THE INSTITUTE OF CHARTERED ACCOUNTANTS OF SRI LANKA

SUGGESTED SOLUTIONS

KC4 – Corporate Governance, Assurance & Ethics

December 2015

SECTION 1

Answer 01

Relevant Learning Outcome/s:
5.2.1 Evaluate the system of quality control of a firm and recommend improvements under SLQC1. 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 5.1.3 Advise on the impact of current topics relevant in performing an assurance engagement. 5.3.1 Propose areas that are important in undertaking an engagement quality control review for a given engagement.

Suggested detailed answer

(a) Financial statements have to be prepared by RT in fulfilling the contractual agreement with the bank. They are only for the use of the bank (internal purpose). These financial statements cannot be called "general purpose financial statements" as they are not for general use and the accounting framework is not Sri Lanka Accounting Standards. The framework used is the special purpose framework**.** Hence, the audit report on these special purpose financial statements have to be issued in accordance with SLAuS 800 - Special Considerations -*Audits of financial statements prepared in accordance with special purpose framework*.

(SLAuS 805 will not be applicable as these financial statements are a complete set of financial statements whereas SLAuS 805 deals with a single statement of financial statements)

(b)

- In planning and performing an audit of special purpose financial statements, the auditor shall determine whether the application of SLAuS 800 requires special consideration in the circumstances of the proposed engagement. The auditor (Tally Accounts) have to comply with relevant ethical requirements including those pertaining to independence in relation to financial statement audit engagements.

- In this case, the financial statements are prepared in accordance with the provisions of the loan contract. The auditors - Tally Accounts shall obtain an understanding of the provisions of the contract and the significant interpretations of the contract the management had made in preparation of those financial statements.

- The auditor should also consider all SLAuS relevant to the audit. The auditor should comply with each requirement of a SLAuS unless in the circumstances of the audit, the entire SLAuS is not relevant or the requirement is not relevant because of its condition that does not exist.

- Although the management has agreed for a threshold with the bank, this does not relieve the auditors from the requirement of determining materiality in accordance with SLAuS 320 for the purpose of planning and performing the audit of special purpose financial statements.

- The auditor needs to understand the party to communicate (communication with those charged with governance). It depends whether those charged with governance are responsible for overseeing the preparation of those special purpose financial statements. Since Tally Accounts performs the audit of general purpose financial statements, SLAuS 260 requirements may be relevant.

(c) The auditor should evaluate whether the financial statements adequately refer to or describe the applicable financial reporting framework. As per the given scenario, the financial statements should be prepared in accordance with the provisions of the loan agreement. Therefore, the auditors shall evaluate whether the financial statements adequately describe any significant interpretation of the agreement on which the financial statements are based.

The auditor's report should also describe the ***purpose*** for which the financial statements are prepared and the ***intended user***, or refer to a note in the special purpose financial statements that contains this information.

The auditor's report on these special purpose financial statements shall include an *emphasis of matter paragraph* alerting users of the auditor's report (in this case the bank), that the financial statements are prepared on a special purpose framework and as a result the financial statements may not be suitable for another purpose (SLAuS700) If the management has a choice of the financial reporting frameworks in the preparation of such statements, the explanation of management responsibility for the financial statements shall also make reference to its responsibility for determining that the applicable financial reporting framework is acceptable in the circumstances.

(d) There are several factors involved in good engagement performance.

Direction – the partner directs the audit. He is required by auditing standards to hold a meeting with the audit team to discuss the audit, in particular the risks associated with it. The meeting will enable to communicate the understanding of the business, engagement team's responsibilities, objectives, etc.

Supervision – the audit should be subject to overall supervised by the engagement partner. However, more practical supervision should be given within the audit team by senior staff to more junior staff. This should also be the case with review. Supervision includes tackling the progress of the audit engagement, considering the capability and competence of individual members, addressing significant issues that arise and identifying matters of consultation.

Review – this involves consideration of whether the work has been performed in accordance with professional standards and regulatory and legal requirements, significant matters have been raised for further consideration, appropriate consultations have taken place, there is a need to revise the nature, timing and extent of work performed, the work performed supports the conclusions reached and is appropriately documented etc.

Consultation – partners are also responsible for ensuring that if difficult or contentious matters arise, the team takes appropriate consultations on the matters and such matters and conclusions are properly recorded.

Quality control review **–** the audit engagement partner is responsible for appointing a reviewer if one is required. He is then responsible for discussing significant matters arising with the reviewer and not issuing the audit report until the quality control review has been completed.

Answer 02

Relevant Learning Outcome/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). 3.5.1 Advise on the extent to which reliance can be placed on internal auditor in determining the nature, timing and extent of further audit procedures. 4.1.1 Evaluate the sufficiency and appropriateness of audit evidence gathered, and identify changes to plan further audit procedures. 4.2.1 Evaluate the effect of identified misstatements on the audit and the effect of uncorrected misstatements, if any, on financial statements.

Suggested detailed answer

(a) **Audit risks Kanchana should consider in planning the audit of FDPL**

(i) Performance during the year doesn't seem satisfactory as revenue has dropped and margins have deteriorated compared to the previous year. At this stage it is not certain what the exact reason for this is. The available financial data would suggest that FDPL might have a **going concern issue.** The market also seems competitive.

(ii) FDPL operates a farm. Therefore the cows are considered to be biological assets under LKAS 41. Biological assets should be stated at fair value. Determination of fair value may involve assumptions and it would be an estimate. Therefore, there is a risk of bias in making the **estimates** by the management.

(iii) FDPL has a challenge in producing quality dairy products. There is a possibility of quality issues and consumer complaints against the products of FDPL. In such a situation, FDPL may have to pay compensation and the Consumer Authority also may impose penalties. **Therefore there is a risk of not providing for such liabilities or disclosure of contingencies related to such possible claims**.

(iv) During the year, production capacity has expanded. Construction has been carried out. As a result, there is a substantial increase in non-current assets. Therefore, there is a risk of **capitalising non-eligible expenses** under property, plant and equipment (not complying with LKAS 16).

(v) Results during the year do not seem satisfactory. Therefore, management can defer charging depreciation on new assets, as it will have a negative impact on profits for the year. Therefore, there is a risk of **understating depreciation for the year**. As per LKAS 16 depreciation should commence when the asset is ready to use. Therefore, the auditor has to check whether depreciation has commenced at the right time.

(vi) Employees are provided with targets, and directors expect to maximise profits. Therefore in order to achieve the set targets, the management may override the controls established in FDPL (e.g. revenue may be recognised in advance). Therefore, there is a risk of **management override of controls.**

(vii) The finance staff does not appear to be very experienced with the company. Therefore, they may not have a good understanding of the company's policies and procedures. Unless close monitoring is present, there is a risk of making mistakes/errors by junior staff in the finance department. Therefore, there is a risk that **financial statements may include misstatements**. (In finalising monthly accounts, manual journal entries are passed. In passing such journal entries junior staff may make mistakes).

(viii) During the year FDPL has purchased modern machinery. Does this mean the existing machinery were not capable of producing the desired level of production? If so, it provides an indication on **the impairment of fixed assets** (unless they have not been fully depreciated).

(ix) The position of General Manager – Commercial had been vacant for a few months. There is a risk of established internal controls not operating or activities not being supervised. This may have led to fraudulent transactions. Therefore, there is a risk of fraud.

(x) There is a risk of fraud on revenue recognition (a rebuttable presumption). With the given performance there is a possibility of fraud happening on revenue recognition as management is under pressure to achieve profit targets.

(xi) It appears that General Manager – Commercial has left without a pre-plan (a long time has been taken to fill the vacancy). The reason for sudden resignation should be considered as this may indicate **risk of fraud**.

(b) Journal entries and other adjustments are tested in responding to the risk of management override of controls. Since management override of controls prevails in any audit, Kanchana has to test journal entries.

The relevant factors to be considered are:

(i) Assessment of the risk of material misstatement due to fraud – in FDPL, fraud risk factors are present (e.g. revenue targets, profit maximisation objective, poor financial performance in 2015). This may help Kanchana to identify specific classes of journal entries and other adjustments for testing (in this case, Kanchana may have to test journal entries on revenue, provisions etc.)

(ii) Controls that have been implemented over journal entries – the journal entry module of FDPL is restricted. This means that there is no access to unauthorised persons. Hence, unauthorised persons cannot access this module or pass journal entries.

(iii) Entity's financial reporting process and the nature of evidence that can be obtained – the financial reporting process of FDPL indicates that there are automated journals as well as manual journals. Since it uses the FinR system, these details are available in electronic form. Therefore, the auditor needs to consider the method of extracting journal entries. In this case, as there is a sequential order, the auditor can verify whether all journal entries are included in the extract.

(iv) Characteristics of fraudulent journal entries – inappropriate journal entries may have unique identifying characteristics. In this case such characteristics involve, manual journal entries passed to unusual accounts (e.g. revenue - because there are automated entries to the revenue account in the general ledger), entries passed by people other than authorised persons, journals passed other than for authorised limits for recurring accruals, depreciation etc., journal entries recorded at the end of each month etc.).

(v) Nature and complexity of the accounts, inappropriate journal entries or adjustments may be applied to accounts that certain transactions and significant estimations. In this case for biological assets as it involves estimation of the fair value of such assets at each reporting period. Kanchana also needs to consider any misstatements identified in the previous year accounts and the presence of un-reconciled accounts.

(vi) Journal entries processed outside the normal course of business – there can be non-standard journal entries that do not have the same level of controls as standard journal entries.

(c) **Impact to the audit strategy of FDPL**

This year's findings of the system auditor indicate that Kanchana and the team cannot adopt the same audit strategy for the sales business process as previous years. It seems that these deficiencies have arisen mainly due to the resignation of the General Manager – Commercial and the time taken for the replacement. The main issue is segregation of duties as the sales manager who approves the invoices has approved discounts above 25%.

However, Kanchana needs to understand the period in which these issues/deficiencies have arisen in FDPL. If he can confirm that before the Commercial General Manager's resignation these controls were effective (provided that there had been no fraud), Kanchana will be able to rely on the controls up to the date of the Commercial General Manager's resignation. For the rest of the period, the audit team will not be able to rely on the controls over the sales process.

As a result, Kanchana has to seek for compensating controls (perhaps other manual controls). If there are no mitigating/compensating controls, detailed testing needs to be performed on sales. For example, testing the discounts given after July 2015 through substantive testing. Therefore this year, more detailed testing will be carried out in the revenue and receivables area.

Further, Kanchana may have to design additional audit procedures for the possible risks arising due to the above deficiencies. For example now sales manager is allowed to override the credit limits and generate invoices which may result in a risk of bad debts. Now, more in depth testing needs to be carried out (for existence of debtors and their recoverability).

(d) **Audit procedures to be performed**

Deficiency	**Audit procedures**
(i) Approval of sales discounts	• Check since when the sales manager has been given access to approve and from that period onwards perform testing. • Understand what management controls had been in place to mitigate the risk of giving excess discounts to customers who are not eligible. If those are there, test operating effectiveness of those mitigating controls. • If there are no mitigating controls, the audit team can obtain details on discounts given

Deficiency	Audit procedures
	and those approved by the sales manager and independently verify whether those discounts have been granted as per the company's policy.
(ii) Credit limits	• Understand whether the management has implemented any detective controls in monitoring sales done in excess of the credit limits set. If controls exist, test the operating effectiveness of such controls. • If there are no controls or they are operating ineffectively, test the credit limits granted during the year, the reasons for granting or whether additional guarantees, if any, have been obtained from those credit limits granted. • Test the outstanding period of customers' dues and assess whether the management has provided adequate allowance for doubtful debts.

SECTION 2

Answer 03

Relevant Learning Outcome/s:
1.1.1 Evaluate "rules" and "principles" based approaches to corporate governance.
1.2.1 Advise the effectiveness of a board in 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
1.3 Audit committee
1.4.2 Evaluate the ethical behaviour in a given scenario
2.2.1 Demonstrate the roles and responsibilities relating to enterprise risk management including the role of chief risk officer.
2.6.1 Explain the objectives and role of a modern internal auditor.
2.5.1 Compile a risk grid for a given business case, incorporating risk event, related objective, type of risk, risk rating, risk measurement and risk mitigation plans.
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.

Suggested detailed answer

(a)

(i) **Talent –** diversity provides the best chance of finding and employing the best available talent rather than artificially limiting itself.

(ii) **Broad range of knowledge –** no one individual director can be knowledgeable and informed about all aspects of the business, given the information and expertise necessary to manage the business. A group makes better decisions if the available information is more diverse and provided that the group understands who knows what and takes advantage of the knowledge.

(iii) **Greater range of constituencies –** diverse boards can reach out more effectively to a broader range of constituencies to help them deal with problems. This can also send positive signals to different stakeholder groups and contribute to a better understanding of the stakeholder group that underpins commercial success.

(iv) **Independence and judgment –** a board with a broad range of experience is more likely to develop independence of mind and a probing attitude. It can also enhance corporate decision-making by having sensitivity to a wide range of risks related to its reputation.

(v) **Corporate citizens** – greater diversity can enhance a company's reputation as a corporate citizen that understands its community. A company can have the objective that its board reflects the make-up of society within which it operates, in order to maximise its strategic fit within the community.

(b) **Importance of the external auditor's role**

The external audit is one of the most important corporate governance procedures. It enables investors to have much greater confidence in the information that their agents (the directors/managers) are supplying. The main focus of the external audit is on giving assurance that the accounts give a true and fair view. The external auditor of TSEL has been mainly engaged in providing assurance on the financial statements prepared by the management. In doing so, the external auditor can highlight governance and reporting concerns. As per the given information, the external auditor has raised concerns over internal controls of TSEL in its previous management letter. Therefore, it is important that the management of TSEL gives attention to these issues and rectifies the internal control weaknesses in TSEL, as it will enhance good corporate governance in the company.

The external auditor is employed to scrutinize the activities of the managers, who are the shareholders' agents. The audit fee is an agency cost. Therefore external auditors are also shareholders' agents. Therefore, the board of directors needs to understand the external auditor's agency responsibilities. If the management unduly interferes with the agency relationship of the auditor, it will not reflect good corporate governance. The management needs to allow them to carry out their duties. This will ensure the financial statements of TSEL are true and fair.

Because of the significance of the external audit, the external auditor must be independent. Therefore a balance is required between working constructively with the company's management and at same time serving the interest of shareholders. The management of TSEL needs to identify the importance of independence of the external auditor. Therefore, threating the external auditor with regard to a dispute does not reflect good corporate governance of TSEL. Instead the management should allow the auditor to be independent, perhaps by establishing a sub-board committee (e.g. audit committee).

Therefore, the external auditor's role is vital in good corporate governance of TSEL and the management needs to understand it, if they want to see TSEL as an entity practicing good corporate governance.

(c) (i)

- The management has targeted an occupancy rate in budgeting the profit targets of TSEL. The occupancy drives revenue. Therefore, if the desired occupancy rate is not achieved, there is a risk that TSEL might not achieve the budgeted profit targets.

- Presently, TSEL requires fresh capital in order to turnaround the company and be a profitable venture. There is a risk that the management may not be able to obtain the desired amount of fresh capital. If TSEL is unable to get fresh capital, it will become an obstacle in achieving the budgeted profits.

- TSEL is located at a world heritage site. Therefore, TSEL has a great responsibility towards environment protection. If there are any damages to the environment or the Sinharaja forest, it will have adverse consequences to TSEL. Environmental protection authorities may suspect the activities of TSEL and it could even result in significant penalties.

- TSEL will have to deal with travel agents and provide attractive credit facilities to secure business. Travel agents may default payments or take excessive time for settlement. This will result in a credit risk and the working capital management of the entity might get affected.

- Loss of trained staff due to the nature of industry – the hospitality industry is a unique industry that employs trained staff to serve customers. TSEL customers are mainly foreigners and they expect a good quality service. If the trained or skilled staff leaves, there will be an adverse impact on the quality of TSEL's services. Therefore, TSEL needs to ensure retention of critical staff.

- Increase in overhead costs.

- Loss arising from foreign currency translation.

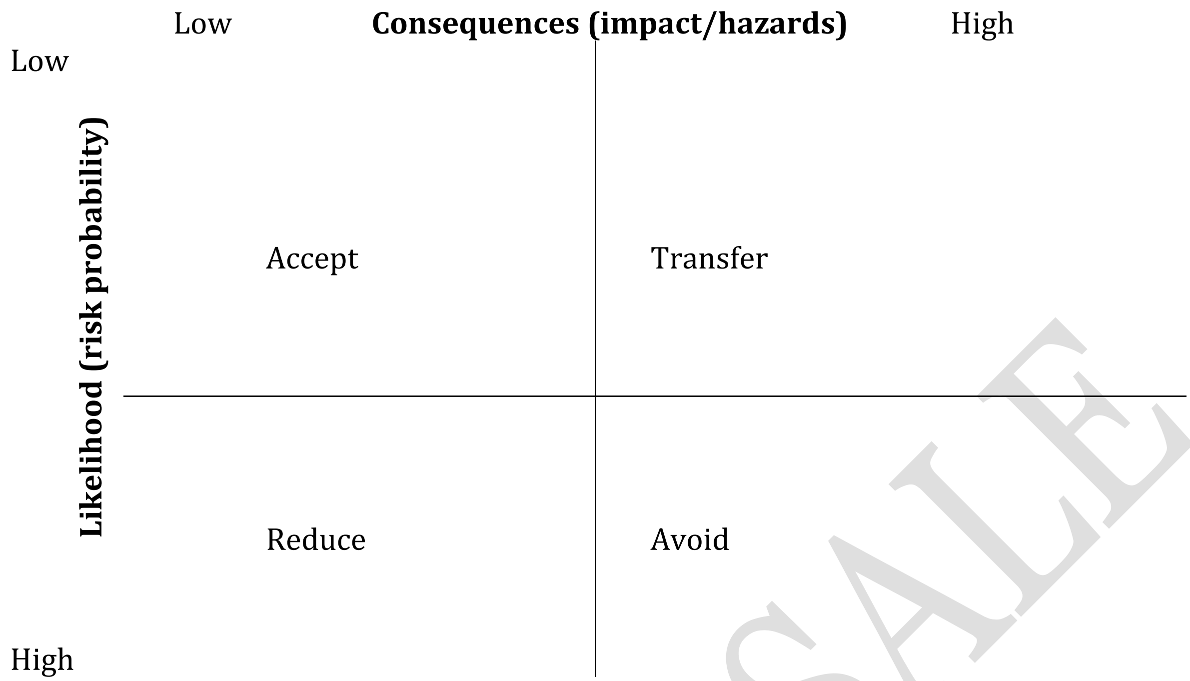
- High commission to the ITA.

- Risk of global recession having an adverse effect on tourist arrivals.

- Presently, there is an increased demand for eco-tourism. Therefore new competitors can enter the market if they see this as a profitable business. Increase in competition will have an adverse impact on business activities.

(ii) The board of directors could use the likelihood/consequence matrix to group the analysed risks into risk families.

The likelihood/consequence matrix is depicted below:



It is important to give special attention to those risks that will fall into the family of "avoid" because here both the likelihood and consequences are high. On the contrary, if the consequences and likelihood are both low, the management can "accept" those risks.

Based on the above categorisation, certain risks can be "transferred" or "reduced". Transfer involves obtaining insurance. Alternative strategies/contingent plans will help to reduce the risk. The position of risks can vary over time as environmental conditions vary. The profile can then be used to set priorities for risk mitigation.

(d) **Independence of internal audit division**

The board of directors of TSEL can consider the following to ensure the independence of the internal audit division of TSEL:

- The board can establish a special committee to which the internal auditor should report. This committee could comprise independent directors.
- If the internal audit division is to comprise of existing employees who have worked in other divisions of the company, the management can establish controls to ensure that they are not involved in auditing the departments they previously worked in.
- Where internal audit staff has also been involved in designing or implementing new systems, they should not conduct post-implementation audits.
- The board of directors should ensure internal audit staff is given the appropriate scope to carry out their responsibilities and is provided with unrestricted access to records, assets and personnel.
- Rotation of staff over specific departmental audits should be implemented.
- Provide adequate resources to conduct duties.

(e) **Benefits**

- Reasonable assurance on achievement of set objectives
- Assets are safeguarded and comply with laws and regulations
- Improve efficiency and effectiveness of activities
- Indirect benefits – external auditors place more reliance on controls, time spent is less

Costs

- Additional cost of employing extra staff as the management needs to ensure segregation of duties, and also employ a night auditor.
- Increased manager time spent on adhering to established control procedures (opportunity cost).
- More general costs and reduced flexibility, responsiveness and creativity within entity.
- Cost of salaries to internal audit staff will be wasted if they provide recommendations that are flawed because they reflect the lack of independence.
- Risks unnecessarily highlighted by the internal audit may be over-managed thereby incurring an excessive cost.
- Risk that are not highlighted by the internal audit, when they should have been materialised, causing significant losses to the organisation.

(f) (i) **Risks the external auditors of TSEL should consider in auditing room revenue of TSEL**

The room (chalet) revenue is driven from web bookings. Therefore, the auditor needs to consider the process in place for revenue generation through web/online bookings, and importantly, how these are tracked by TSEL, and the point at which the revenue recognition takes place (revenue should be recognised after delivering the service).

- Revenue is mainly generated through web sales. This suggests that there is less paper evidence and that there will be no audit trail. Obtaining audit evidence will not be straightforward.

- There are less manual controls in place in the system as the sales initiation is web based. Therefore, control risk exists. The auditor needs to consider the controls embedded into the system (such as automated controls) in order to ensure the integrity of the system.

- Risk on sales recognition – the sales cut-off will be a risk area. Since the sales are online, they need to track the point of sales separately (i.e. the point at which the company recognises revenue). Therefore the auditor needs to test whether the sales have been recognised at the right point and there are no cut-off issues. There are possibilities in recognition of immature revenue (e.g. before the visitor occupies the chalets, TSEL may recognise revenue).

- Since it is web based, there can be unauthorised access and unauthorised activities could happen. As a result there is a threat of manipulation of system data. This results in increased audit risk. There is a risk of fraud.

(ii) **Controls to be in place over the web based sales process**

- Establish controls to ensure that the Internet system is safeguarded from unauthorised access. The company needs to establish firewalls within the system and secure it. IT audit involvement is also required.

- Chalets (rooms) are reserved as per web booking details. There must be a control to ensure that as per the web booking, the chalets are reserved for the visitors to occupy them. If the web system is not integrated to the company's booking system, careful considerations should be given to avoid rooms being unavailable for reservations that are made (if the reservations are done through travel agents).

- Controls should be established to ensure that revenue is only recognised after delivering of service (occupancy). This can be done by performing a reconciliation of actual occupancy details (reconciliation of daily transactions).

- If the travel agents settle their dues through the web, a reconciliation should be made between the actual occupancy and cash received. Cash received should be accounted as deferred revenue. The management can establish controls to ensure the completeness of deferred revenue, and check the credit worthiness of travel agents.

- Employing a night auditor to ensure that all records on occupancy are accurate and complete.

- Restrict access to the company's system or the records on which occupancy details are maintained, so that no one can manipulate the data. Impact on revenue recognition will be limited.

(g) The external auditor of TSEL is involved in a business. However, the auditor should comply with the code and conduct issued by CA Sri Lanka as a practicing accountant.

The external auditor needs to maintain professionalism. Therefore, professional behaviour is to be maintained in all what they are involved as a practicing accountant.

In marketing themselves and their work, the external auditor should not bring the profession into disrepute. The external auditor should avoid making exaggerated claims about the services they offer, their qualifications and experience, and should not refer to others disparagingly.

When the external auditor engages in marketing professional services, there may be a threat to compliance with the fundamental principles. Therefore, marketing should not be carried out in a way that is inconsistent with the principles (e.g. self-interest). The external auditor has to always behave professionally and ensure the confidentiality of information about its clients and uphold ethical behaviour in marketing the services. Professional accountants in public bodies shall be handed and truthful and not make exaggerated claims about services they offer and their qualifications/experience.

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