SUGGESTED SOLUTIONS

KC4 – Corporate Governance, Assurance & Ethics

December 2016

Answer 1

Relevant Learning Outcomes/s; **3.1/3.4/ 4.1 / 4.2**

(a) **Suggested Detailed Answer:**

(1) **Audit Strategy of EH**

The overall audit strategy determines the scope, timing and direction of the audit and guides the development of the more detailed audit plan.

Characteristics of the engagement:

- Financial reporting framework
- Industry-specific reporting requirements
- Expected audit coverage
- Nature of business segments
- Effect of information technology on audit procedures
- Availability of client personnel and data

- W&P is the group auditor of the EH group. Therefore W&P is responsible for the group audit opinion on the consolidated financial statements of the EH group. EH needs to identify the material components of the Group and ensure adequate work is carried out for W&P to form a group audit opinion (e.g. what is the materiality level to be determined for group opinion purpose etc.). It is important to consider the significance of each component. W&P shall specify the scope of work the auditor of Hi-Tech should perform (if it is a significant component, W&P has to use the work of the component auditor)

- The group uses an off the shelf package (integrated) for financial reporting. Therefore, IT has an impact on the audit strategy of the Group. Since there are certain issues that have been noted on ITGCs, EH needs to consider whether reliance could be placed on IT systems. If ITGC cannot be relied on, the auditor will not be able to rely on automated controls in the EH Group.

(2) Reporting objectives, timing of the audit and nature of communications

- Entity's timetable for reporting
- Organization of meetings with management and those charged with governance.
- Discussions with management and those charged with governance.
- Expected communications with third parties.

- Nature of the communication with management and audit committee: Whilst the audit committee has expectations on communication with the auditor, the auditor may have to communicate certain facts to the audit committee as well as to the management. This needs to be agreed and determined.

A date of publishing the annual report is determined. This requires drawing a time table which should include the date of commencement of the audit, initial discussion with the management and the audit committee, date of obtaining financial statements from management, date of issuance of draft audit report, management letter, date of signing the audit report etc.

(3) Significant factors
Other significant recent developments

- Materiality: Although P&W performs the audit of all subsidiaries, it still has to ensure that the materiality level established would be appropriate for the group reporting. If the work of the auditor of the associate company is to be used, may need to communicate the materiality applicable for the associate auditor's work as well.

- The areas of high risk need to be identified. These areas require the performance of additional audit procedures. Therefore, it is essential for the auditor to consider the areas of high risk.

- It seems there is a good control environment. The right balance in the Board of Directors and the audit committee has been established. The auditor may need to consider the other aspects of the control environment including management's commitment to design, implementation and maintenance of sound internal control. If the control environment is sound, certain risks would be minimal.

(4) Nature, timing and extent of resources
- Selection of the engagement team
- Assignment of work to team members
- Engagement budgeting

Nature, timing and extent of resources: Selection of the engagement team which comprises of experienced and competent staff who can work for a large group in a variety of businesses (e.g. poultry) and also the assigning of tasks to the members.

(ii) Audit risks and procedures to be considered

Audit risks	**Appropriate audit procedures to address the risk**
The management has set objectives and they may be under pressure (given the increase in revenue is not expected) and the management compensation is based on achievement of KPIs. Therefore, there is a risk of management override of controls	• Testing of unusual transactions that have occurred during the year • Test the non-standard journal entries • Test the significant estimates made by the management (for any bias)
Fraud in revenue recognition: One criteria to measure the performance may be achievement of revenue targets. Therefore, the management may attempt to inflate revenue or recognize revenue in advance. Therefore there is a risk of fraud in revenue recognition	• Understand, evaluate and test the controls in place on revenue recognition • Perform test of details to identify revenue recognized in advance. For this year-end cut-off testing could be carried out and establish whether the revenue has been recognized during in the correct period
As per the information provided in the scenario, the newly acquired company (Green) has incurred losses and management has made business plans for this entity. It is required annually to assess the impairment of goodwill as per SLFRS / LKAS. The given information does not indicate whether the management has carried out the impairment assessment. Therefore there is a risk of not carrying out n impairment assessment and if carried out the existence of bias on the estimates made by the management	• Make inquiries of the management as to the assessment of goodwill impairment and if it has not been carried out request management to do so, if the management refuses consider the impact on the audit report. • If an impairment has been carried out on goodwill, the auditor needs to assess the reasonableness of the assumptions made
Impairment of investment in associate company: The associate company (Hi-Tech) has made losses and there may be a risk of going concern of that entity which in turn would have an impact on the impairment of the investment held in the associate company.	• Evaluate the financial results and other qualitative factors to determine whether there is an impairment on the investment and request management to perform an impairment assessment. • The impairment assessment should be tested by the auditor for the reasonableness of the assumptions made
There are deficiencies in ITGCs which include issues on access controls. If unauthorized persons have been provided with inappropriate	• Detail testing of those transactions that would have an impact due to unauthorized access to the system to verify whether those transactions are related to the entity

Audit risks	**Appropriate audit procedures to address the risk**
access, there will be a risk of fraud as the date could be manipulated or errors could occur.	
Related party transactions: There is a group structure in this scenario and certain sales and purchases are made within the group. Also, there is a possibility of other transactions with related parties (associates, subsidiaries) including related persons. Therefore, there is a risk of not disclosing all the related party transactions in the financial statements.	• Understand the related parties of the group and transactions that have occurred with those parties. Test a sample of those transactions and assess the completeness of the disclosures on related parties.
Fair valuation – Investment properties of the parent is fair valued. The fair valuation involves assumptions and judgments. Therefore, there could be management bias. There is a possibility of inappropriate fair valuation of investment property.	• Test the fair valuation of the investment properties (may be carried out by the management or by an expert) and assess the reasonableness of the assumptions made
Agri business: The biological standard is applicable for agri business and poultry business. Biological assets should be fair valued. There is a risk of arriving at inappropriate fair values.	• Test the reasonableness of the fair valuation on biological assets with reference to market data available and assessing the reasonableness of any assumptions made

(b). The audit procedures required

(1) Debtors' confirmations: There is an intensive competition in the market and targets have been set on revenue. This means there is a possibility of manipulating sales. As a result, would involve hold and bill revenue. Invoices could be generated for bogus debtors or goods would never be delivered to the debtors. Therefore, it is essential that the auditor follows up the confirmations that have not been received from debtors. May have to see whether these debtors are really in existence, what evidence is available to confirm whether the goods invoiced have been delivered to these debtors. Further, there are discrepancies in the confirmed balances. The reconciliation should be sought from the client and those should be investigated. Also the auditor may need to consider extending the audit procedures to the other debtors from whom confirmations were not called.

(2) Impairment: Impairment is an estimate. This involves forecasting the cash flows for future. Therefore the auditor needs to provide special attention to the data and information that have been used for assessing the impairment. The management has concluded that there is no impairment. Therefore, it is appropriate for the auditor to seek additional evidence to confirm this. These include the following:

- VIU calculation requires the consideration of the discount rate that is specific to the asset. In this case the rate applicable for the whole group has been used whereas the impairment assessment is on the medical device division. Therefore the auditor needs to inquire from the client the reason for using this rate and what would be the specific discounting rate and the impact on the impairment assessment.
- Cash flows include new capital expenditure in the third year. In the VIU calculation only the assets that currently in use are considered. Therefore, future investments are not considered. The auditor has to challenge this and ask the client to exclude this from the cash flows.
- Growth value: In deriving the terminal value this needs to be used. The growth rate should be applicable for the medical device industry and should not exceed the average industry growth rate. Therefore, the auditor needs to seek relevant evidence to support the appropriateness of using the 8% of growth rate.
- Cash flow forecasts should reflect a steady state and the auditor needs to check the reasonableness of the cash flows. In order to do this the auditor would refer to the approved budgets, past records and industry data.

(Total 25 marks)

Answer 2

Relevant Learning Outcomes/s; 5.1

Suggested Detail Answer:

(a) ***The appropriate type of assurance engagement***

The auditor should perform a limited assurance engagement in compliance with SLRE 2410, Review of Interim Financial Information Performed by the Independent Auditor of the Entity which result in negative assurance and where the level of assurance given is deemed to be moderate.

The objective of an engagement to review interim financial information is to enable the auditor to express a conclusion whether, on the basis of the review, anything has come to the auditor's attention that causes the auditor to believe that the interim financial information is not prepared, in all material respects, in accordance with an applicable financial reporting framework. The auditor makes inquiries, and performs analytical and other review procedures in order to reduce to a moderate level the risk of expressing an inappropriate conclusion when the interim financial information is materially misstated.

(b) ***Procedures you should consider when performing an interim review.***

I. In planning a review of interim financial information, the auditor should update his understanding of the entity and its environment. The auditor should also obtain a sufficient understanding of internal controls as it relates to the preparation of interim financial information as it may differ from internal controls as it relates to annual financial information.

II. Using this understanding of the entity and its environment, including its internal controls, determine the inquiries to be made and the analytical and other review procedures to be applied, and to identify the particular events, transactions or assertions to which inquiries may be directed or analytical or other review procedures applied.

III. Read the documentation, to the extent necessary, of the preceding year's audit and reviews of prior interim period(s) of the current year and corresponding interim period(s) of the prior year, to enable the auditor to identify matters that may affect the current-period interim financial information.

IV. Consider any significant risks, including the risk of management override of controls that were identified in the audit of the prior year's financial statements.

V. Read the most recent annual and comparable prior period interim financial information.

VI. Consider materiality with reference to the applicable financial reporting framework as it relates to interim financial information to assist in determining the nature and extent of the procedures to be performed and evaluating the effect of misstatements.

VII. Consider the nature of any corrected material misstatements and any identified uncorrected immaterial misstatements in the prior year's financial statements.

VIII. Consider significant financial accounting and reporting matters that may be of continuing significance such as material weaknesses in internal control.
IX. Consider the results of any audit procedures performed with respect to the current year's financial statements.
X. Consider the results of any internal audit performed and the subsequent actions taken by management.
XI. Inquiring of management about the results of management's assessment of the risk that the interim financial information may be materially misstated as a result of fraud.
XII. Inquire of management about the effect of changes in the entity's business activities.
XIII. Inquire of management about any significant changes in internal control and the potential effect of any such changes on the preparation of interim financial information.
XIV. Obtain written representations from management of the process by which the interim financial information has been prepared and the reliability of the underlying accounting records to which the interim financial information is agreed or reconciled.

(c) ***Significant areas of concern noted by you based on the information given in the scenario***.

- The audited financial statements for the year ended 31st March 206 included a matter of emphasis on the going concern**.** For the 6 months ended 30th September 2016, the company has made a marginal profit of Rs 27 Mn. However, the bank loan obtained by the company has been used to settle most of its current liabilities and to purchase inventory for the Supermarkets which may not have helped in improving the going concern. **The auditor needs to reassess the matter of emphasis and determine whether he should include a matter of emphasis para in the opinion on the interim financial statements.**

- ***Receipt of the bank loan-*** The Company has obtained the bank loan in June 2016. This was one of the key mitigating factors for the going concern as of 31st March 2016. The loan includes several debt covenants such as prohibition of declaration of dividends without the approval of the Bank of Sri Lanka or making cash distributions or making payments for any shareholder loans until the repayment of the bank loan. **As the loan is a key factor in mitigating the going concern impact, the auditor should verify compliance with loan covenants.**

- As per the Finance Manager due to the delay in obtaining the loan, Mr. Anura Perera who owns 25% of the company has given a temporary loan of Rs. 25 Mn. The company has repaid this loan in August 2016. This could amount to a violation of the loan covenant unless, the company has specifically obtained specific approval from the Bank of Sri Lanka by declaring that this temporary loan was given due to the delay in receiving the loan and approval of the Bank to pay same on receipt of the Bank loan. **The auditor should ensure that loan covenants have not been violated.**

- If the company has not obtained such approval this will amount to a violation of the loan covenants and will result in the loan being classified as current. This could have a significant impact on the financial statements of the company and make the company insolvent. **In the event that it is determined, there is a violation of the loan covenant, the auditor should ensure that the interim financial statements correctly reflect the bank loans under current liabilities.**

- If the loan is to be classified as a current liability, the "going concern" of the company will be in serious doubt. **The auditor may need to consider whether he should qualify the going concern assumption of Gamunu & Sons Plc.**

(d) ***The conclusion paragraph and the basis for a modified opinion for the interim audit of G&S PLC for the 6 months ended 30 September 2016 assuming that the going concern assumption is not valid (which is not agreed by the management).***

(As per SLAuS 570 Going Concern, if the financial statements have been prepared on a going concern basis but, in the auditor's judgment, management's use of the going concern assumption in the financial statements is inappropriate, the auditor shall express an adverse opinion regardless of whether or not the financial statements include disclosures of the inappropriateness of management's use of the going concern assumption.)

Basis for Adverse Conclusion

The Company incurred a net losses of Rs 92 Mn. during the year ended 31st March 2016 and, as of that date; the Company's current liabilities exceeded its current assets by Rs 77 Mn. The company obtained a long term loan of Rs 100 Mn in June 2016, as without such assistance; there was material uncertainty that cast significant doubt about the Company's ability to continue as a going concern. However, as the company has not complied with the loan covenants, as per the terms of the loan agreement, the loan is payable immediately and has now become a current liability. These events indicate a material uncertainty that may cast significant doubt on the Company's ability to continue as a going concern and therefore the Company may be unable to realize its assets and discharge its liabilities in the normal course of business. The financial statements do not disclose this fact.

Adverse Conclusion

Our review indicates that, because of the omission of the information mentioned in the Basis for Adverse conclusion paragraph, the interim financial statements do not give a true and fair view of the financial position of Gamunu & Sons PLC as at September 30, 2016 and of its financial performance and its cash flows for the six-month period then ended in accordance with Sri Lanka Accounting Standards.

(Total 25 marks)

Answer 03

Relevant Learning Outcomes/s; 1.4/1.8/1.9/2.1/2.4/2.5/2.7

Suggested Detail Answer:

I. ***Factors that determine an effective internal control environment of an entity.***

1. The **philosophy** and **operating style** of the directors and management
2. The entity's **culture**, whether control is seen as an integral part of the organisational framework, or something that is imposed on the rest of the system.
3. The entity's **organisational structure** and methods of assigning authority and responsibility (including segregation of duties and supervisory controls)
4. The directors' **methods of imposing control**, including the internal audit function, the functions of the board of directors and personnel policies and Procedures
5. The **integrity, ethical values** and **competence** of directors and staff.

II. ***How the factors outlined in (a) (i) above are reflected in the internal control environment of CSL.***

1. ***The philosophy and operating style of the directors and management***

Ceylon Sugar is 51% owned by the government and 49% owned by B Ltd-a private entity. The Board is probably made up of a mix of directors from the Government and B Ltd. While B Ltd.'s sole objective is shareholder maximization, the objective of the government will probably be job creation and price control of Sugar.

Out of the 7 Directors, 4 Directors including the Chairman and CEO are from the Government. The information given states that "*Directors appointed by the government are likely to follow political imperatives in order to meet the needs of the electorate. In the worst case, such objectives may be traded off for commercial objectives.*"

This could lead to conflicting philosophies and operating styles amongst the directors. Therefore, it is unlikely that there is a clear philosophy and operating style of the directors and management of Ceylon Sugar Ltd. This is further confirmed by the statement that *"there is a lack of clear objectives amongst the directors*."

2. ***The entity's culture, whether control is seen as an integral part of the organisational framework, or something that is imposed on the rest of the System.***

As per the information give, it appears this company has a dysfunctional board coupled with careless expansion strategies and lack of a risk management strategy.

Board members have also failed to exercise proper business judgment in pursuing expansion strategies to reduce costs of production and increase revenue.

In such an environment, it is unlikely that there is a culture where control is seen as an integral part of the framework, or something that is imposed on the rest of the System.

3. ***The entity's organisational structure and methods of assigning authority and responsibility (including segregation of duties and supervisory controls)***

Significant number of the workforce appears to be illiterate with low commitment to work. The workers also include, workers nominated by the minister. It also appears that at present the factory is overstaffed as, as per Mr. Perera the factory can be run with an effective labour force of around 650.

Further salaries are also generally lower than in the private sector and there is a lack of performance based contracts.

In the above scenario, it is unlikely, that Ceylon Sugar Ltd has an effective organizational structure with clear segregation of duties and supervisory controls.

4. ***The directors' methods of imposing control, including the internal audit function, the functions of the board of directors and personnel policies and Procedures***

It appears that this company had a dysfunctional board coupled with careless expansion strategies and lack of a risk management strategy. Board members had failed to exercise proper business judgment in pursuing expansion strategies to reduce costs of production and increase revenue.

There also appear to be conflict of interest and excessive ministerial intervention which may impair the ability of the board to make sound decisions.

The company also does not have an independent internal audit function.

In the above scenario it will be difficult for the directors' to impose effective methods of control, including the internal audit function, the functions of the board of directors and personnel policies and Procedures.

5. ***The integrity, ethical values and competence of directors and staff***

There does not appear to be an effective nomination process to identify qualified board members. Some of these members will be purely political appointees and therefore, will not have the required integrity, ethical values and competence.

As mentioned earlier, even the majority of factory staff do not appear to be competent.

Therefore it is difficult to conclude that there is high integrity, ethical values and competence of directors and staff at present.

III. *The effectiveness of the current internal environment of CSL based on the evaluation done in (a) (ii) above*

Company should have a strong commitment at the level of Directors to implement sound control compliance, integrity and ethical values across the organization. This appear to be lacking due to the board composition being based on political and other appointees who may not have the correct skills or competency to set the correct tone at the top.

This along with the other factors identified above, leads to the conclusion that the internal controls environment at Ceylon Sugar Ltd is weak and could lead to a poor risk management culture.

(b) ***Fernando brothers are of the view that the risk analysis would be done through a risk matrix based on the likelihood/consequences***

I. ***Analyse five (05) operational risks of CSL to assist the Fernando brothers.***

1. **Business Interruptions/ slow down due to the break down in factory machinery**

- The factory PPE were installed many years ago and are technologically obsolete and require urgent replacement if production is to be increased.

- **Inadequate Funding to meet working capital requirements**

  There could be business interruptions if the company is unable to meet the working capital requirements.

- **Increase in cost of production due to excess staff**

  The cost of sugar production increased significantly due to wage increases. As per the management there is an excess staff of around 350

- **Noncompliance with Loan covenants.**

  Company has significant borrowings. Any non-compliances could result in defaulting the loans and the loans will become repayable immediately. This will result in a significant going concern issue to the company.

2. **Loss of Executive Directors (Loss of key-person)**

On completion of the sale of their stake in Ceylon Sugar Ltd, the three Executive Directors of B Ltd plan to resign.

3. **Losses due to Internal control systems not detecting frauds/errors**

No proper Internal Audit Function at Ceylon Sugar Ltd. There is also no proper tone at the top to implement a robust internal control system.

4. Fraud
5. Human Error

II. ***Recommend risk management strategies that could be used by Fernando brothers for the risks identified in (b) (i) above by using the likelihood/consequences matrix.***

Consequences (Impacts or hazard)

Likelihood (Risk Probability)	***Low***	***High***
Low	***Accept***	***Transfer*** Losses due to internal control systems not detecting frauds/errors.
High	***Reduce*** Loss of Executive Directors Increase in cost of production due to excess staff.	***Avoid*** Business Interruptions/ slow down due to the break down in factory machinery Inadequate funding to meet working capital requirements. Noncompliance with loan covenants.

III. ***Auditors are required to assess any "self –review threat" prior to accepting services other than assurance services to an audit client.***

I. Discuss the importance of assessing a "self-review threat" by an auditor prior to accepting services other than assurance services to an audit client.

The provision of non-Audit Service services may create threats to the independence of the auditor by threatening the objectivity of him performing the financial audit. Therefore, it is necessary to evaluate the significance of any threat created by the provision of such services. The Auditor should be independent of the audit client in fact and appearance to ensure that he is able to issue an independent opinion on the audited financial statements of his client. It may be possible to eliminate or reduce the threats created by application of safeguards.

To maintain this level of independence the auditor should ensure that in providing a non-audit service, external auditors do not:

- audit their own work
- make management decisions for the company
- create a mutuality of interest, or
- find themselves in the role of advocate for the company.

Provision of such services could be considered impairing the independence of the auditor as there are no safeguards to reduce the self-review threat to acceptable levels in the above instances.

II. Advise Silva Associates whether to accept the assignment to perform the valuation of CSL.

A self-review threat may be created when a firm performs a valuation for an audit client that is to be incorporated into the client's financial statements.

- Silva Associates are the auditors of A (Pvt) Ltd which will also include the consolidated financial statements of A (Pvt) Ltd. Therefore, Silva Associates are required to be independent of the consolidated financial statements of A (Pvt) Ltd...
- If A (Pvt) Ltd acquires a 49% stake in Ceylon Sugar Ltd, it will become a significant associate of A (Pvt) Ltd.

The valuation could involve a significant degree of subjectivity and could create a self-review threat as Silva Associate will have to accept the assessments made by their own firm.

- Ceylon Sugar Ltd is owned by the government and is in a specialized industry.

  As the valuation service relates to items which are both **material** to the financial statements and involve a significant degree of **subjectivity**, the self-review threat created cannot be reduced. Accordingly, such valuation services should not be provided to the audit client. Therefore, Silva Associates should not accept the work to perform the valuation of Ceylon Sugar Ltd.

(Total 50 marks)

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