Certified Finance and Accounting Professional Stage Examination

The Institute of
Chartered Accountants
of Pakistan

7 December 2017
3 hours – 100 marks
Additional reading time – 15 minutes

Audit, Assurance and Related Services

Q.1 You are the audit manager of Mehmood Auto Limited (MAL), a listed company, for the year ending 31 December 2017. MAL assembles and manufactures a wide range of motor vehicles. All motor vehicles sold by MAL are under warranty up to a mileage of 50,000 km and are also eligible for free service every quarter for two years.

The extracts from the draft financial statements prepared by the management are as follows:

	2017	2016
	------- Rs. in million -------	
Revenue from sales of motor vehicles	54,000	70,000
Revenue from sales of spare parts	1,500	1,000
Cost of sales	(49,950)	(63,190)
Gross profit	**5,550**	**7,810**

	2017	2016
Assets	------- Rs. in million -------	
Property, plant and equipment	6,600	4,510
Deferred tax	233	194
Instalment sales receivables	1,200	700
Stock in trade	16,000	13,000
Other assets	13,817	15,476
	37,850	**33,880**

During the course of the audit, you came to know that there have been 37 instances of serious accidents involving newly manufactured cars where MAL had to pay compensation aggregating Rs. 145 million plus cost of repairs amounting to Rs. 14 million.

An investigation into the matter has revealed that 15 such accidents were because of failure of the brakes. The management has assured you that the fault has been identified and appropriate corrective measures have been taken in this regard. However, you have noted that the entire compensation amount is being shown as receivable from a supplier who has provided the brake system.

Required:
Identify the audit risks in the above situation and specify the key audit steps which you will perform in respect thereof. **(20)**

Q.2 (a) You have been the auditor of Venus Limited (VL) for past few years. During the current year's audit, the report of the valuation expert shows that the fair value of buildings of VL is slightly above their carrying amount. However, during the course of audit, you discovered a copy of a draft report by the same valuer in which the value assigned to the buildings was lower by Rs. 20 million. While investigating the matter, the audit senior has identified that had the assets been valued on the basis of the unsigned valuation report, it would have resulted in breach of a loan covenant. You have also noted that the same valuer has been used by VL for the last many years.

Required:
Specify the steps that you would take in the above situation and discuss the possible effects on the audit report, if the materiality limit on this audit is Rs. 80 million. **(10)**

(b) You are the audit manager at the client Lavender Product Limited (LPL). Your team had proposed various adjustments including the impairment of a plant. LPL's CFO has agreed to record all the adjustments including the impairment loss. However, the CFO is reluctant to disclose in the financial statements, the circumstances that lead to the impairment of plant and machinery.

Required:
Evaluate the above situation and state the implications on the audit report, if any. **(05)**

Q.3 You are the audit manager in GMP Chartered Accountants. The following matters are under your consideration for the year ended 30 September 2017:

(i) Kamran Limited (KL) is in the business of manufacturing generators. On 1 October 2016, KL acquired 750,000 ordinary shares of HL (which supplies generator components to KL), constituting 75% of the issued, subscribed and paid-up capital against a gross consideration of Rs. 700 million. KL paid Rs. 500 million on the date of acquisition whereas Rs. 200 million was paid on 1 October 2017.

At the acquisition date, the identifiable net assets were recognized at their carrying amount which was approximately equal to the fair value of Rs. 670 million, except the building and leasehold land whose fair value was assessed at Rs. 130 million above their carrying amount. The fair value of NCI at the date of acquisition was assessed at Rs. 155 million.

KL recognised goodwill amounting to Rs. 45 million on acquisition of HL, under the full goodwill method.

(ii) Waris Limited has changed its accounting policy for property, plant and equipment from historical cost to revaluation model.

Required:
Guide your audit team on key audit procedures with regard to the above information. **(15)**
(Audit procedures related to verification of property, plant and equipment are not required)

Q.4 Aster Textile Limited (ATL) manufactures industrial grade safety garments. It uses certain chemicals whose waste needs to be disposed of in a certain manner to prevent any harm to the environment.

The government has prescribed the safety standards which are required to be adhered to, with regard to disposal of these chemicals. ATL has its own internally developed standards which have been approved by some of its international customers. These customers require that ATL as well as all its suppliers should comply with these standards. However, the standards set by the government are far more comprehensive and stringent as compared to ATL's internally developed standards.

ATL has approached your firm to report on compliance with its internally developed standards. ATL has informed you that the report would be submitted to the concerned international customers.

Required:
In the light of the relevant international standards on assurance engagements:

(a) Discuss what steps would you take before deciding to accept the above assignment. **(12)**

(b) Assuming that you have accepted the engagement, what matters would you like to include in your report to ensure that it is not misleading for the intended users. **(03)**

Q.5 You have recently completed the audit of the financial statements of Rose Limited (RL), a listed company having a net profit of Rs. 1,500 million. You have identified following matters which will be reported as key audit matters in the audit report:

(i) RL has pending tax litigation in which tax department has raised demand aggregating Rs. 175 million. The demand has been challenged by RL and the decision in respect of this matter is currently pending. The amount is disclosed as a contingent liability in the financial statements.

(ii) RL makes significant purchases from related parties and also incurs significant advertising expenses through related parties. These transactions are properly disclosed as related party transactions in the financial statements.

(iii) RL has decided to sell a manufacturing facility located in Faisalabad having a carrying value of Rs. 300 million and would replace it with another facility in Gujranwala. The manufacturing facility has been classified as non-current assets held for sale.

Required:
Draft the key audit matters section to be included in the audit report of RL relating to the above matters. ***(You may assume necessary details where required)*** **(15)**

Q.6 You are the quality control partner of Lotus & Co. Chartered Accountants. You have been assigned additional responsibilities for assessment of risks associated with the firm's clients. At present, the following matters are under your consideration:

(a) Clean Limited (CL) has failed to pay the fee for review of its half yearly accounts for the six month ended 30 June 2017. The issue was discussed with the management in the planning meeting for the audit of the year ending 31 December 2017. The management has assured that the amount would be paid in about 30 days. During the discussion, the audit manager was also informed that CL has been facing liquidity issues and it has closed two of its plants. The management has also requested for a reduction in the audit fee for the year ending 31 December 2018 because of the decline in the volume of business. Further, the management has requested the firm to consider some relief as regards audit fee for the current year. **(10)**

(b) During the review of working papers of Daffodil Limited (DL), the engagement manager came to know that a large consignment of import of raw material is stuck with the custom authorities. On his query he was informed that the DL's clearing agent was unable to resolve the matter. However, now DL has approached another custom clearing agent for clearing the said consignment and the matter with the custom authorities would be resolved shortly. DL has agreed to pay 1.4% of the value of consignment to the clearing agent. A junior member of the team has informed the engagement manager that clearing agent appointed by DL is the brother of the audit senior. **(05)**

Required:
Discuss the categories of threats involved in each of the above situations and advise the possible course of action that may be followed.

Q.7 Bluebell Foundation (BF) is a non-profit organisation. It is in the process of receiving a grant from the federal government. To receive such grant BF has to submit a report of factual findings on the projects being run by BF. The trustees approached your firm and on their request you provided a specimen of the report that may be issued in the given situation.

Subsequently, you have received a letter from the trustees in which they have requested to remove the statement from the report, *"this report is not to be distributed to any other parties other than the federal government"*, as BF also intends to distribute the report to its current corporate donors.

Required:
Discuss how the firm should deal with the request of the trustees. **(05)**

(THE END)