THE INSTITUTE OF CHARTERED ACCOUNTANTS OF SRI LANKA

SUGGESTED SOLUTIONS

KC4 – Corporate Governance, Assurance & Ethics

December 2019

Answer 01

Relevant Learning Outcomes/s; 2.6.2, 2.4.1, 2.2.2
Study text reference: 318, 267- 270, 242-248

(a) The role of the internal auditor in risk management including assessing the following:

- The adequacy of the risk management and response processes for identifying, assessing, managing and reporting on risk;
- The risk management and control culture;
- The appropriateness of internal controls in operation to limit risks;
- The operation and effectiveness of the risk management processes, including the internal controls.

(b) Risk areas	(c) Key audit procedures/s
1. Risk of incorrect application/reporting of Revenue and Cost of Sales. Since hotels operate on an all-inclusive basis, there is a risk that departmental revenues and costs are not properly reflected through the departmental management accounts.	• Understand internal controls on "all-inclusive basis" packages from the initiation of transaction up to reporting in the management accounts. • On a sample basis, test those controls to ensure whether those controls are effective, throughout the period. • Review departmental level monthly GPs with recent years and analyse reasons for exceptions. • Compare actual departmental results with budgets and investigate cost overruns and/or drop in revenue.
2. Weak cash management While having Rs.20 million cash balance, the Company plans to utilize undrawn balance of the borrowings to incur capital expenditure of Rs.45 million. Further, proposed facility is taking at a fixed interest rate. Considering the economic decline on Easter attack, taking a loan at a fixed interest rate is not favorable to the company. Also, there is a risk of loosing some interest income by keeping excess cash in short term deposits.	• Discuss with management to find out rationale for not utilizing excess cash and instead use of a borrowing facility. • Perform an independent cost benefit analysis on cash management and report to the board on findings.
3. Risk of investment in loss making capital projects.	• Inquire management for due diligence review conducted for propped investment.

The company has invested in a property at Nuwara Eliya for which no specific plan is agreed on. Also, A small Boutique was purchased, however, no operation is continued as there is land use restriction in that area. Having those on the side, the company is considering to invest in another property using external borrowings. There is a significant risk that those investments will not be recovered, as no cash return is visible at the moment.	• Review correspondence with government and any concern made by government which may negatively impact on the proposed project. • Review financial position, working capital structure and return on assets and report any negative findings.
4. Non-compliance with laws and regulations The hotel is subject to environmental protection laws and they have already received a complaint from MEPA claiming damages caused by hotel's guests. This indicates a possible non-compliance with environmental laws. Also, the management has acquired a Boutique hotel in Matara where local legislations prohibits private ownership of properties and beaches in that area.	• Discuss with management on any reported or possible non-compliance with laws and regulations. • Obtain copies of correspondence with regulatory authorities (such as MEPA, IRD) during the year and review those to see whether any non-compliance. • Review policies and procedures of the company to ensure whether adequate policies and procedures have been included. • Review company policies and procedures to check whether policies on guest awareness are adequately discussed.
5. Risk on the reputation of its brands and the intellectual property rights The company has entered into an agreement with international franchise to use its name, adopt their menus, etc. for 10 years. Any failure to adherence to the requirements of the agreement would significantly affect the reputation of the Hotel. Further, the company has agreed for a "Service Guarantee Scheme" with its customers where customer will be given uninterrupted service under natural disaster situation (e.g. flooding). There is a significant reputation risk, if the guaranteed service could not be delivered.	• Review management and franchise agreements against local regulations and quality standards and investigate actions taken to address any significant gaps. • Review whether reasonable effort has been taken to invest in brand management, including registration/renewal of brand names, trademarks, etc. • Review staff training activities conducted in resorts and examine whether adequate training has been provided to staff on maintaining operating and quality standards, in compliance with management agreements and local regulations. • Review a sample of customers served under "service guarantee scheme" and see whether agreed commitments have been fulfilled on a timely basis.

6. **Risk of incorrect application of financial reporting principles - under this revenue, Impairment and provision**	
<u>Revenue recognition</u> The Group's revenue could be over or understated due to timing issues relating to the recognition of revenue. Customers pay 40% of the cost of their holiday in advance, and the Group has to refund any bookings which are cancelled a week or more before a guest is due to stay at a hotel. There is a risk that revenue is recognised when deposits are received, which would be against the requirements of SLFRS 15 *Revenue from Contracts with Customers*, which states that revenue should be recognised when, or as, an entity satisfies a performance obligation. Therefore, the deposits should be recognised within current liabilities as deferred revenue until a week prior to a guest's stay, when they become non-refundable. There is the risk that revenue is overstated and deferred revenue and therefore current liabilities are understated if revenue is recognised in advance of the date the amount becomes non-refundable.	• Review and understand company's revenue recognition policy and its compliance with Sri Lanka Accounting Standards. • Understand the revenue process and related internal controls and on a sample basis, test those controls to ensure operating effectiveness during the period. • Perform revenue cut off tests close to the period end, bearing mind advances received from customers have properly been accounted for. • Perform substantive analytical procedures to test the reasonableness of revenue reported in the financial statements. • Examine supporting documents for a sample of customer advances and deposits and ensure that those advances have been recognized as revenue, only upon satisfying the underline performance obligation/s.
<u>Impairment of non-current assets due to political instability and regulatory issues</u> The sites acquired at a cost of Rs. 75 million represent 21·4% of total assets, and the hotel complex acquired at a cost of Rs. 23 million represents 6·6% of total assets; these assets are material to the Group financial statements. There are risks associated with the measurement of the assets, which are recognised as property, plant and equipment, as the assets could be impaired. None of these assets is currently being used by the Group in line with their principal activities, and there are indications that their recoverable value may be less than their cost. Due to the political instability and the regulatory issues, it seems that the assets may never generate the value in	• Review the status of property, plant and equipment to identify any indicators of impairment of assets and obtain formal impairment assessment from management. • On a high level, independently perform impairment assessment and to check whether any critical asset is got impaired. • Discuss with management for their views/assessment of impairment of assets.

use which was anticipated, and their fair value may also have fallen below cost. Therefore, in accordance with LKAS 36 Impairment of Assets, management should conduct an impairment review, to determine the recoverable amount of the assets and whether any impairment loss should be recognised. The risk is that assets are overstated, and profit overstated, if any necessary impairment of assets is not recognised at the reporting date.	• Review whether adequate controls are in place to ensure financial reporting and communication on those significant matters.
<u>Provision/contingent liability</u> The letter received from MEPA indicates that it may be necessary to recognise a provision or disclose a contingent liability, in respect of Rs.10 million damages which have been claimed. The amount is material at 2·9% of total assets, and 67·9% of profit before tax. According to LKAS 37 *Provisions, Contingent Liabilities and Contingent Assets*, a provision should be recognised if there is a present obligation as a result of a past event, and that there is a probable outflow of future economic benefits for which a reliable estimate can be made. It remains to be seen as to whether the Group can be held liable for the damage to the coral reefs. However, the finance director seems to be implying that the Group would like to reach a settlement, in which case a provision should be recognised. A provision could therefore be necessary, but this depends on the negotiations between the Group and MEPA, the outcome of which can only be confirmed following further investigation by the audit team during the final audit. A contingent liability arises where there is either a possible obligation depending on whether some uncertain future event occurs, or a present obligation but payment is not probable, or the amount cannot be measured reliably. There is a risk that adequate disclosure is not provided in the notes to the financial statements, especially given the finance director's reluctance to draw attention to the matter.	• Obtain the letter received from MEPA and review to understand the basis of the claim, for example, to confirm if it refers to a specific incident when damage was caused to the coral reefs. • Discuss the issue with the Group's legal adviser, to understand whether in their opinion, the Group could be liable for the damages, for example, to ascertain if there is evidence that the damage to the coral reef was caused by activities of the Group or its customers. • Review whether adequate controls are in place to ensure financial reporting and communication on those significant matters.

<u>Foreign exchange</u> The Group holds Rs. 20 million in cash at the year end, most of which is held in foreign currencies. This represents 5·7% of Group assets; thus cash is material to the financial statements. According to LKAS 21 *The Effects of Changes in Foreign Exchange Rates,* at the reporting date foreign currency monetary amounts should be reported using the closing exchange rate, and the exchange difference should be reported as part of profit or loss. There is a risk that the cash holdings are not retranslated using an appropriate year end exchange rate, causing assets and profit to be over or understated.	• Conduct a physical cash count to ensure the existence and completeness of foreign currency balance reported in the books of accounts. • Perform independent calculation for translation of foreign currency cash balance, referring to closing rate at the reporting date, as required by LKAS 21. • Review whether adequate controls are in place to ensure financial reporting and communication on those significant matters.
<u>Effect of the Flooding</u> Two of the Group's hotels are closed due to extensive damage caused by a recent flooding. It is anticipated that the Group's insurance policy will cover the damage of Rs. 25 million and the terms of the policy are that half will be paid in advance and the remainder on completion of the repairs, although this will need confirming during our audit testing. The accounting for these events will need to be carefully considered as there is a risk that assets and profit are overstated if the damage and subsequent claim have not been accounted for correctly. The damage caused to the hotels and resultant loss of revenue is likely to represent an indicator of impairment which should be recorded in line with LKAS 36. LKAS 16 *Property, Plant and Equipment* requires the impairment and derecognition of PPE and any subsequent compensation claims to be treated as separate economic events and accounted for separately in the period they occur. The standard specifically states that it is not appropriate to net the events off and not record an impairment loss because there is an	• Perform physical observation/visit of those hotels to reasonably ensure the existence of damages. • Discuss with key managerial team of the hotels to get a detail understanding of the damages. • Review computations made by the management for losses/damages and expected insurance covers. Also ensure that those computations are approved by the board of directors. • Review company's insurance policy together with computations made and discuss with management, if any exceptions. • Obtain written confirmation from insurance company for estimated insurance cover and compare same with accounting entries made for any material difference. • Review whether adequate controls are in place to ensure financial reporting and

insurance claim in relation to the same assets. As such, this may mean that the Group has to account for the impairment loss in the current year but cannot recognise the compensation claim until the next financial period as this can only be recognised when the compensation becomes receivable. If it is indeed the case that the insurance company will pay half of the claim in advance, then it is likely that Rs. 12·5Mn could be included in profit or loss in the current year.	communication on those significant matters.

(d)

1. Comprehensive training to all staff on a regular basis regarding the compliance requirement embedded in the franchise agreement.
2. Obtaining written confirmation from all staff that they have read and understood the compliance requirement.
3. Specific instructions to maintain confidentiality of the recipes relating to the franchise owner.
4. Include specific clauses into the appointment letter and attach specific job descriptions
5. Display notices/instructions in the premises to remind employees on key franchise risk/ regulations.
6. Link compliance with franchise rules/regulations to performance appraisal.

(Total: 25 marks)

Answer 02

Relevant Learning Outcomes/s; **5.2,1.9**	
Study text reference: 404-410, 192-193	

(a) **Root causes**

1. Insufficient number of partners - There was no replacement to the retired partner during the year and the assurance partners have other responsibilities (advisory, internal audit engagements, supporting function responsibilities). This allows partners to have a limited time to review the work performed and to actively engage in the engagements. The available data confirms that the engagement leaders, managers have spent less number of hours for the engagements.
2. No adequate training – During the year planned training has not been conducted due to various reasons. These training are critical to engagement performance. This is critical as most of the time has spent by trainee accountants who may have not undergone the training.
3. Low retention rate – the firm is unable to retain people with the right talent as there is a high turnover in the firm. The low compensation level, unavailability of technological advancements and less career development opportunities make less attractive staff to continue with the firm. As a result of these limitations, the firm may be unable to attract new recruits as there had been staff unavailability.
4. Quality culture of the firm – There had been recurring audit findings from the regulatory reviews. There is a question whether the firm was serious about the findings communicated by the regulator previously. Even the senior partner suggestion on having an independent review was not welcomed by other partners. Therefore, there is no engagement level monitoring in the firm as required by SLQC 1.This is evident from delaying the implementation of network firm required initiatives.
5. Technical knowledge –As per the observation made by SLAASMB the staff may not have sufficient technical knowledge on application of new accounting standards and to audit complex areas which involves significant judgment and estimates (e.g. impairment).
6. As per the given information in the scenario rewards to the partners are mainly based on achievement of financial performance as there is a high weightage for it and less weightage given. This may have implication on quality.
7. No monitoring over rotation may be due to less focus on this area. Independence of the audit team should be monitored on a regular basis.
8. Presently the firm has not appointed a person or group of persons to oversee the quality of the firm. As a result the leadership of the firm has not entirely fulfill its responsibility for the quality.
9. Presently there is no indication of having a robust monitoring on the quality control of the firm or formal reporting on the issues to the senior partner. Hence the quality issues have not been timely identified for corrective actions.
10. H&C has delayed the implementation of global initiatives for more than a year.

(b) Additional information required:

- How the client portfolio of 420 has been allocated among the partners, whether senior partner too handles a client portfolio.

- How many managers are engaged as engagement managers and what is the portfolio allocation to assess whether there is any imbalance in portfolios allocated to the managers
- What other client responsibilities and support function responsibilities of senior partner in order to assess his time involvement for audit practice of the firm
- The financial stability of the firm – whether the delayed implementation of global initiatives whether due to financial constraints
- How often the assurance meetings are conducted, what had been discussed at these meetings on a regular or as a standard agenda item. i.e. to identify whether quality is an area of continuous focus.
- How the senior partner monitors the assurance practice e.g. under-productivity, under-utilization, high staff turnover etc. reported to him
- How the support functions are structured, whether adequate resources have been allocated (e.g. trainers, staff to carry out the related functions)
- What is the present level of compensation compared to the rates applicable in other practices, and in the industry
- What is the performance measurement of the firm in having to reward high performers and to identify poor performers and provide support for those staff

(c) **Quality improvement plans**

1. New partner admission, Identify potential candidates from the firm for partner admission or get new persons externally in order to ensure sufficient number of partners are available to perform the engagements.
2. Staff retention initiatives to be taken which include increase in pay, socializing activities, availability of new technological facilities to attract and retain millennials.
3. Provide required training to the staff with additional resources being obtained or getting help from the network firm, making them to attend special training organized by professional bodies on accounting standards, auditing standards (e.g. by CA Sri Lanka)
4. Regular quality messaging from the leadership i.e. senior partner on the importance of quality to the staff and partners
5. **Accountability and recognition framework to be drawn to include quality related performance measurement to partners and the present weightage provided on financial performance to be reduced and have a balance between the financial and quality related achievements.**
6. As suggested by the senior partner to have an independent review of engagements to assist quality improvements in engagement performance. These reviews may take both as real time reviews and cold reviews.
7. Have a robust performance measurement to staff and identify high performers and draw a career plan for them and have action plans to improve the poor performers.
8. Draw a policy on engagement leader rotation and timely monitoring of the rotation of engagement partners and audit engagement.
9. The firm has to establish robust monitoring procedure and have a formal reporting process to identify the weaknesses in the quality control of the firm and draw an action plan there on.
10. Appointment of a person or group of persons who will be responsible for the quality of the firm. The responsibilities are to be determined and formal reporting should be agreed.

(d) **Independence**

- Need to understand the nature of services (whether included management support, implementation support).
- If implementation work was the responsibility of the Indian firm, it will have a self-review threat as the parent will provide a group opinion which includes the financial statements relating to the Indian subsidiary.
- What are the mitigation measures taken if there is a threat to independence (e.g. by not involving the team who performed accounting advisory services for the audit work etc.)
- If still the threat cannot be reduced, should not accept the engagement

(Total: 25 marks)

Answer 03

Relevant Learning Outcomes/s; **1.2, 1.7, 3.4, 3.5, 4.3, 4.7**	
Study text reference: 78-88, 181-186, 187-189, 478-481, 436-440,715, 699-709	

(a) Effectiveness of the board

1. The board procedures to be formalized. Presently informal procedures are being followed. This shall be extended to frequency of meetings, taking up minutes, circulation of minutes with action plans taken thereby evaluate strategy implementation
2. All are executive directors; the board should have independent non-executive directors to have new growth strategies
3. The Chairman may have a dominant role as he also has the managing director role. These two roles shall be divided
4. Continuing professional development of the board members – The areas include on strategy, risk management, audit and remuneration issues etc.
5. Appraisal of the board's performance is an important control over it, aimed at improving board effectiveness, maximizing strengths and tackling weaknesses which is presently not evident in the company.
6. Chairman of the board should encourage directors' participation on decision making by providing necessary information on timely basis (issue: lack of proper deliberation at board level on key decision).
7. Since the statutory audit is continuously delayed it is appropriate to appoint an audit committee to enhance the quality of the financial reporting.
8. The internal auditor directly reports to the FD, and this reporting line of internal auditor to be reviewed in order to ensure independence of the internal auditor.

(b) (i) By having a code of conduct in place it gives the message that the ethical behavior is importance in carrying out the business but to have a positive impact the following should be in place:

1. The commitment of senior management to the code needs to be real, and it needs to be very clearly communicated to all staff. Staff need to be persuaded that expectations really have changed.
2. Measures need to be taken to discourage previous behaviors that conflict with the code (e.g. bribes taken /given)
3. Staff need to understand that it is in the organization's best interests to change behaviour and become committed to the same ideals. For this training and awareness sessions are required
4. Some employees – including very able ones – may find it very difficult to buy into a code that they perceive may limit their own earnings and/or restrict their freedom to do their job.
5. In addition to a general statement of ethical conduct, more detailed statements (codes of practice) will be needed to set out formal procedures that must be followed.

(ii)

- Professional accountant shall undertake any assignment if he / she has right competencies and experience.
- The accountant is not knowledgeable and have not undergone any training on integrated reporting. Therefore, he may not be able to deliver as per the expectations and in accordance with the applicable framework. This will disappoint the stakeholders**.**
- He did the right thing by communicating it to the finance director, the FD is also being a chartered accountant has intimidated the accountant.
- The accountant shall do the right thing and take the right decision. He should not compromise his personal interests (employment) to the public interest.
- Hence, he should escalate this issue to a higher level and if no resolution can be reached, he should not take up this assignment or continue with the job role**.**

(c) **Audit procedures to perform on impairment**

1. The auditor shall obtain an understanding of the following as part of the process of understanding the business which include applicable accounting standard (in this case LKAS 36), how the management identified the cash flows, how the estimates were made or the rationale for making the estimates.
2. Based on the assessed risks the auditor will determine whether the financial reporting framework has been properly applied and whether methods for making estimates are appropriate and have been applied consistently. In this scenario whether the management has taken the right cash flows as the **cash flows** represent both rubber and tea. Therefore, the auditor needs to ask management to provide right cash flows relating to rubber business unit**,** whether the **assumptions are correct (discount rate, growth rate, sales increase, the relevance of the cash outflows considered etc.)**
3. The auditor will also determine whether events occurring up to the date of the audit report provide evidence regarding the accounting estimate i.e. if past records indicate 50% of achievement, then challenge the management, make inquiries, what's the basis of making estimates.
4. Evaluate the internal controls over preparation and approval of VIU computation**.**
5. Develop point estimation or range to evaluate management estimate.
6. Assess the sensitivity of the assumptions used in VIU computation and evaluate the possible impact of those assumptions based on the head room of the impairment assessment**.**

(d) **Reliance of the internal audit work**

1. **Internal audit's organisational status and relevant policies and procedures.**
   - Are the internal auditor's objective – this is a recently established function and it is at the very early stage of conducting the internal audits.
   - This function is headed by former manager engaged in plantation activities. Although he is well experienced in plantation there is a question of the objectivity, if he is to conduct internal audits in his former areas of operations as some of the procedures would have been designed and implemented by him**.**
   - Presently under him only one staff who is also a part qualified accountant and still the structure to be expanded to take up more rigorous internal audit testing**.**

- There is no formal plan on internal audit work, the testing is done randomly. The reporting is to the FD, and it is not considered to be sufficient from independence perspective

2. ***The level of competence of the internal audit function***
   - The competency area of internal auditor is on planting and his qualification is on plantation. He has no experience as an internal auditor. As stated above, the staff member is also not a fully qualified accountant. Therefore, the level of competency is questionable.

3. ***Whether the internal audit function applies a systematic and disciplined approach, including quality control***
   - There is no indication of specific methodology applied for testing. The basis of selecting the areas for testing is not clear as some of these areas may not be critical considering the nature of the operations (e.g. travel) –
   - The documentation is not robust, only maintain findings relating to the testing. The method applied, sample selected, timing etc. not evident from the available information / documentation. Therefore, this will have an issue for the auditor to understand the nature, extent and timing of testing
   - The process to follow on remediating the issues noted is not formalized as to date the remediation actions have not been taken to address the issues noted by the internal auditor.
   - The reporting is restricted to the finance director not to the board level therefore whether the required actions have been taken is questionable.

(e) (i) **Applicability of KAM**

- KAMs applicable or mandated for the auditor's report of listed entities. As at 31 March 2019 the company remains unlisted and it is not mandatory for the auditors to report KAMs.
- However, if management opts the auditor can report the KAMs, then the applicable auditing standard shall be complied with.

(ii) **KAMs to be reported**

- **Biological assets** - The assets are valued at fair value which involves estimates and judgments. Additional focus is required from the auditors on these areas in understanding, assessing and evaluating the reasonableness of estimates which also include obtaining other corroborative evidence.
- **Revenue recognition** – due to the applicability of SLFRS 15 for the first time, this area requires assessment of right application of SLFRS 15 and requires auditor to focus. Further considering the present control environment auditor may have to focus on revenue recognition of the company.
- **Financial assets which includes equity instruments recognized as FVTOCI**. The equity instruments do not have a market price and estimates are involved as per new SLFRS 9. Therefore, assumptions and unobservable data are included. As a result, additional audit focus is required.

- **Impairment assessment of non-current assets used in the rubber plantations.**
  The rubber division is not performing well and this provides indicators on impairment. Therefore if impairment becomes applicable this becomes a key audit matter.

(f) **Prior year qualification**

- In this case the prior year qualification has been rectified during the year by valuing the inventories in accordance with LKAS 2. However, there is an impact on opening balance of inventories. The misstatement is seen in the opening balance as it is not rectified.
- The auditor needs to assess the impact of unresolved issues with respect to corresponding figures. If the impact of the opening inventory balance is material to this year's financial results, then the auditor needs to modify the audit report to that effect.
- If the impact is not significant, the auditor need not modify the audit report for this year.
- If adjusted in the current financial statements need not modify the audit report.

(Total: 50 marks)

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