Multi Subject Assessment Stage

The Institute of
Chartered Accountants
of Pakistan

5 June 2017
3 hours and 30 minutes
100 marks

Financial Reporting and Assurance – Professional Competence

CENTRALISED REGISTRATION NUMBER (CRN)

INSTRUCTIONS

Read the instructions carefully before answering the question:

1. Answer all **THREE** questions.

2. Write your Name and Roll Number on the top perforated portion of the **MAIN ANSWER SCRIPT ONLY.** Do not write your Name, Roll Number or any other identification mark on any other portion of the main or supplementary answer script.

3. Answers to each question must begin on a new page and must be clearly numbered. Use both sides of the paper in your main and supplementary answer script.

4. Answer each question in black pen only.

5. Do not write anything on the question paper except CRN.

6. The questions in this paper have been prepared on the assumption that candidates will not have a detailed knowledge of the types of organisations to which they relate. No additional mark will be given to candidates displaying such knowledge.

7. Only **FIVE** original books duly bound shall be allowed.

8. Mathematical tables will be supplied on request.

QUESTION 1

You are an audit senior with Wazim and Co, a firm of Chartered Accountants. Shahid Chowdry is the audit manager of Jan Company Limited (JC) and has asked you to be the new audit senior for JC. Shahid would like you to assist with the audit planning; he has recently attended a planning meeting with the client and has presented you with information to assist you in this task.

He has provided you with background information about JC in Appendix 1, the draft financial statements of JC in Appendix 2 and a summary of his recent meeting with the client is in Appendix 3.

Shahid also presents you with information about a phone call between himself and the finance director of JC. The detail of this phone call is provided in Appendix 4 along with financial forecast in Appendix 5.

(a) Shahid has sent you an email asking you to prepare a working paper in which you:

(i) Review JC's financial statements for the year ended 30 April 2017 (Appendix 1) and the background information (Appendix 2) and identify key audit risks.

(10 marks)

(ii) Identify the key audit risks and explain the correct financial reporting treatment for the transactions outlined in the planning notes (Appendix 3), and prepare journals for any potential adjustments that you identify.

(20 marks)

(iii) Outline the key audit procedures for the transactions outlined in the planning notes (Appendix 3).

(10 marks)

Ignore taxation.

(b) The email also asks you to prepare a file note that covers the following issues:

(i) Identify the ethical issues arising from the client's request for us to undertake the assurance engagement (Appendix 4).

(5 marks)

(ii) Assuming we accept the engagement, outline the key procedures on the forecast prepared by the client (Appendix 5).

(5 marks)

Requirement
Draft the working paper and file note requested by the audit manager.

Total: 50 marks

Appendix 1 – Background information on JC provided by Shahid Chowdry

JC is a long established company that operates through two divisions, one division in food processing and the other division in chemicals manufacturing. Until recently the company had a small number of factories, primarily centred in one geographical area. JC was historically managed by a highly experienced group of senior managers and directors and was consistently profitable but with very low growth rates. After the appointment of new directors further opportunities for growth were identified and JC began to pursue a strategy of significant growth. This strategy was successful and resulted in JC listing on the Stock Market during 2016.

A key area of growth was entering into contracts for supplying food products to major supermarkets and other retailers. This growth began in 2016 and for the first time in their history JC have borrowed money to fund this growth. JC have ambitious plans to continue the growth of the business and the expansion will continue into the next financial year. These plans will require JC to raise additional finance. The sales director is currently negotiating new contracts that will require significant investments in new processing plants. This has resulted in the finance director being under pressure to ensure the financing arrangements are all agreed as soon as possible.

Having read a number of industry journals I am aware that there is an increased scrutiny on hygiene standards within the food processing industry. The articles did not refer to any specific companies but they suggested that inappropriate practices were widespread throughout the food processing industry. The Food Standards Agency commented that they will be actively pursuing investigations in this area.

Historically the company has only operated in Pakistan but during this financial year they have also expanded overseas; this has resulted in them supplying overseas customers and acquiring an overseas processing plant.

Last year's audit was challenging due to timing pressures as a result of the listing requirements along with issues regarding the competence of JC's accounting and finance department. JC's Finance Director has now assured me that they have recruited a qualified chartered accountant with sufficient technical competence and experience to deal with complex transactions and reporting requirements.

APPENDIX 2 – EXTRACTS FROM DRAFT FINANCIAL STATEMENTS OF JC

Statement of profit or loss and other comprehensive income for the year ended 30 April 2017

	2017 draft	2016 audited
	Rs. in million	
Revenue	970	670
Cost of sales	(365)	(301)
Gross profit	605	369
Administrative expenses	(160)	(140)
Profit from operations	445	229
Finance costs	(145)	(70)
Profit before tax	300	159
Taxation	(54)	(29)
Profit for the year	246	130

Statement of financial position at 30 April 2017

	2017 draft		2016 audited	
	Rs. in million			
Assets				
Non-current assets				
Property, plant and equipment		4,770		3,101
Current assets				
Inventories	35		25	
Receivables	65		42	
Cash and cash equivalents	20		92	
		120		159
Total assets		4,890		3,260
Equity and liabilities				
Equity				
Share capital		1,650		1,650
Share premium		250		250
Reserves		822		226
		2,722		2,126
Non-current liabilities				
Long-term borrowings		1,500		1,050
Deferred tax liabilities		20		5
		1,520		1,055
Current liabilities				
Bank overdraft		557		12
Trade and other payables		59		42
Tax liabilities		32		25
		648		79
Total equity and liabilities		4,890		3,260

Appendix 3 – Notes taken by Shahid Chowdry at audit planning meeting with client

(1) On 1 January 2017 JC granted 1,000 share options to 1,500 of its employees. The conditions attached to the share options are that the employees must remain in employment for 3 years and the share price of JC must be more than Rs. 450 for the options to vest. This is the first time JC has granted share options.

At the year end the share price of JC was Rs. 300, therefore the finance director has not accounted for the share option scheme as the vesting condition has not been met. The fair value of the option at the grant date was Rs. 250 and at the year end the fair value was Rs. 270.

(2) JC owns an overseas food processing plant that was acquired on 1 May 2016 for Y$ 7 million when the exchange rate was Rs. 1/Y$ 0.5. The year-end carrying value has been calculated as Y$ 5 million. The finance director believes that due to changes in recent legislation an impairment review is required. The recoverable amount of the plant was assessed as Y$ 6 million. The finance director used the exchange rate prevailing at the time of purchase to convert this amount into Rs. and concluded that no impairment was required.

The exchange rate on 30 April 2017 was Rs. 1/Y$ 0.7.

(3) On 1 May 2016 JC acquired a new machine to be used in one of its chemical plants at a cost of Rs. 100 million, with an estimated useful life of 20 years. The finance director states that the machine has been capitalised at cost and correctly depreciated; however, he then mentioned that the machine will need dismantling safely at the end of its useful life for a significant cost. He has been told that the production team have estimated that the cost at the end of its estimated useful life is estimated at Rs. 25 million but as this will arise in the future he has excluded this from the draft financial statements. JC's cost of capital is 10%.

(4) On 1 May 2016 JC raised Rs. 400 million (at par value of Rs. 100) by issuing convertible bonds which are convertible to equity shares in 5 years' time. The finance director tells us that the board is confident that the bond holders will all opt to convert to shares at maturity; this is based on their confidence in the future increase in JC's share price. The finance director has therefore treated the Rs. 400 million cash received as equity.

The convertible bonds carry an interest rate of 5% and similar non-convertible bonds would carry an interest rate of 8%.

At the year end the interest due on the convertible bonds has not been paid.

Appendix 4 – Details of a phone call between Shahid Chowdry and the finance director at JC

I received a phone call from JC's finance director to discuss their proposed bank loan. JC has prepared a forecast to support this bank loan. The finance director said that the bank has requested an assurance report on the forecast. The finance director was very insistent that we prepare the assurance report and the additional cost would be very low as the work involved should be part of the normal audit process. The finance director also mentioned that the directors have discussed the possibility that the audit might be going out for tender in the near future.

APPENDIX 5 – FORECAST PREPARED IN SUPPORT OF A BANK LOAN

Profit and cash flow forecasts for the year ended 30 April 2018

	2018 forecast Rs. in million
Revenue	1,570
Cost of sales	(588)
Gross profit	982
Administrative expenses	(185)
Profit from operations	797
Finance costs	(400)
Profit before tax	397
Taxation	(70)
Profit for the year	327
Profit before tax	397
Add back depreciation	250
Working capital movements	(20)
Tax	(30)
Dividend	(50)
Purchase of PPE	(1,500)
Loan	1,500
Net cash inflow	547
Opening cash balance (557–20)	(537)
Closing cash balance	10

QUESTION 2

Best Engineering Group (BEG) is a family run company that is controlled by the Swan family. BEG has been expanding and is looking towards a future listing on the stock exchange. You have just been appointed as the financial controller of BEG having taken over from a family member. Your first task is to review the draft consolidated financial statements of the group that were prepared by the previous financial controller, these are presented in Appendix 1. The finance director, Asad Swan, is aware that there have been changes in the group structure but he is not sure of the impact this will have on the group's result. The changes to the group structure are outlined in Appendix 2. He has to present the information to the board of directors and needs your help. The board is very concerned about profit levels as a result of their future plans to list the group.

Whilst looking through some handover files from the previous financial controller you have discovered a handover note (Appendix 3) about an acquisition that took place during the financial year. You are concerned about the potential issues raised by this transaction.

The finance director has asked you to prepare the following:

(a) A briefing note explaining the impact of the transactions on the consolidated statement of profit or loss and other comprehensive income for the year ended 31 March 2017.
(Use the transactions outlined in Appendix 2.)

(15 marks)

(b) A redrafted consolidated statement of profit or loss and other comprehensive income for the year ended 31 March 2017.

(Use the transactions outlined in Appendix 2 and ignore the information given in Appendix 3.)

Ignore any further income tax or deferred tax adjustments.

(6 marks)

(c) Explain any accounting and ethical issues arising from the handover notes (Appendix 3) and outline any actions you should take.

(4 marks)

Requirement
Respond to the finance director's request.

Total: 25 marks

Appendix 1 – Draft consolidated statement of profit or loss and other comprehensive income for the year ended 31 March 2017

	Rs. in million
Revenue	9,000
Cost of sales	(2,225)
Gross profit	6,775
Operating expenses	(1,870)
Profit from operations	4,905
Finance costs	(475)
Profit before taxation	4,430
Income tax expense	(768)
Profit for the year	3,662
Other comprehensive income	
Revaluation	670
Total comprehensive income for the year	4,332
Profit attributable to	
Non-controlling interests	358
Owners of parent company	3,304
	3,662
Total comprehensive income attributable to	
Non-controlling interests	470
Owners of parent company	3,862
	4,332

Group structure

BEG has controlling interests in the following companies:

- Daud Ltd (DL) 85% holding that was acquired in 2014
- Electronics Ltd (EL) 65% holding that was acquired in 2012
- Gahib Ltd (GL) 75% holding that was acquired in 2013

The previous financial controller prepared the draft consolidated financial statements on the assumption that there had been no changes in the group structure.

APPENDIX 2 – TRANSACTIONS DURING THE YEAR

Gahib Ltd (GL)

On 1 October 2016 BEG sold 112.5 million shares in GL from its existing holding of 187.5 million shares, for Rs. 1,200 million. The value of the remaining shares that it still owned was Rs. 250 million at 1 October 2016.

The following information is provided for GL:

Statement of profit or loss and other comprehensive income for the year ended 31 March 2017

	Rs. in million
Revenue	1,350
Cost of sales	(375)
Gross profit	975
Operating expenses	(230)
Profit from operations	745
Finance costs	(80)
Profit before taxation	665
Income tax expense	(120)
Profit for the year	545

On acquisition of GL goodwill had been calculated at Rs. 350 million and it had been impaired by Rs. 100 million in the year ended 31 March 2015. Non-controlling interest is calculated using the proportion of net asset method.

The equity section of GL's statement of financial position as at 31 March 2016 was:

	Rs. in million
Share capital – Rs. 1	250
Share premium	75
Retained earnings	277.5

GL had not paid or declared any dividends for the year ended 31 March 2017 and the profits of GL accrue evenly over the year.

FGH Engineering (FGH)

On 1 April 2016 BEG acquired 4,000 million shares in FGH Engineering (FGH), a company located overseas, paying G$15,000 million.

The following information is provided for FGH:

Statement of profit or loss and other comprehensive income for the year ended 31 March 2017

	G$' in million
Revenue	1,700
Cost of sales	(700)
Gross profit	1,000
Operating expenses	(230)
Profit from operations	770
Finance income	12
Profit before taxation	782
Income tax expense	(55)
Profit for the year	727

Extracts from statement of financial position of FGH as at 1 April 2016

	G$' in million
Share capital – G$1	5,000
Retained earnings	12,000

At 1 April 2016 FGH owned a piece of land that had a carrying value of G$2,000 million. A fair value exercise showed that the fair value of the land was G$2,120 million.

BEG is measuring non-controlling interest using the proportion of net asset method. The directors performed an impairment review at 31 March 2017 and they concluded that goodwill had been impaired by 10%.

Exchange rates are:

1 April 2016	Rs. 1/G$2.7
Average for April 2016–March 2017	Rs. 1/G$2.5
31 March 2017	Rs. 1/G$2.4

APPENDIX 3 – HANDOVER NOTE FROM PREVIOUS FINANCIAL CONTROLLER

During 2016 we acquired an investment in a start-up technology company, WebDesigners (WD), as a way of diversifying our business. BEG acquired 48% of the shareholding in WD for a cost of Rs. 1,000 million and this has been recorded as an investment, within non-current assets. As WD is a start up company they have not paid a dividend and I understand our board of directors have been told there is no profit impact from this transaction.

I have seen a document associated with the share purchase that mentions BEG having an option to purchase an additional amount of shares that would increase BEG's holding to over 50%. I also understand that two of BEG's directors attend Board meetings of FGH and are heavily involved in the decision making process. I tried to discuss this issue with Asad Swan but he told me that he was satisfied that the accounting treatment is correct. I knew that the board of directors were unlikely to listen to my concerns as they fully trust Asad Swan.

A recent news article reported that WD was making significant losses but commented that WD could be the next Facebook.

QUESTION 3

BTV is a company that produces TV programmes and news items for a variety of TV channels. BTV is controlled by Fazal Bashir and the board has been concerned that Fazal is disappointed with the performance of BTV. The directors are aware that he may be considering selling his shares in the near future.

You are Maria Fahad and you work as an audit senior for Zafar, Awan & Company (ZA) Chartered Accountants. The audit manager, Shaan Sardar, has asked for your help with the review and completion stage of the audit as he is concerned that the audit procedures performed by a staff member have not covered the potential audit issues relating to prepayments and receivables. Shaan has provided you with a working paper (Appendix 1) that Javed Yousaf, the audit junior, has prepared. Shaan received a phone call from Rafiq Sabri, the finance director of BTV, and he has provided you with a summary of the phone call (Appendix 2).

He has asked you to prepare a working paper that covers the following issues:

(a) Explain the key weaknesses in the audit procedures performed by Javed. Identify additional audit procedures that are required to ensure we obtain sufficient and appropriate evidence before we sign the audit report (Appendix 1).

(14 marks)

(b) Identify, where relevant, any financial reporting issues not identified by the audit junior (Appendix 1).

(5 marks)

(c) Summarise the audit issues arising from Shaan's phone call with Rafiq and outline the impact this could have on BTV's audit report (Appendix 2).

(3 marks)

(d) Explain the financial reporting implications for the proposed transaction identified in the e-mail from Rafiq Sabri (Appendix 3).

(3 marks)

Requirement
Draft the working paper requested by the audit manager.

Total: 25 marks

Appendix 1 – Working paper prepared by Javed Yousaf

This working paper summarises the results of audit procedures performed on prepayments and receivables for BTV for the year ended 31 May 2017.

Planning materiality is Rs. 102 million.

	31 May 2017	31 May 2016
	----------- Rs. in million -----------	
Trade receivables	800	450
Accrued income	10	90
Property sale	140	–
Prepayments	70	55
Total	1,020	595

Trade receivables

The results of analytical procedures have identified that the main reason for the large increase in trade receivables is amounts owed relating to the production of a new TV show. BTV has invoiced Channel 45 for Rs. 295 million which is the total amount due under the contract during April 2017. I have agreed the amount to the production agreement and the cash has been received after the year end. Whilst looking at the agreement I did notice that BTV has agreed to produce 12 episodes over a period of 6 months.

Cash after date testing was performed on 75% of the year-end trade receivables amount and results were satisfactory except for 2 balances. An amount of Rs. 200 million was still outstanding from AE Channel when I performed my testing and the finance team were unsure of when the amount would be received. I have been informed that the invoice was raised just before the year end on the instructions of the finance director but that have not received any agreements or contracts to identify when the amounts are due.

An amount of Rs. 40 million, due from SL News, has been outstanding for over 6 months. Following a discussion with the credit controller I was told that the client is disputing this invoice which was for cost overruns on the production of some news items. I have performed no additional testing as the amount is immaterial.

Included within trade receivables is an amount that BTV is owed from an overseas TV channel. The invoice was issued in a foreign currency. I checked that the amount had been correctly translated at the spot rate on the invoice date of 8 April 2017. When the cash was received late in June 2017 BTV retranslated the amount and recognised an exchange loss at that point. I agreed the amount received to the bank statement.

I noticed that there was an amount of Rs. 2 million that was owed by Fazal Bashir but as the amount is immaterial I decided to perform no testing.

Accrued income
As this amount is immaterial no testing was performed.

Property sale
I have agreed the amounts to the property sale agreement and confirmed that receivable is correct. The cash was received by BTV late in June 2017. I noted that the sale agreement was not signed until 16 June 2017 but the correspondence shows the sale negotiations were in place at the year end.

Appendix 2 – Summary of phone call between the audit manager and finance director of BTV

I received a phone call from the finance director of BTV about the details of a late adjustment that he is making to the financial statements in relation to a forward contract. The derivative showed a loss of Rs. 600 million and this is currently shown within profit or loss. He is now saying that the derivative was entered to hedge themselves against foreign exchange risk. BTV has signed a contract to purchase an item of equipment from overseas; they will have to pay for the equipment in the relevant foreign currency. The late adjustment will remove the loss on the forward contract of Rs. 600 million into other comprehensive income to match the loss against the future cash flow gain when we purchase the equipment.

I have reviewed our audit papers and have confirmed that we have correctly audited the forward contract and the amount of Rs. 600 million is correct.

Appendix 3 – Email to Audit Manager from Finance Director of BTV

To: Shaan Sardar
From: Rafiq Sabri
Subject: Future transaction

Hello Shaan,

As you are aware we have been looking at ways of relocating parts of our business from Karachi to reduce our operating costs. This strategy is becoming more important as a result of pressure from Fazal Bashir and his expectations regarding our profitability.

A property company has approached us and they have made an offer for our head office site. We are very keen to accept their offer as they are prepared to pay more than the current market value. The additional benefit of this transaction is that next year's profit figure would be enhanced by a significant profit or loss on disposal.

The property company have also agreed to lease the property to us over the next three years and this will give us more time to plan our relocation.

I would like you to check that I have understood all the financial reporting issues that will arise with this sale.

Best regards,

Rafiq