SUGGESTED SOLUTIONS

KC4 – Corporate Governance, Assurance & Ethics

February 2020

Answer 01

Relevant Learning Outcomes/s; 5.1.1,4.1.1,4.5.1,4.4.2
Study text reference: 352, 595, 713

Accepting procedures

- P&P should ensure that there are **no ethical issues, including independence** which are a **barrier** to accepting nomination because as the external auditor it has to carry out its work objectively.
- P&P is a new client and in a different industry. Therefore it is important to ensure P&P Associates is professionally qualified to act as the auditor and that there are no legal or technical barriers (specially industry knowledge and application of accounting and auditing standards to this type of client engagement).
- P&P needs to assess existing resources and see whether these resources are adequate in terms of staff, expertise and time and if not whether any actions need to be taken to fill the resource gaps.
- As this is a new client, P&P should have a good understanding of the control environment of this client and its directors and other officers. As they are not known personally to P&P Associates, they must assess whether there is any record of adverse behavior, in carrying out their business' activities.
- It is important that P&P understand the reasons for there being a change in auditor, and whether they should consult the previous auditors, to ensure that there are no reasons behind the vacancy, which the new auditors ought to know of (for e.g. any ethical issues preventing P&P accepting this engagement).

(b) **Effect of the matters**

(i) **The industry experience of P&P –** Presently there are no audits of the mining industry and those persons with this industry experience, are no longer with the company. Therefore P&P should consider whether it has the right experience to audit the financial statements of GPL. In this instance, P&P Associates needs to consider whether they can have a specialist / expert to be involved for the audit, who will be part of the engagement team, or consider undergoing specific training on auditing and application of relevant accounting standards relating to mining, before engaging in this assignment. If it is feasible, P&P may accept the audit engagement.

(ii) **Raj Fernando –** He is a politically exposed person (PEP). Therefore, the firm policy on working with PEPs is to be considered, including obtaining the approval of the senior management of P&P Associates. Further, P&P Associates should take reasonable measures to establish sources of funds or wealth of this director, in order to ensure he is not involved in money laundering and corruption activities. Otherwise working with such PEPs will bring disrepute to P&P Associates.

(iii) **Director –** The auditor needs to understand allegations faced by Ajith Fonseka, and ascertain whether there had been any other adverse publicity of his behavior, in other directorships which he had held in the past. They would also need to know whether he has a significant shareholding of GPL, in his present role as director. So too, re any of the other members of the board, including any involved in the governance structure of the company. If these searches yield negative responses, the auditors may take into consideration, any other mitigating measures, and then accept the audit, accordingly. Ajith Fonseka may influence the company officers to get involved in illegal activities. The auditor should consider this fact when evaluating the integrity of the Company's officers.

(c) Sufficiency and appropriateness of audit evidence

- **Debtors' not responded**

  Since the debtors have not responded to their request and their call was not connected, this would seem to indicate that there is a risk of existence of such debtors or may be an indication of fraud. Although alternative procedures have been carried out, the audit team had been unable to verify whether the goods had in fact, been delivered to the customer. Therefore, the auditor should have done further audit procedures on actual delivery of the goods, existence of the debtors and the entity with whom the client had transacted. If these had not yielded satisfactory responses, they should have assessed the materiality and would have extended the sample to assess other similar debtors included in the financial statements of the company.

- **Differences in the confirmations received**

  The audit evidence has been largely from inquiries. Inquiries alone will not provide strong audit evidence. The auditor should have verified the sales with these entities (with differences in debtors' confirmations) to corroborate the explanation provided by the accountant, and design further audit procedures, if there had been any further differences.

- Differences in confirmations received –When inquiring via telephone calls the auditor should consider the appropriateness of the confirming party. Further, if the particular debtor confirms sales rather than year-end balance, the auditor should request the debtor to re-confirm the correct balance directly to the auditor, in writing.

- **Sequential order of invoices**

  The audit team had not been able to identify the exceptions to the completeness of the invoice listing. This should have been investigated thoroughly, and further explanations and evidence should have been obtained on those duplicated entries. This would have required the auditor to perform alternative audit procedures, to verify completeness of sales for the year.

The Auditor should have obtained the invoice listing and checked for duplicate and missing invoice numbers. Further, the auditor should have called for an explanation and conducted investigations on exceptions.

(d) Appropriateness of the paragraph

- This is an 'emphasis of matter' paragraph relating to the going concern of the company
- There is a material uncertainty as to the going concern of the company.
- When there is material uncertainty, the financial statements of the company should include appropriate disclosures on this matter and the uncertainties included with mitigating measures.
- In this case, there had been no disclosures made in the financial statements. Therefore, the auditor should have qualified its opinion on 'going concern'. If management agrees to make the required disclosures, emphasis of matter can be included, and reference made to the relevant note in the financial statements, as the intention is to draw the attention of users of the financial statements, to this matter.

(e) The company had not appropriately measured the non-current assets described in the scenario, which was considered to be in noncompliance with the applicable Sri Lanka Accounting Standard (i.e. LKAS 36). Therefore, this would be considered as a disagreement and considering the materiality, should have resulted in a qualification to the auditor's report.

However, given the materiality levels, this misstatement cannot be considered to be pervasive, in the financial statements.

Therefore, the audit report should have included a qualification re not recognizing impairment on non-current assets.

(Total: 25 marks)

Answer 02

Relevant Learning Outcomes/s; 2.4.1,.2.7.1	
Study text reference: 242, 318	

(a) The internal environment of S&S

- The members of the board were of differing viewpoints when it came to the internal control environment. Whilst some directors had identified the need for stronger control, the chairman had a negative attitude to internal controls, and viewed it as an administrative burden with no benefit to the organization, as it came with a cost.
- Although an Internal Auditor was appointed after identifying the needs of the business, it appears this appointment had not been made with serious intent. Prior to appointing the Internal Auditor, the company should have assessed what controls needed to be implemented, and which would then need be regularly verified by the Internal Auditor. However, in this instance the Internal Auditor was doing a routine operational activity rather than performing an internal audit function.
- With the growth and expansion in the business the need for formalizing the business processes had not been identified. Management had not identified the need to have qualified persons to oversee the business processes such as finance, procurement, and human resources, with the expansion of the business. The management is possibly of the view that the same controls that were in place since inception, would be sufficient to meet the needs of the expanded business.
- Levels of authority and responsibilities had not been appropriately assigned to the officers, as most decisions were taken by the chairman. Although a board was appointed, its activities had not been formalized. The chairman had a dominant personality and collective business decisions were not seen as important, for growth in the business.
- It was perceived that integrity and ethical values were not held as important, as overtime hours worked by employees had not been compensated and as a result the employees were leaving the entity. Therefore, there was a doubt as to whether the company was in compliance with the relevant laws and regulations.
- There were no clear strategies in place to deal with significant risks identified i.e. changes to the business, the competitive environment etc; and no timely responses could be made to counter such risks, as strategies had not been identified.
- There was concern as to whether the company had employed people with the right knowledge and competencies, to take responsibility for the main activities of the entity. For instance, the accounting function was overseen by a part qualified accountant and one person was in charge of procurement, administration and human resources, giving rise to the question re non-availability of skilled resources to operate the business activities.
- Overheads. These indicate the company does not have proper procedures or policy in place re its expansion activities and basic procedures re selection of suppliers for leasing necessary accommodation.

(b) Risk mitigating measures

1. Management should assess which age group of people, opt to buy online. On-line sales were to be introduced accordingly, and the outlets were to be more focused on selling fashion wear to other age segments. With the introduction of online sales, procedures were to be set in place to deliver goods sold in a timely manner, and this required changes to the existing business model.

2. Be alert about the changes in the fashion industry. Have a close partnership with the suppliers, to get the latest fashion items. To achieve this, a good relationship with the suppliers was important.

3. S&S has a traditional business model and it should seek changes to its business model as well as changes to its promotional activities. For example, web based promotional activities, specially the use of social media should be considered for advertising its products. New Arrivals in particular, should be promoted using social media, and through its website.

4. Expand online sales to overseas customers (specially targeting Sri Lankan communities living overseas) by getting into arrangements with the dealers who connect sellers to make online sales (line ebay).

5. Review existing product categories in the business and identify areas for expansion, to cater to changes in customer preferences and demand.

6. The company imports products from foreign countries and because of that it is exposed to foreign currency exchange rate fluctuation risk. This can be managed by entering into foreign currency forward contracts.

(c) Controls

Area	Control
(i) Completeness of daily sales of each outlet	Reconcile daily sales of each outlet and compare with cash collected and with credit sales made and ensure the cash collections are deposited and that cash in hand is deposited on the following day. These reconciliations to be prepared by someone and reviewed by an authorized person. Internal Auditor to perform random checks to ensure that this control is in place.
(ii) Selection of supplier for procurement	Identify potential suppliers and perform supplier due diligence. Call for tenders. A tender committee to be established to make recommendations and then the selection needs to be approved.
(iii) Existence of inventory items recorded in the system	Perform cyclical inventory verification to reconcile the physical inventory to system records and investigate variances if any. As the invoicing system and inventory system are integrated, missing inventories may be attributed to intentional misappropriation/ fraud. Therefore, the entity should fix security equipment on 'cloths and accessories' which indicate such fraudulent acts. Further, employees are required to be checked when leaving the business premises. Fixing of CCTVs in the stores and at the cash collection point, and monitoring CCTV records are also important.

(d) Effectiveness of the present Internal Auditor

- The appointment is only to respond to a specific issue. The scope covers operation control and has no reporting responsibilities with the reporting line that has been established. Therefore there is doubt whether his work adds value to the entity and whether the purpose is being achieved.
- The person is the previous accountant who was in charge of finance and accounting, which gives rise to questions re independence, especially if involved in carrying out internal audits which have an impact on accounting. (1 mark)
- The person is part qualified and therefore his competencies, and knowledge may also be in question.
- There is only one person performing internal audit work, and no team is established to effectively utilize the internal audit tools to benefit the organization

(e) Action to improve effectiveness

- Assign a qualified and experienced person to head the internal audit function and form a team to suit the organization.
- Agree an internal audit plan for the year which should be aligned with business strategy and the business needs of S&S
- Establish a reporting timeline and reporting channel to ensure their findings are communicated in a timely manner, and timely actions are taken to address such issues
- Agree the scope of work of the Internal Auditor and ensure that the entire function is made independent from operational activities.
- The Board of Directors should conduct an annual review of the Internal Auditor's work i.e. scope of work, authority, independence and resources
- Identify the technology required to enable the internal audit work to be conducted efficiently and bridge technology gaps.

(Total 25 marks)

Answer 03

Relevant Learning Outcomes/s;
Study text reference: 415/54/205/406/384/435

(a)

1. The engagement team's evaluation of the firm's independence in relation to the audit engagement:
   - Pedris & Co has provided significant IT related professional services.
   - The work included design of IT controls and implementation of digital IT App.
   - Independence threats if any are to be evaluated in providing implementation assistance for SLFRS 15 and 16 by Pedris & Co.

2. Malini should perform an objective evaluation of the significant judgments made by the engagement team
   - Fair value gain on consumable biological assets required significant judgments to be applied and an evaluation of prospective estimates to be carried out.
   - The impairment adjustment for non-current assets used for rubber production employs significant judgments and complex estimates about the future.

3. Malini should review the financial statements and the proposed auditor's report
   - The previous years audit report had been modified. Therefore Malini should discuss the conclusion reached by the audit team on the implication of the modification in inventory in the opening balance sheet, and in the draft audit opinion.

(b) The Audit Committee Charter should include the following: (no marks given for areas such as financial and management information reporting, internal controls, internal and external audits and conflict of interest.)

Under *role and authority* of the audit committee, the following areas are not included in the charter:

- retain independent experts to advise the committee
- seek any information it requires from management or employees-all of whom are directed to cooperate with the committee's requests- or those of external parties.
- meet with company officers, external auditors, or outside experts, as necessary.

The following aspect is inappropriate in the *Composition*:

- Two members may not be adequate as decisions can be deadlocked / difficult to arrive at

The following aspect is inappropriate in the *Meetings*:

- Two meetings are not adequate for effective and timely oversight
- Holding private meetings with auditors, and executives is best practice - and is not mentioned.

(c)

Pedris & Co has provided IT system implementation services to the company.

- The work involved included setting up and designing IT controls to mitigate risks. Designing of controls is a management activity, and as the auditor this can create a self- review threat.
- The situation creates a significant threat to independence of the auditor.
- Given the wide scope and taking of management responsibility for the IT transformation, it appears that the threats were not reduced or managed to an acceptable level
- Pedris & Co has provided assistance to UEL on implementation of SLFRS 15 and SLFRS 16. The scope of work should be evaluated to determine if there had been any threats to independence

(d)

- Malini acts as the EQCR for the audit engagement. The SLAuS 220 requires EQR to be carried out by a partner or other person, who is not part of the engagement team. Given Malini assists the audit team in the identification of IT related risks of the audit, she becomes a part of the audit team. This is not in compliance with SLAuS 220.

(e) (i)

– *Commitment and competence of staff*: in the accounting department at head office was not sufficient to meet the current demands in reporting. Also, a high staff turnover was witnessed that potentially caused issues to the effectiveness of internal controls.

– *Management style of operating* and *attitude and action towards financial reporting*: seems to lack focus. The Finance Director had continually highlighted the poor quality of financial information, but nothing seems to have been put in place to correct these issues, particularly the lack of accounting software in certain estates and the inability to prepare consolidated financial statements.

(ii)

Calculation of planning materiality based on a low proportion (max 10%) of PBT:

- Fair value gain - due to subjectivity - in measurement
- Carrying value of biological assets based on FV, due to significant judgments and estimates used.
- Accounting for Right of Use Assets and corresponding liability arising from leases, due to judgments involved in its measurement, based on incremental borrowing rate which is judgmental and a first time adoption
- Significant interest bearing loans and low interest cover threaten the ability to make future repayments, when due.
- Inventory counts having revealed variances and the existence of impact of closing inventory .
- Evaluation of Impact of modified opinion on the financial statements of UEL for the year ended 31 March 2018 and required audit procedures, to understand its recurrence.
- Impairment adjustment for non-current assets related to rubber production - due to subjectivity - in measurement, and Significant changes in actuarial loss in 2019 vs 2018

(iii)

1) The fair value of Biological assets is the biggest item in the balance sheet, which is subject to critical judgments and complex estimates. The relevant assertion is valuation.
   - Understand the valuation carried out by UEL and assess compliance with LKAS 41.
   - Appropriateness of valuation model used is to be determined.
   - Evaluate the judgmental inputs into the model. Such inputs would include projected cash flows, discount rate, growth rate, number of years in projection and other key assumptions, used.
   - Assess the appropriateness of the expert valuer involved as well as independence, objectivity and competence.

2) Adoption of SLFRS 16 for leases- requires complex determination of incremental borrowing rate given the circumstances in the pre-seen. The relevant assertion is valuation.
   - Understand how management has rationalized the IBR and determine its appropriateness by estimating the sensitivity of the IBR.
     OR
   - Understand and evaluate the appropriateness of the Reference Rate, financing spread adjustment, and lease specific adjustment.

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