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Serial No.....

**Institute of Certified Management Accountants of Sri Lanka**  
**Strategic Level**  
**May 2018 Examination**

**Examination Date :** 13<sup>th</sup> May 2018      **Number of Pages :** 05  
**Examination Time:** 1.30 p:m. – 4.30 p:m.      **Number of Questions:** 05

**Instructions to Candidates**

1. Time allowed is **three (3) hours**.
2. Total: **100** Marks.
3. Answer **all** questions in Part I and **three (3)** questions from Part II.
4. The answers should be in **English Language**.

| <b><u>Subject</u></b>                                      | <b><u>Subject Code</u></b> |
|--|----------------------------|
| <b>Corporate Governance, Control Strategy &amp; Ethics</b> | <b>(GCE / SL 4 - 404)</b>  |

**PART I**

Answer **all** questions

**Question No. 01 (40 Marks)**

**N&K Supermarket PLC**

Mr. Nissanka Wijerathna holds a Master degree in Business Administration from Harvard University and came back after serving as the Chief Operating Officer (COO) of a world-famous Supermarket Chain in Dubai in year 1998 with a dream to start a similar supermarket chain in Sri Lanka. Just after arriving, he discussed this idea with his good friend Mr. Kamal Gunaratne and agreed to proceed with it. They incorporated **N&K Supermarket (Pvt) Limited** in year 1999 and started the first supermarket in Colombo in 2000. Mr. Kamal Gunerathne also holds a Master's degree in Business Administration from University of Colombo. Both of them brought initial capital of Rs. 10 Mn equally and became initial directors of the company. Mr. Nissanka Wijerathna was the Chairman / Managing Director of the company while the Chief Operating Officer was Mr. Kamal Gunaratne.

The first outlet was successful and popular among the consumers and demand for supermarkets was high during that period. They decided to establish more supermarkets in order to expand the supermarket chain covering larger part of the country. Initial plan was to establish fifty supermarkets island-wide within next three years except in north and east since the war has been escalated in that area during that period. The required capital has been borrowed from the bank.

N&K gradually increased the number of supermarkets as stated above, and they changed the management strategy since the organization structure became larger than it was at the beginning. They appointed new four directors to the board and allocated responsibilities in different areas, Mr. Nimal Silva, a Chartered Accountant as the Finance Director, Mr. Gamunu Wijerathna who is elder son of Mr Nissanka Wijerathna, a Chartered Marketer as the Director - Marketing, Mr. Sunitha Thenabadu, Lawyer as the Director- Human Resources and Mr. Sunimal Perera, a B.Sc. Engineer from University Moratuwa as the Director-Supply Chain.

The growth of N&K increased tremendously and they kept opening outlets every corner of the island and became one of the largest supermarket chains in Sri Lanka. However, the N&K faced a liquidity issue due to the rapid growth and high leverage due to borrowing. A financial expert suggested going to the public to get the essential finance. N&K went public in year 2010 just after the end of the war, and sixty percent (60%) of the Stated Capital was traded in the Colombo Stock Exchange in the year 2010. Three more new directors, Mr. Nishantha Balasooriya who had worked as the Chief Operating Manger in a world-class retail chain in Australia, Mr. Mahesh Saparamadu, who is a practicing lawyer and Mr. Ramal Kodituwakku, who is a retired civil servant and served as a permanent secretary to Ministry of Finance were appointed in order to comply with the requirement of Code of Best Practice on Corporate Governance published jointly by the Institute of Chartered Accountants of Sri Lanka and the Securities Exchange Commission. Mr. Sunimal Perera joined as the Chief Executive Officer from the Namal Equity Fund PLC, which holds 8% of the ownership of N&K Supermarket PLC in December 2017. Table 1 below indicates the ownership structure of N&K Supermarket PLC as at 31/03/2018.

**Table 1: Ownership Structure of N&K Supermarket PLC as at 31/03/2018**

| Description                   | No. of Investors    | Holding %         |
|-------------------------------|---------------------|-------------------|
| Mr. Nisanka Wijerathna        | 1                   | 20                |
| Mr. Kamal Gunaratne           | 1                   | 20                |
| Institution Investors         | 15                  | 25                |
| Individual Investors (public) | <u>1,000</u>        | <u>35</u>         |
| <b>Total</b>                  | <b><u>1,017</u></b> | <b><u>100</u></b> |

**You are required to:**

- Explain what is meant by the Agency theory and discuss the applicability of the Agency theory to N&K Supermarket PLC. **(05 Marks)**
- Identify different corporate governance regulations that are applicable to N&K Supermarket PLC with reference to the respective regulations related to Sri Lanka. **(08 Marks)**
- Explain the importance of having a proper corporate governance framework for N&K Supermarket PLC. **(08 Marks)**
- Critically evaluate the structure of the board of directors of N&K Supermarket PLC in terms of *types of directors* on its board with reference to the Code of Best Practice on Corporate Governance of Sri Lanka, and suggest any action which should be taken to correct the situation. **(14 Marks)**
- Discuss challenges that are currently faced by Sri Lankan companies in terms of good corporate governance. **(05 Marks)**

**(Total 40 Marks)**

End of Part I

## Part II

Answer any **three (3)** questions

### **Question No. 02 (20 Marks)**

When Water Sup PLC (a listed company involved in water supply) decided to establish an internal audit function, the board approached Ms. Liana Fernando, an external consultant. She explained that internal audit is especially important in highly regulated industries but that it could also offer benefits to companies regardless of the industry context.

Liana was particularly keen to talk to Mr Mohan Alvis, the head of the audit committee. Mohan explained that because Water Sup PLC was a water supply company and therefore is highly regulated, he considered it important that all of the members of the audit committee were professional water engineers so that they fully understood the industry and its technical challenges. All three members of the audit committee were non-executive directors and all were recently retired members of the Water Sup PLC executive board. When Liana asked about the relationship with external auditors, it was said that they had an ‘excellent’ relationship, saying that this was because the external audit practice was run by the chairman’s son-in-law.

Liana said that one of the essential functions of internal audit is to provide assurance that the internal controls which underpinned financial reporting are effective. She said that effective internal controls are necessary for maintaining the integrity of financial reporting and that the new internal audit function could help with that.

#### **You are required to:**

- (a) Discuss the importance of internal audit in a highly regulated industry such as the water industry that Water Sup PLC operates in. **(08 Marks)**
  - (b)
    - (i) Evaluate whether Water Sup PLC’s audit committee is in compliance with corporate governance best practices related to audit committees. **(06 Marks)**
    - (ii) Explain why the audit committee is responsible for overseeing the internal audit function. **(06 Marks)**
- (Total 20 Marks)**

### **Question No. 03 (20 Marks)**

The Committee of Sponsoring Organizations of the Treadway Commission (COSO) is an organization providing thought leadership and guidance on internal control, enterprise risk management (ERM) and fraud deterrence. It is recognized as a leading framework for designing, implementing, and conducting internal control and assessing the effectiveness of internal controls. COSO released its long-awaited updated Internal Control Integrated Framework (new framework) in May of 2013.

- (a) According to the new COSO framework, in an “effective” internal control system, what are the five components that work to support the achievement of an entity's mission, strategies and related business objectives? Explain. **(10 Marks)**

Mrs. Rose Ferdinand, the Chairperson of the Board of Directors of FI, a non-banking financial institution, is concerned that the purpose of the internal control systems in the company are not fully understood, especially by the new board members. She has asked you to prepare a report for the Board covering the matters noted below.

- (b) You are required to explain in the context of an internal control system, the terms **control environment** and **control procedures and policies**, providing examples of the areas within a financial institution where an internal control system is expected. **(10 Marks)**

**(Total 20 Marks)**

**Question No. 04 (20 Marks)**

DLG PLC is a quoted public company listed in Colombo Stock Exchange. The Board of Directors (Board) comprises of 08 directors, of whom 07 are non-executive directors and one is an executive director who is the group chief executive officer (GCEO). The non-executive directors of the company have considerable depth of knowledge that has been collectively gained from experiences, whilst serving in a variety of public and private companies in various industries. The Board considers that the composition and expertise of the board is sufficient to meet the present needs of the group. Based on the declarations made annually by each of the non-executive directors in accordance with the requirement set out in the Listing Rules of the CSE, Mr. Gamini Silva, Mr. Mohan Fernando and Ms. Talatha Dalpadadu are considered as independent directors of the group. Mr. Kasun De Silva who is one of the non-executive directors holds the Chairmanship of the group since 2016. The roles of the Chairman and The GCEO are separate with a clear distinction of responsibilities between them, which ensure the balance of accountability and the authority between the running of the Board, and the executive responsibility for the running of the Group's business. The role of the GCEO, Mr. Hesana Wickramasooriya is to implement policies and strategies approved by the Board and develop and recommend to the Board the business plans and budgets that support the Group's long-term strategy and vision that would lead to the **maximization of shareholder value**. Other than the matters for the Board, the Board has adopted a Group policies and Limits of authority framework applicable to the Group, by which the Board has delegated authority to its Board committees and management. The Board is supported by the following committees.

1. **Audit Committee:** Mr. Gamini Silva is heading this committee. In addition, Mr. Mohana Feranando and Ms. Thalatha Dalpadadu serve as members of this committee.
2. **Nominating and Remuneration Committee:** Mr. Hesana Wicjramasooriya is the chairman of the committee while having one independent non-executive director and two non-executive directors as committee members.

**You are required to:**

- (a) Discuss the corporate governance structure of DLG group in relation to the Anglo-American Rule-based model. **(06 Marks)**
- (b) Critically evaluate the statement "maximization of shareholder value" with reference of the Stakeholder view on corporate governance. **(06 Marks)**
- (c) Analyze and comment on the composition of the two committees of DLG in relation to the Code of Best Practice on Corporate Governance. **(08 Marks)**

**(Total 20 Marks)**

**Question No. 05 (20 Marks)**

Surgical Rubber Product (Pvt) Limited (SRP) was established in Bulathsinhala as a subsidiary of HTL Export PLC in 1995. It is a leading manufacturer in industrial gloves to US and European markets. The key raw material used in manufacturing of rubber gloves is latex. Sri Lanka's production of natural rubber has been on a declining trend over the past few years, affected by adverse weather conditions, rising cost of production as well as subdued auction prices. Accordingly, a difficulty in sourcing raw material has been a key challenge faced by the Sri Lankan manufacturers. However, the demand for industrial gloves is on the rise due to increase in aging population and outbreaks of diseases. SRP'S main factory is situated in Bulathsinhala adjoining a stream which is a branch of "Kalu Ganga".

The company has introduced a mechanism to purify the waste and minimize the pollution that can occur due to manufacturing process. However, it has only maintained the minimum standard enforced by the related environmental regulatory body. The company has appointed a committee to look after the environmental pollution. The community of the area protested against releasing purified water (waste) into the stream as they use the river water for cultivation purpose as well as human consumption. Clean water supply has not been established in this area by the government.

The protest has been controlled by the company using forces such as helping in different ways to the key people in the community and also sending gift packs to key officers of the government regulatory bodies. The annual license from the environmental authority has been obtained annually despite these protests.

**You are required to:**

- (a) Discuss the importance of ethics while conducting business. **(06 Marks)**
- (b) Evaluate the behaviour of Surgical Rubber Product (Pvt) Limited in relation to the concept of business ethics. **(06 Marks)**
- (c) Recommend strategies on how Surgical Rubber Product (Pvt) Limited could resolve this issue ethically. **(08 Marks)**

**(Total 20 Marks)**

End of Part II

End of Question Paper

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