Study text reference: Pages 262 – 291, 410 – 417

(a) Risks	**(b) Mitigating measures**
1. The local regulations do not permit foreigners to purchase property in Sri Lanka. There is a risk that by contracting with **foreign buyers for sale of units**/apartments, the company may have to face with adverse consequences in terms of non-compliance, and lose the opportunity to sell the apartments to alternative buyers.	(i) Awareness of the company personnel involved in marketing regarding the applicable rules and regulations for the business. (ii) Customer due diligence (CID) to be performed before entering into contractual arrangements. This can be included as one of the items to be checked as part of the customer due diligence.
2. **Foreign exchange losses** – the company has obtained USD loans at variable rates. Rupee depreciation will have an adverse impact on the cash flows and it will result in exchange losses.	(i) The company can enter into forward contracts with banks and minimise the effect of exchange rate fluctuations. (ii) The company may consider possible hedging arrangements with banks.
3. LKR loans of the company are at **variable interest rates**. Present interest rates are at the higher end and this will increase the cost of finance and reduce expected margins.	(i) Renegotiate the rates, payment period etc. with banks, and have a cap on the interest rate applicable for the loans. (ii) Consider alternative refinancing arrangements and the settlement of existing financial commitments.
4. Presently there is **uncertainty regarding the applicable taxes** and the rates on apartment sales (i.e. VAT, NBT). If a higher rate becomes applicable, this will have a significant impact on expected sales.	(i) Clarify the applicability of tax rates with the tax authority. (ii) Make an industry lobby regarding the uncertainness in taxes and get a clear direction from the tax authority.

(a) Risks	(b) Mitigating measures
	(ii) Re-consider the pricing model to ensure the market/customers will not be communicated a price which is much lower than the market price.
5. Constructions are based on approved plans from various authorities (municipal council, Condominium Management Authority (CMA) etc.). There is a risk of refusal of issuing the final certificate by the CMA (**Certificate of Conformity) if constructions are not in accordance with the approved plans** (there are certain modifications to the initially approved plans to meet customer requirements).	(i) The proposed subsequent significant modifications should be duly informed to the relevant authorities and approval obtained in order to avoid issues of non-compliance. (ii) Effective monitoring of the constructions and requests for modifications in order to avoid any non-compliance.
6. Capital appreciation is around 5% in apartments. This may discourage investors from buying such units as investment assets.	(i) Diversify business activities to other areas such as land development.
7. Changes to the customs duty ordinance and policies would result in a **higher cost** of inputs, since a majority of the inputs for construction are imported.	(i) A competitive pricing model to be determined in case of increased costs that are unavoidable. (ii) As part of risk management, the company to be alert on possible changes, negotiate with contractors on the possible consequences, and take appropriate action to expedite the processes of acquiring relevant inputs required for construction.
8. **Other competitors** have entered the market, offering space and apartments at lower prices. Hence there is a risk of the company losing its price competitiveness.	(i) Encourage innovations to manage costs. (ii) Carry out effective marketing campaigns to promote the products. (iii) Offer value-added services.
9 Strict compliance **on anti-money laundering** rules effected by CBSL may keep away customers who cannot prove the origin of funds.	(i) Customer due diligence process to be robust. (ii) Identification of the right segment of customers to sell the products.

(a) Risks	(b) Mitigating measures
10. Risk of **non-compliance with the rules and regulations** of the CSE, SEC, Central Bank, RDA and Central Environment Authority.	Appoint a compliance officer to ensure that the company is complying with the CSE and SCE rules and regulations.
11. **Fraud risk –** the industry is associated with a high volume of cash transactions. Therefore there is a high risk of cash misappropriation.	(i) Encourage whistleblowing policies within the entity. (ii) Establish strong controls on cash management.
12. Reputational risk – maintaining the quality of construction and the possibility of cost overruns.	(i) Encourage innovations to manage quality and costs. (ii) Effective monitoring of constructions.
13. Violation of SLAS (revenue recognition) – 60% of advances have been recognised as revenue, which is not in line with LKASs. It results in the overstatement of revenue.	(i) Carry out internal audit and audit committee revisits. (ii) Make arrangements to comply with the applicable accounting standards.

(c) GVP is a public listed company and it has a wider responsibility on public accountability. Therefore **strong corporate governance is important.** As a result there should be a good **relationship between the management of GVP, the internal audit division and the audit committee.** The three lines of defense model demonstrates how **roles, responsibilities and accountabilities can be structured to achieve effective risk management and assurance.** The management, internal audit and risk management responsibilities of GVP should be **clearly defined and communicated,** and the activities should be timely managed to achieve effective risk management**.**

(d) **Anti-money laundering programme**

Actions that should be undertaken by Somaweera Associates to mitigate the audit risk related to possible anti-money laundering issues.

- There must be **a money laundering reporting officer**, who has a suitable level of seniority and experience. Suspicions of money laundering should be reported to the MLRO, who should then consider whether the matter should be referred to the relevant authorities.

- There should also be a firm-wide anti-money laundering programme. A **training programme is essential to ensure that individuals are aware of the relevant legislation and regulations regarding money laundering. Individuals should be trained in the firm's identification**, record keeping and reporting policies. Individuals should also be trained in the money laundering risk factors, and be able to identify such risk factors and respond appropriately (including matters such as tip-off offences).

- An important part of anti-money laundering is customer due diligence, or **know your client (KYC)** procedures. Audit firms must establish the identity of clients using documents such as certificates of incorporation and passports, and obtain information **about the business activities in order to gain an understanding of matters such as the sources of income, and the rationale for business transactions.**

- Finally, the audit firm must ensure that it maintains **records of client identification procedures, as well as of all the transactions relevant to the audit clients,** for example, the receipt of cash for services performed. This is important to ensure that the audit firm does not inadvertently become party to a transaction involving money laundering.

- Carry audit procedure such as;

  - Ensure that there is a compliance officers in the client's office.
  - Inquire management what appropriate regarding compliance with Central Bank.
  - Inspect correspondence with licensing authorities.

  Include a para in the engagement letter with regard to compliance with Money Laundering Laws and Regulations.

(Total: 25 marks)

Answer 02

Relevant Learning Outcomes/s: 1.8.1, 5.1.1 and 5.1.2

1.8.1 Resolve ethical issues faced by members in practice, in complying with fundamental and ethical principles, in the context of:

- Appointment ethics
- Conflicts of interest
- Second opinion
- Fee and other type of remuneration
- Marketing
- Gift and hospitality
- Custody of clients assets

5.1.1 Evaluate factors relevant in accepting and agreeing the terms for a new engagement for audit, review, assurance and related services

5.1.2 Advise on suitable engagements in a given scenario, considering the requirements of intended users and the assurance framework, including following areas:

- Special purpose audits
- Assurance engagements
- Review of financial statements
- Related services

Study text reference: Pages 189 – 204, 345 – 362, 676 – 677, 660 – 662

(a)

1. **Ethical matters**

Presently MAC Associates is not involved in providing any services to SA. However, it has to consider the past services it has provided and the impact on independence, prior to bidding for the audit of SA for the year ending 31 March 2019.

The services performed in respect of formulating the internal controls of SA will have an impact on independence if MAC is to act as the auditor of SA. This is because MAC would be involved in providing services on the design and implementation of internal controls. This is critical to the independence of the auditor, as the auditor has to consider the internal controls relating to financial reporting. The auditor has to review its own work performed in this area, and this will have a self-review threat to independence.

An advocacy threat will arise as MAC has provided advisory services on the restructuring of loans obtained from a foreign bank.

The fees overdue are well beyond the general credit period given by MAC. In a situation where there are overdue fees, the auditor runs the risk of, in effect, making a loan to a client. Therefore, this will give rise to the risk of self-interest, which is a threat to independence.

The former partner joining a prospective audit client will have a threat to independence. If MAC is to be the auditor then the former partner will influence the audit team, as he has too much knowledge on the audit firm's system. This is considered a threat to independence.

Therefore MAC should consider the above ethical matters prior to making the decision to bid for the engagement, if there are no adequate safeguards available, it might have to refrain from the bidding process.

Alternative answers

- As it is a state-owned enterprise, the auditor should assess the integrity of the management before bidding. Further, the auditor should evaluate whether it will be able to comply with the fundamental principles of objectivity and integrity when performing the audit since there can be high political pressure.

- SA being a state-owned enterprise will create an additional risk to the auditor. The key management personnel of these entities are considered to be political appointments, and those persons are identified as politically exposed persons (PEPs). Generally the political influence is high for this type of entity and the auditor may be exposed to political influence. This would affect the independence of the auditor, as the auditor may not be able to act objectively. This is a high risk for the auditor and MAC needs to be alert on this area before bidding for this engagement.

- MAC should consider the fee of the quote. The fee should reflect the involvement of competent staff and compensate for the work involved. A low fee should not be quoted by MAC with the intention of securing the engagement.

(b) (i) Acceptance

- Tally Associates is a small-scale audit firm with a limited number of partners and senior staff. Therefore, it has to consider whether the resources available are adequate to provide the required service.
- Tally Associates clientele mainly includes entities in manufacturing, trade and finance. It has no previous experience with clients who provide airline services. Therefore, Tally has to consider how the relevant industry knowledge should be gained in providing the required services to Airways (Pvt) Ltd.
- Before accepting the client Tally needs to understand the client. Hence it should obtain relevant information about the management, directors and evaluate whether by accepting clients like Airways the firm is exposed to an undue risk.
- Consider independence matters – for instance in this case, one of the partners' spouse is the finance director. Therefore prior to accepting Airways (Pvt) Ltd. as a client, appropriate safeguards should be implemented.

- Airways has received criticism over its management. Therefore, it is essential that Tally considers the integrity of the client. If any information comes to the attention of Tally Associates on lack of integrity of Airways, Tally needs to be cautious in accepting the client.

  Ramesh Fernando emphasises his desire to accept the proposed engagement with Airways (Pvt) Ltd. However before accepting it, it is essential that Tally Associates carries out the required acceptance procedures and considers other factors**.**

(ii) Services

- **Assurance over the operating Expenses** – this is an element of the financial statements. The management seeks assurance over expenses of 3 years. Therefore, Tally can perform an audit on the expenses incurred by the company. However, this can be considered a special purpose audit and the auditor's report can be issued under SLAuS 805 *Special Considerations – Audits of Single Financial Statements and Specific Elements, Accounts or Items of a Financial Statement*. The management can prepare the statements of expenditure for each year concerned with the relevant disclosures.

- **Deviation from tender procedures –** the management wants to know whether there are deviations from the required procedures, which need to be followed in procuring aircrafts. The management provides the auditor with details of the relevant procedures to be followed. Based on those, the auditor may seek evidence for compliance with the specified procedures. The findings can be reported to the client. For this the auditor may undertake an "agreed-upon procedure" engagement in accordance with SLSRS 4400 *Engagement to Perform Agreed-Upon Procedures Regarding Financial Information*. It would provide a factual finding report and not provide an assurance. This may be appropriate here, as the management does not expect an assurance.

(iii)

- Ramesh is a partner and chartered accountant. Being a chartered accountant who is in practice, he is bound by the ethical principles and Code of Ethics.

- Objectivity is important when professional accountants provide statutory audits or other assurance services. Section 291 of the Code of Ethics specifies the independent considerations when providing other assurance services. Therefore, even when providing the expected services by Airways, Ramesh needs to ensure he is independent from the client and there are no conflicts of interest.

- In this scenario Ramesh will be the engagement partner. His client's finance director is his spouse. The finance director can exert significant influence on the subject matter of the engagement. Both Ramesh and spouse hold senior positions, and have a close relationship. This will result in a familiarity threat. As a result there is an adverse impact on the independence of Ramesh, as well as Tally Associates.

Ramesh has not demonstrated professional behaviour by not disclosing his relationship. As such his integrity is questionable.

- Not disclosing the relationship will have adverse consequences on the firm (i.e. Tally Associates) as well as on Ramesh personally. Ramesh has violated the ethical principles and disregarded his responsibility towards the firm, public and client. This might result in sanctions being imposed on him personally and on the firm as well.

(Total: 25 marks)

SECTION 2

Answer 03

Relevant Learning Outcomes/s: 1.3, 1.5, 3.1, 3.2, 3.4, 3.5, 4.1.2, and 4.4.1 1.3 Audit committee 1.5 Ethical conflicts 3.1 Overall audit strategy 3.2 Risk of material misstatements. 3.4 Audit response in complex areas. 3.5 Internal audit 4.1.2 Advise on the need to change the audit approach for a given scenario. 4.4.1 Recognise the implications of modifications to an audit report or review report.
Study text reference: Pages 428 – 430, 378 – 398, 596 – 597, 688 – 689, 663 – 667, 108 – 116, 440 – 445, 157 – 165

(a) **Auditor's assessment of risks and audit strategy**

The auditor has determined that there are no significant risk areas that require special focus. Given the facts provided in the pre-seen, the assessment on risks does not seem appropriate. Further, the auditor expects to perform less substantive testing and rely on the controls of the entity. If the control environment is sound and there is a robust monitoring of the financial reporting function, and the operating effectiveness of controls is also satisfactory, this strategy is acceptable.

However, the following suggests that the auditor's risk assessment and audit strategy is not appropriate.

Financial Reporting

The finance function is overseen by a recently qualified accountant, and there is no supervisor above him. Two delayed audits is a clear indication that there is no timely financial reporting, and monitoring of the finance function is not robust. There is further doubt whether the applicable accounting policies have been correctly applied in the absence of a qualified accountant to supervise the financial reporting (e.g. whether intercompany loans have been considered a financial instrument and the correct accounting policy has been applied). Further, no adequate impairment charge on trade debtors has been made. This suggests that there may be a number of misstatements and the auditor is required to perform detailed testing of the transactions and balances of the entity.

Control Environment

Given the number of issues indicated in the pre-seen on governance and controls, the control environment of the company is also a question. There were non-compliances noted and as a result the company has incurred fines/penalties. The entity does not seem to have an internal process of reviewing and monitoring its financial performance. Weaknesses in the control environment may create doubt on the existence and implementation of relevant internal controls. Further, there is no indication of the auditor obtaining sufficient understanding of the entity, its operations and controls, and evaluating the design effectiveness and implementation of controls. Determining the audit strategy without providing reference to the above will result in an inappropriate audit strategy. Therefore relying on controls for the audit is not appropriate.

Revenue Recognition

In terms of risk assessment, SLAuS specify that there is a rebuttable presumption on fraud in revenue recognition. This is a significant risk. It is not clear how the auditor rebutted this presumption and determined there is no significant risk. Further SLAuS specify management override of controls to be a significant risk for all engagements, and this is not considered for the audit of TWPL. Therefore, the auditor has not performed a rigorous risk assessment of TWPL.

It appears that the auditor has not analysed the financial statements as part of the risk assessment. For instance the financial performance indicates the existence of a going concern risk due to the losses made and the significant variances of the profits of the entity. Also, there is no evidence of a proper risk assessment being performed on related parties and transactions although there are a number of related party transactions with the shareholders of TWPL.

The above indicates the risk assessment process of the auditor is not robust. The risk assessment was done without obtaining a proper understanding of the entity and its business and controls, resulting in an inappropriate audit strategy being determined by the auditor. This strategy may not identify the misstatements, and as a result there is a risk that the auditor may form an inappropriate audit opinion.

(b) **Planned audit procedures**

PPE

- The planned audit procedures are not sufficient. Given that there is no control reliance, testing 2% of the population of additions to PPE is not sufficient. Hence, the sample size needs to be extended. The testing should be performed in detail, specially testing the procedures performed in procuring new PPE items, the approval process and whether tender procedures were applicable etc.

- There is capital work-in-progress (WIP), and the auditor should obtain comfort over the ageing of this WIP, and whether those are in fact in progress. The existence of WIP and other assets should be ensured. The auditor should also check whether only eligible costs have been included in WIP.

- There is no audit procedure to evaluate the valuation of assets. Given the widely fluctuating financial performance, the auditor may need to assess whether there are indications of impairment and whether the management has performed an impairment assessment.

- Evaluate physical controls and physical verification of assets. Carry out audit procedures to identify impairment indicators (check repair and maintenance expense account), and verify disposals to ensure accuracy.

- Check the accuracy of the capitalisation of borrowing costs.

Trade and other receivables

- No impairment has been charged in view of the management assessment that the debtors are collectable. The auditor should assess objective evidence for impairment and the reasonableness of the management assessment that no impairment charge is required.
- SLAuS require confirmations to be requested. However, if the auditor can determine, based on past experience, that it is an ineffective process, this can be rebutted. However, this needs to be assessed and documented by the auditor first.
- Recoverability of other receivables, including ESC, WHT and advances, should be assessed by the auditor.
- The auditor should cover a sufficient sample of subsequent settlements if no confirmations are called for or received from trade debtors. If there are no subsequent settlements, other alternative tests should be designed by the auditor.

Borrowings

- There is already concern from the banks on the delay of audited financial statements. The auditor should review the agreements for those borrowings and see what the terms and conditions, covenants included, consequences of breach of covenants and penalties include for delayed payments etc. are.
- Obtain direct confirmations from the banks for the loan outstanding amounts as at the balance sheet date and assess whether there are any differences with the amounts recorded in the ledger.
- Investigate the non-compliance with loan covenants and the possible impact on exercise property mortgage and going concern ability of the company.

Expenses

- Completeness of expenses – variance analysis from the previous year as already the management has noted significant variances in the expenses.
- Sample selection is from routine expenses. Testing should extend to other expenses selected on a risk basis to see whether those expenses are appropriately supported.
- Perform unrecorded liabilities and leverage it to expenses to verify whether all expenses have been recorded.

Cost of sales

- Control testing alone is not appropriate and may not give comfort given the status of the control environment and weaknesses in the treasury function. Therefore more detailed testing needs to be performed.
- Select a sample of hiring costs to verify the occurrence and accuracy of the amounts recorded by reference to agreements and other correspondence.
- Test the completeness of expenses with reference to the agreements entered into, and compare them to the previous year's expenses.
- Valuation of the film stock.

(c) **Auditor's report**

- SLAuS 700 was revised and the new auditor's report became applicable for year ended 31 March 2018 and onwards.

- The auditor's report for 31 March 2017 would be similar to the format used for the 31 March 2016 auditor's report.

- For the 31 March 2018 auditor's report, the new format specified by the revised SLAuS 700 should be used.

- The key audit focus area refers to "Key Audit Matters", which was introduced under SLAuS 701. KAM is mandatory only for public listed entities. Therefore, the KAM section need not be included in the auditor's report of the company as it is not a public listed entity.

- The audit report format for 2018 begins with the audit opinion, unlike the previous auditor's report format.

- The engagement partner's CA membership number needs to be stated in the auditor's report. This was not a requirement under the old format.

(d) **Forecasted Income Statement**

- The cash flows may have been based on the unaudited financial statements prepared for the years ended 31 March 2017 and 31 March 2018. The auditor needs to assess, based on the audit findings, whether there are any adjustments arising that have an impact on the projected income statement (based on which cash flow forecasts are prepared).
- The expected increase in revenue is in the range of 16% – 18%, which is not really supported by past results (because in the last 3 years the revenue has fluctuated). Therefore, the auditor needs to assess the management's plan for such a consistent increase in revenue by a significant %.
- Over the past years, the GP margin has been around 45%. But the projected GP margin is above 50%. Therefore, it is worthwhile to check whether the management has considered all the costs elements involved in projecting the income and costs.
- **Other income** – consistent increase. The auditor should understand the nature of this other income and the reason for this consistent increase.
- **Administrative expenses** – despite the variation noted in 2017, usually it has been 40% of sales. However in the projected income statements it is in the 32% – 35% range, which is consistent with the aggressive expected increase in sales.
- **Sales and distribution costs** – given the expected sales, the increase in this cost is not significant. How the management is going to achieve such a sales target without spending adequately on sales and distribution (which should involve significant promotional activities) must be looked into.
- **Finance income** – the reason/s for the consistent increase in finance income and the source/s of this finance income must be verified. There are borrowings at present and they are expected to increase with the expected expansion activities; therefore it is less likely for excess money to be there to invest.

- **Tax expenses** – should be looked into to verify the current compliance of the company.
- Gain or loss on Investments.

(e) **Audit committee**

Presently there seems to be a number of issues. Firstly, no qualified person is there to oversee the finance function of the company. Further, no timely audits are being performed, and there are delays in statutory payments resulting in fines and penalties. There are also no proper adjustments in the financial statements for impairment of debtors etc. If an audit committee is appointed, the audit committee will oversee the financial reporting function. It will review the financial statements and systems. This will happen on a periodic basis (monthly or quarterly). The audit committee will challenge the judgments and assumptions made in preparing the financial statements and review the appropriateness of the disclosures made in the financial statements.

Further the audit committee will focus on the controls involved in financial reporting and other monitoring activities (e.g. budgetary process, performance indicators etc.) By doing so, the audit committee will identify significant business and finance risks and monitor the progress towards achieving financial objectives.

(f) **Work of the internal auditor**

The auditor, before using the work of the internal auditor for statutory audit purposes, should consider the following:

- Internal audit's organisational status, relevant policies and procedures, and objectivity. To whom the internal auditor is reporting, and whether professionalism is maintained within the organisation.

- The level of competence of the internal audit function – whether persons with the right skills and experience are performing the internal audit function, and whether the internal audits are done objectively.
- Whether the internal audit function applies a systematic and disciplined approach, including quality control for the work they perform.
- Appropriate areas being covered for the audit (scope of the work), nature and depth of coverage of the assignment it discharges for the management.

(g) **Ethical dilemma**

- Anna Alwis is facing an ethical dilemma. The CEO (Charith Perera) has made an unethical request to manipulate the financial statements of the company in view of maximising the profits available for the year.

- There is a significant threat created by financial interest of Anne.
- Anna is a qualified accountant. She should adhere to the CA Code of Ethics for Professional Accountants.
- Since the CEO is her immediate supervisor, she has an obligation to him. However, she may attempt to explain her position to Charith, as what he is suggesting is not ethical. Despite the financial benefit she is being promised, manipulating the financial statements will involve other repercussions if it comes to the attention of the auditors, directors, statutory bodies and other organisations.
- If Charith is not willing to listen, Anna should escalate the issue to a higher level, perhaps the directors of the company, those charge with governance or relevant professional bodies. The amounts are material to the financial statements and it would be a violation of the fundamental accounting principles. Further, this will create a bad image of the company, as it involves negotiations with a third party.

(Total: 50 marks)

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