



Audit, Assurance and Related Services

Q.1 You are the audit manager of Saqib Shaukat and Company, Chartered Accountants, responsible for the audit of Modern Electronics Limited (MEL) for the year ended 31 May 2018. MEL is a listed company and is engaged in manufacture of wearable sports sensors, smart watches, GPS navigation systems, vehicle cameras and fleet management system, and sells it through a chain of distributors throughout the country.

The extracts of segment information as disclosed in the draft financial statements for the year ended 31 May 2018 is as follows:

	GPS navigation system		Wearable sports sensors		All other segments		Total	
	2018	2017	2018	2017	2018	2017	2018	2017
----- Rs. in million -----								
Revenue	6,323	7,978	4,119	5,319	3,480	2,346	13,922	15,643
Cost of sales	(3,830)	(5,158)	(3,234)	(4,149)	(2,749)	(1,643)	(9,813)	(10,950)
Gross profit	2,493	2,820	885	1,170	731	703	4,109	4,693
Net profit	1,141	1,244	257	351	133	282	1,531	1,877
Fixed assets	1980	2,329	2,395	2,661	2,777	1,662	7,152	6,652
Debtors	633	685	361	488	334	196	1,328	1,369
Inventory	640	665	378	444	294	196	1,312	1,305

The following information is also available:

- (i) MEL was witnessing a shift of customers from wearable sports sensors to smart watches which have additional features as compared to the features being offered by wearable sports sensors. Therefore, to maintain its customer base MEL started developing its own smart watch and successfully launched it in 2018. MEL intends to expand its product range in the smart watch segment by expanding its manufacturing facility which would be financed through a right issue.
- (ii) On 10 April 2018 MEL publicly announced that it was closing an old (fully depreciated) plant which was used to manufacture a component used in the wearable sports sensors and will instead import it from China at cheaper rates. The management is considering various options in respect of this plant. However, the affected employees were communicated about the decision on the same date and negotiations with the labour union were started for agreeing on the termination payments.
- (iii) A significant portion of the sale of GPS navigation system consists of sale to the tourism industry. The government had made it mandatory for all tour operators to install GPS navigation system. The compliance has to be made by all tour operators over a period of four years. Association representing the country's tour operators had signed a four-year agreement in April 2016 with MEL under which discounted sale price has been offered to the tour operators which cannot be raised. A natural disaster destroyed the supplier's plant which supplied several components of the GPS navigation system and consequently MEL has to import these components from Malaysia at twice the cost of local purchase. At the year-end 200 contracts for supply of 4,000 GPS navigation systems are still pending.

Required:

Identify the audit risks in the above situation and specify the key audit steps which you will perform in respect thereof.

Q.2 Your firm has been approached by Eagle Courier Limited (ECL) to provide due diligence review on a potential acquisition. ECL is a leading courier service company having a network of offices throughout the country. ECL has a vast fleet of delivery vans and motorcycles.

ECL intends to use its courier industry experience and expand into food delivery business by using its current fleet of motorcycles. However, it would require bringing on board a vast number of restaurants and build its own online food ordering website, of which they do not have any expertise and experience.

For this purpose, ECL has identified an online food ordering business Foodi.com (FC) for acquisition. FC is a partnership concern and was set up by three college friends in 2014. FC received the best 'start-up business' award in 2015. Founders of FC had borrowed funds from two individual investors, which are to be repaid in 10 years.

IT, restaurant relation, customer support and administrative departments are led by the partners. Being an online service business, the only major assets of FC are a fleet of motorcycles obtained on an operating lease of 5 years and computers.

Apart from 500 riders, FC employs 30 staff, out of which 10 are related to IT department, 10 belong to customer support, 5 belong to restaurant liaison and the remaining 5 are responsible for the accounts, HR and administration of the business.

Extracts from audited profit or loss statement for four years are as follows:

	2017	2016	2015	2014
----- Rs in million -----				
Revenue	55,000	50,000	20,000	10,000
Operating expenses	(34,650)	(30,000)	(16,000)	(15,000)
Lease rentals	(5,750)	(4,600)	(2,875)	(1,150)
Operating profit/(loss)	14,600	15,400	1,125	(6,150)
Finance cost	(3,075)	(3,155)	(1,615)	(1,615)
Profit/(loss) for the year	11,525	12,245	(490)	(7,765)

Required:

Identify and explain the matters you would focus on in your due diligence review. Also identify any additional information / document you would require during the review. (15)

Q.3 You are the audit manager of Zia Yaqoob & Company Chartered Accountants. You have asked Aslam, one of the team members assigned on the audit of Black Sugar Limited to draft the audit report for the year ended 31 May 2018. The extracts from the draft report are as follows:

Adverse Opinion

In our opinion, except for the effects of the matter described in the Basis for Adverse Opinion section of our report, the accompanying financial statements present fairly, in all material respects the financial position of the Company as at 31 May 2018, and its financial performance and its cash flows for the year then ended.

Basis for Adverse Opinion

The Company's stores and spares consist of capital spares of machineries for smooth and uninterrupted production of sugar during the crushing season. These are carried at lower of cost and net realisable value as per IAS-2. The Company's Chief Financial Officer has refused to reclassify it as capital stores and spares as per IAS-16 as it would adversely affect the current ratio, as prescribed by the financial institutions. We verified the Company's records and ascertained conclusively the value of the capital spare at Rs. 100 million. Had the management stated them as capital spares, Non-Current assets would have increased by Rs. 100 million and consequently Current Assets would have reduced by the same amount.

Emphasis of Matter Paragraph

We draw attention to note 2 to the financial statements, which describes the early adoption of IFRS-2. However, due to time limitation, certain disclosures required by IFRS-2 could not be provided in the financial statements. Our opinion is not modified in this respect.

Required:

Critically analyse the audit report drafted by Aslam.

(11)

Q.4 Chester Limited (CL) has introduced an equity settled share based payment plan for its executives on 1 April 2017. Under the plan, 50 of its executives have received 100 share options each, which will vest on 31 May 2022 if the executives remain in employment at that date and CL’s share price increases to Rs. 180 at 31 May 2022.

Required:

Mention the key audit procedures for share based payment options described above, assuming that evaluation of the competency and integrity of the management expert has already been tested.

(06)

Q.5 Nisar Khalid & Co. Chartered Accountants (NKC) has been approached by Hector Limited (HL) a listed company, for appointment as HL’s auditors for the year ending 30 April 2019.

The core departments of NKC along with the names of the partners are as follows:

Assurance Department	Quality Control Department	Tax & Corporate Advisory Department
Nisar	Ali	Khalid
Hashmat	Usman	Ovais
Moin		Hasan
Rashid		
Arif		

NKC intends to appoint Rashid as the engagement partner. As part of the client acceptance procedures, an email was circulated to all the staff of the firm to disclose any investment in HL and its related parties by any partner/employee or their family member(s).

A summary of response of Rashid and his staff is as follows:

- Rashid has confirmed that he does not hold any shares in HL although his wife has invested Rs. 2 million in a mutual fund. The mutual fund has invested 14% of its total investment in shares of HL.
- Zahid has been working as an audit manager with Rashid. Zahid has disclosed that he has invested Rs. 50,000 in the shares of Troy Limited (TL). HL owns 20% shareholding in TL.

Response by other partners of the firm are as follows:

- Ali has invested Rs. 45,000 in the shares of Achilles Limited, which is the holding company of HL.
- Ovais has confirmed that his son has invested Rs. 500,000 in the debentures issued by HL.

Response by other staff of the firm:

- Some of the junior audit staff who are not working with Rashid and the staff of the firm’s accounts department have confirmed holding in shares of HL of nominal amounts ranging from Rs. 5,000 to Rs. 60,000.

Required:

In the light of Code of Ethics for Chartered Accountants, evaluate the above situation and discuss the threats (if any) in each case along with the available safeguards if NKC decides to accept the assignment.

(15)

Q.6 (a) The following information relates to the audit of Apex Fertilizer Limited (AFL) for the year ended 31 March 2018:

- AFL has incurred gross loss which is mainly because AFL's plant was not running on optimum capacity due to severe shortage of gas supply from the government. However, AFL has recently made arrangements with a privately owned company for supply of gas. Management expects that continuous supply of gas would help AFL to convert its gross loss into gross profit, although achieving net profit would require more efforts.
- Several instalments of the long term loan appearing on the balance sheet were overdue. AFL entered into a restructuring agreement with the bank on 7 April 2018 whereby the outstanding interest has been converted into a loan of three years and principal payments have also been relaxed. The first payment of principal is now due in July 2019 and the amounts have been reclassified on the basis of the restructuring agreement.
- The method for the depreciation of plant and machinery has been changed from straight line to units of production method.
- The directors' report includes the following information:

"We have entered into a gas supply arrangement with Karim Gas Limited from August 2018. A continuous gas supply will help us to attain the optimum production level and record profits in the next financial year. Furthermore, several cost saving measures have been taken, as a result of which fixed costs have reduced by 15%.

The company has entered into a restructuring agreement whereby the lenders considering the potential of the company's vision and strategies have further extended and relaxed the terms of future payments. As a result, our liquidity position has improved which is depicted by a much improved current ratio."

Required:

- (i) As the audit manager what issues would you like to discuss with the management in respect of the above (other than the issue of going concern)? (10)
- (ii) What could be the possible impact on the audit report if the management does not agree with your point of view about the issues raised in (a) above? (04)
- (b) During the audit of a listed client Pixel Limited (PL), you became aware that a legal action has been instituted against PL by a competitor, on account of infringement of patent rights. The company's lawyer was not able to give any estimate about the outcome of the case.

No provision was made in the financial statements for the possible loss as a result of the claims (which are considered to be material), although details of those legal claims were fully disclosed in the notes.

Required:

Draft how the above matter would be reported in the key audit matter section of the audit report. (*You may assume necessary details*) (05)

Q.7 Kiran is the audit senior responsible for the audit of Xengen Limited. She has noticed that a large number of journal entries were processed near the year end.

Required:

- (a) What controls should she expect to be in place for recording and processing of journal entries? (07)
- (b) What course of action should the audit team take if serious deficiencies are identified during the control testing process? (07)

(THE END)