The Institute of Chartered Accountants of Pakistan

Multi Subject Assessment Stage

4 December 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. Answer 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 do 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 and work for Hussain and Co, a firm of Chartered Accountants.

You receive the following email from Shamala Ahmad, the newly appointed audit manager of Best Food Company Limited (BFC) for the year ended 31 October 2017:

Thank you for agreeing to help out on the audit of BFC. The previous audit manager has been unwell and I have taken over and the audit senior is now on study leave. I know that you have no experience of BFC so I have provided some background information (Appendix 1). I have also provided you with summaries of the board minutes that were prepared by the previous audit manager as part of the audit planning process (Appendix 2) and more detailed financial information that had been based on discussions with the finance director (Appendix 3). Finally, I have provided the summary of the procedures performed in certain areas by the outgoing audit senior Shahid Chowdry (Appendix 4).

Planning materiality has been set at Rs. 30 million.

I would like your help with the following:

(a) In advance of my meeting with the client next week, I would like you to review all of the above information and prepare a briefing note on any financial reporting and auditing issues. For each issue identified you should:

(i) Explain the financial reporting issues and, where relevant, prepare calculations for any additional adjustments that you identify from your review.

(16 marks)

(ii) Evaluate the testing performed by Shahid Chowdry and explain any outstanding audit issues.

(08 marks)

(iii) List additional key audit procedures that should be performed before the audit report is signed.

(11 marks)

You may ignore taxation.

(b) Prepare a briefing note that outlines the provisions of corporate governance relating to accounts and audit that BFC will need to comply with as part of their listing. The note should also include any opportunities for us to provide any additional services to BFC.

(05 marks)

(c) The quality control partner has also asked for details of any issues to do with our audit of BFC. Prepare a briefing note which explains any professional and ethical issues for the firm arising from the audit of the client.

(05 marks)

(d) Explain the financial reporting implications of the proposed transaction outlined in Appendix 5 so that I can prepare a response to the email.

(05 marks)

Requirement
Draft the briefing notes requested by the audit manager.

Total: 50 marks

APPENDIX 1 – BACKGROUND INFORMATION FOR BFC

BFC operates a chain of supermarkets and fast-food retailers throughout Pakistan. BFC has grown slowly by opening more of its own supermarkets and fast-food outlets over the last 5 years. It has created significant brand loyalty over this period of growth.

The board is currently focused on a strategy of continued growth and a stock market listing is planned within two years.

Board Structure

CEO/Chairman:	Najeeb Saeed
CFO and executive director:	Sadia Khan
Executive director:	Omar Rumi
Executive director:	Amna Malik
Non-executive director:	Abid Javed

Financial statements are currently only presented to the Board on an annual basis by Sadia Khan.

In November 2016 BFC acquired a chain of high-end restaurants, Fine Dining. This represented a new direction for BFC as it has traditionally operated restaurants which are aimed at the mass market. Najeeb Saeed was the key driver of this acquisition as he believes that high end restaurants is a growing market and feels BFC can utilise the existing brand loyalty within this chain. His wife, Sarah, was hired by him as a consultant on this acquisition. Her report was presented to the board and it was relied upon by them in deciding to approve the acquisition.

Accounting policies
Property, plant and equipment and investment properties are held at fair value.

Audit information
The audit partner has been involved in the audit for 10 years and has a close relationship with the current board.

APPENDIX 2 – SUMMARY OF RELEVANT EXTRACTS FROM BOARD MINUTES OF BFC

Rental
In January 2017, the board discussed a proposal that two floors of one of BFC's owned office buildings should be leased out, as these floors are only occasionally used for meetings. Discussions focused on whether this would impact on the company's ongoing activities and, in particular, whether the tenants would be able to gain access to BFC's offices. Omar Rumi explained that he had discussed this with BFC's property teams and they had told him that the two floors have their own separate access so this will not be an issue.

The board approved the rental and Omar was instructed to inform the relevant teams to proceed further.

Purchase of new plant
In April 2017 Amna Malik explained that BFC needed some new equipment for some of its supermarkets and, after detailed research, she believed the best equipment could be acquired from Europe. She outlined that they could take out an option to acquire the equipment for delivery in December 2017 for a cost of €6 million.

Sadia suggested that she should investigate ways of reducing the foreign currency risk for this contract.

The board accepted that buying the equipment was a good business decision but would await Sadia's research before any decisions were made.

Forward contract
In May 2017 Sadia presented her research and explained that BFC could enter into a forward contract to buy €6 million at an exchange rate of Rs. = €0.012 in December 2017. The cost of the transaction is very low compared to the potential losses and she was confident that the contract would hedge the risks associated with the future purchase.

The board approved both the purchase of the equipment and the forward contract.

Fine dining chain – discussion in September 2017
The board reviewed up to date management information for the chain of restaurants which was acquired earlier in the year. The key issue is that the performance of the chain is significantly below the forecasts presented at the time of acquisition. Najeeb strongly defended the performance and explained that the current performance was as a result of temporary issues with a management change. He stated that he is confident that the future performance will be in line with expectations and that BFC did not overpay for this chain.

Closure of storage facility at Peshawar
In September 2017, the board discussed a proposal to close the storage facility at Peshawar as part of a cost savings plan. A proposal was presented by Sadia Khan that showed that, over the next two years, considerable savings could be made by closing this facility, as a nearby facility has spare capacity. Sadia also explained that, whilst BFC would still be committed to pay for the lease of this facility, she was confident that the storage facility could be sublet as demand is high for this type of facility.

The board approved this proposal.

APPENDIX 3 – DETAILED FINANCIAL INFORMATION

Rental
Two floors of the building were rented out to a third party for an annual rental of Rs. 8 million. The lease commenced on 1 May 2017 and was for a period of 2 years.

Purchase of new plant
On 1 June 2017 BFC signed an option agreement to buy an item of plant for €6 million with the new plant being delivered in December 2017. The spot rate on 1 June 2017 was Rs. = €0.01. The board has agreed this future purchase and the plant is required, so BFC is highly confident that the option will be exercised.

Forward contract
On 1 June 2017 BFC entered into a forward contract to buy €6 million on 1 December 2017 at an agreed rate of Rs. = €0.012. The reason for entering into the forward was to specifically hedge the risk of any future changes in the exchange rate.

Closure of storage facility at Peshawar
The proposal to close this facility was based on the following amounts:

	Rs. in million
Redundancy payments	60
Costs of moving machinery to the nearby facility	15
Compensation to employees agreeing to transfer employment to the nearby facility	20
Lease costs – remaining lease term of 5 years	5 per annum

APPENDIX 4 – SUMMARY OF PROCEDURES PERFORMED BY SHAHID CHOWDRY

Rental
Rental income has been included within other income at Rs. 4 million. This figure has been calculated based on an annual rental of Rs. 8 million. I recalculated the figures to confirm they are correct and have agreed the annual amount to the lease agreement.

Purchase of new plant
The equipment has been included as an asset at Rs. 600 million (with a corresponding liability to accounts payable) as at 31 October 2017. No depreciation has been charged as the asset is not yet available for use.

I agreed the contracted purchase price of the plant to the option agreement and then recalculated the amounts to confirm it was correctly translated per the spot rate on 1 June 2017. I have also agreed the spot rate of Rs. = €0.01 to published exchange rates and can confirm the rate is correct.

I discussed the plant with the financial controller who showed me the board discussions that BFC is committed to the future purchase. This explains why BFC has recognised an asset and an amount within payables.

Forward contract
The cost of the forward contract was Rs. 2 million and I agreed the amount to the contract. The agreement also confirmed that the contract was to buy €6 million on 1 December 2017 at an agreed rate of Rs. = €0.012. I have also confirmed that the cost of the contract has been correctly included within current assets.

I then discussed the accounting for the contract with the financial controller. He explained that, as the forward contract will be hedged against future changes in cash flow that will offset each other, he has not processed any entries.

He said that he had checked this by using the following exchange rates at the year-end:

Rs. = €0.0092 spot rate
Rs. = €0.0111 forward contract for delivery on 1 December 2017

I have checked the exchange rates used and recalculated the figures.

Fine Dining
I discussed the performance of the restaurant chain with the financial controller and he provided me with the following information:

> As part of my year-end review I performed impairment testing on this recent acquisition and prepared calculations as at 31 October 2017. The Fine Dining chain is made up of two cash-generating units and I have not been able to allocate the goodwill on a non-arbitrary basis.
>
> The carrying value of the CGU at the 31 October 2017 is:

	CGU1	CGU2	Goodwill	Total
	Rs. in million			
Property, plant and equipment	90	105		195
Goodwill			45	45
Other intangibles	40	45		85
Net current assets	20	35		55
Total	150	185	45	380

To calculate the value in use of the CGUs I used updated budgets for two years but beyond that I only had forecasts prepared at the acquisition date. I calculated the recoverable amounts as follows:

	Rs. in million
CGU 1	130
CGU 2	200
Chain as a whole	350

Summary of audit testing on impairment
Having received the information from the financial controller, I discussed with him why he had performed no additional calculations to calculate any impairment loss. The financial controller explained that after preparing the calculations he discussed them with Sadia Khan. Sadia told him that the performance of Fine Dining was discussed by the board and that Najeeb Saeed was confident about the future performance of the this chain.

I have agreed this explanation to the board minutes and therefore concluded that the treatment was correct and performed no additional testing in this area.

Closure of storage facility at Peshawar
I agreed the closure date to documentation that showed that on 1 November 2017 the equipment was moved from the Peshawar facility. I also agreed the redundancy details to human resources records that confirmed that the employees were made redundant on 1 November 2017.

All evidence therefore confirmed that the closure occurred after the year-end and thus supports the fact that no provision was required in the financial statements as at 31 October 2017.

Matter for the attention of audit partner – online business
The audit junior told me that he had a conversation with a member of staff at BFC and has discovered that they are investigating setting up an online shopping division. The audit junior was very enthusiastic and said he was able to make suggestions as this was an area he had studied at university. I thought this might be a useful area of extra work our firm could explore.

APPENDIX 5 – EMAIL TO SHAMALA AHMAD FROM SADIA KHAN

Shamala,

I would appreciate your advice on the following issue that would potentially impact on our financial statements next year.

We are considering selling one of our properties and then leasing it back. We have been offered a price of Rs. 838 million which is the same as the market value of the property. The property has a carrying value at the date of sale will be Rs. 503 million and has a remaining useful life of 25 years.

The terms of the lease are that we would pay Rs. 62 million annually in arrears for 20 years and the present value of the lease payments is Rs. 657 million and the interest rate implicit in the lease is 7%.

Thanks in advance for your assistance.

Kind regards,

Sadia

QUESTION 2

EAF Limited (EAF) is a listed company that specialises in research and development within the pharmaceutical industry. It also has a healthcare division that produces certain drugs. You are chartered accountant and work as a newly appointed financial controller. You have recently had a meeting with the finance director who is also a chartered accountant and a summary of this meeting is provided (Appendix 1). The draft financial statements for the year ended 30 November 2017 were prepared prior to the commencement of your employment by a junior member of the finance team, and he has given you his working papers with some outstanding issues (Appendix 2). Details of share issues and convertible debentures are also provided (Appendix 3).

(a) Prepare a note for the finance director in which you:

(i) Explain the potential impact on the draft financial statements of any issues identified in reviewing the working papers.
(ii) Calculate adjusted profit.
(iii) Calculate basic and diluted earnings per share.

Ignore any income tax or deferred tax adjustments

(20 marks)

(b) Explain any ethical concerns that you identify from your review of the working papers and actions you should take.

(05 marks)

Requirement
Respond to the finance director's request.

Total: 25 marks

APPENDIX 1 – NOTES FROM MEETING WITH THE FINANCE DIRECTOR

I met with the finance director and he welcomed me to my new role and outlined the current position with the draft financial statements of EAF.

He said, 'The financial statements have already been drafted by a member of your team and I am concerned that there are some outstanding issues that need to be addressed before the financial statements can be finalised.'

The finance director also outlined the details of the profit related pay scheme that EAF operates.

APPENDIX 2 – WORKING PAPERS FROM JUNIOR TEAM MEMBER

(1) During the year we commenced development on a new product that is aimed at providing relief for sufferers of chronic lung conditions. I understand that the board is confident about this product, especially as they see this as a large market with little competition. There has also been lots of favourable coverage in the relevant journals about the industry's expectations for this product. The following costs have been incurred this year and I have capitalised all of the costs as intangible assets. No amortisation has been charged as the product is still in development.

	Rs. in million
Salary costs	15
Property, plant and equipment	180
External consultants	90
Consumables	150
Total	435

I based the capitalisation of these costs on the confidence of the board and the fact that the finance director told me to ensure that I prepared the financial statements on the most optimistic basis possible. He also reminded me of the profit-related-pay scheme that we operate.

During a monthly management meeting which I attended before your appointment the following was presented:

> 'PRODUCT DEVELOPMENT – CHRONIC LUNG CONDITION
> The successful pre-clinical trials for this product were widely reported in scientific journals and this optimism was shared by the production team. However, since this trial we have had technical difficulties in preparing for the first clinical trials and this is delaying the project. The production team is working hard to overcome this and we still expect the clinical trials to commence within the next 6 months.'

(2) In July 2017, we paid Rs. 900 million to another pharmaceutical company to purchase a licence that allows us to manufacture, sell and market a drug that provides relief to arthritis suffers. The licence is for a period of five years beginning on 1 October 2017.

I have capitalised the amount within intangibles but I have not amortised the balance as there was a delay in our production of the drug. I spoke to the production team who confirmed that the drug will be ready for sale from 1 December 2017. The production team also mentioned that a competitor has entered the market since we acquired the licence.

(3) Within accruals there was an existing balance of Rs. 11 million that was labelled as relating to holiday pay. I was unsure how this was calculated so I have not adjusted the balance. I did receive the following details from the payroll department that I think relate to this:

> As per last year the holiday year for EAF is the same as the financial year and employees are entitled to carry forward any unused holiday entitlement. At the year-end we employed 1,400 members of staff and they each have an average of 5 days of unused holiday entitlement. Based on last year's figures, 3% of staff leave without taking their holiday entitlement and there are 240 working days in the year.
>
> The total annual salary cost was Rs. 800 million.

(4) EAF operates two pension schemes and I am unfamiliar with how to account for them so I have not prepared any accounting entries. However I have been provided with the following information:

We operate two schemes: EAF 2008 scheme and then a second scheme that was established in 2015. In the EAF 2008 scheme employees and employers make contributions and the employee's pension is based on years of service and final salary. In the EAF 2015 scheme the company pays an agreed percentage of salary directly into a pension scheme on behalf of staff. On retirement, staff can use their fund to purchase an annuity.

We had an opening present value of defined benefits obligation of Rs. 900 million and an opening fair value of plan assets of Rs. 800 million in relation to the 2008 scheme. During the year the following occurred:

	Rs. in million
Current service cost	80
Pension benefits paid	120
Payment to EAF 2015 scheme	20
Present value of obligation at 30 November 2017	890
Fair value of plan assets at 30 November 2017	940
Yield on high quality corporate bonds at 30 November 2016	10%
Yield on high quality corporate bonds at 30 November 2017	11%

I have recorded the contributions to the 2008 scheme during the year of Rs. 160 million as an expense in profit or loss. The payment to the EAF 2015 scheme represents employees who left the EAF 2008 scheme to move to the 2015 scheme, and the actuary calculated that the corresponding reduction in the liability was Rs. 11 million.

I also know that the directors have mentioned that they are expecting to make reduced contributions to the scheme in the next few years.

During the year we contributed Rs. 26 million to the EAF 2015 scheme and I have recorded this as an expense.

(5) Within investments are shares that were acquired in October 2017. These have been recorded in the financial statements at their fair value of Rs. 200 million, which represents a fall in value of Rs. 50 million since purchase. The finance director told me to present this within other comprehensive income as he said he didn't want profits to fall and he was confident the fall in value was temporary. I know that when these shares were purchased the decision was based on the assumption that the company could use some surplus cash to make a short term gain.

(6) I have prepared the operating segments disclosure note and asked the finance director to review it. This year I included an additional segment that we didn't disclose last year as it was too small, but this year it has increased in size so it is now reportable. The results of this segment are included in the management information that is presented to the board. The finance director said that he didn't want to disclose this segment this year as he didn't want information to be publically available for this segment.

APPENDIX 3 – DETAILS OF SHARE ISSUES AND CONVERTIBLE DEBENTURES

The draft profit for the year is Rs. 1,500 million

There were 50 million ordinary shares in issue at the beginning of the year and on 1 January 2017 the company had a rights issue of one for four shares at a price of Rs. 100. The market value of each share was Rs. 120 just before the rights issue.

On 1 December 2016, we issued Rs. 500 million convertible debentures with an interest rate of 5%. The debenture is convertible at the rate of one ordinary share for debentures of Rs. 140. I have accounted for these by splitting the proceeds into liability and equity. On inception the liability was calculated as Rs. 400 million with an effective interest rate of 7%.

QUESTION 3

KL is a large listed company that operates a chain of retailers specialising in products for the outdoor leisure market. Your audit firm has audited KL for four years and you have been assigned to the audit of KL for the year ended 31 October 2017. The audit manager has asked for help with some specific planning issues.

You have met with the audit manager who has provided you with the following information:

The planning for the audit of KL has been completed but this year KL acquired its first subsidiary, SP. We have not yet done any planning for this acquisition or on the group financial statements. The audit of SP will continue to be performed by Khan & Co, its current auditor. I have provided you with the draft financial statements of the newly acquired subsidiary in Appendix 1 and details of the acquisition in Appendix 2. In Appendix 3 there is some key information from the draft group financial statements, including details of intragroup trading.

Another issue with which I would like your help is the accounting for the cancellation of the share options, and I have provided you with the details of this in Appendix 4.

KL has covenants on its bank loan and I am concerned that some of these are very close to being breached. I would like your assistance in assessing these. I have provided the relevant information in Appendix 5.

Prepare a planning note that covers the following issues:

(a) Perform analytical procedures to assess the financial performance with regard to revenue, profits and working capital of SP.

(05 marks)

(b) Identify the key group audit risks arising due to the acquisition of SP and explain the correct financial reporting treatment of any issues identified. Recalculate any figures where relevant.

(11 marks)

(c) Prepare the note as requested in Appendix 4.

(04 marks)

(d) Consider whether KL is in breach of the bank covenants and consider the implications for our audit of the KL group.

(05 marks)

Requirement
Draft the working papers requested by the audit manager.

Total: 25 marks

APPENDIX 1 – EXTRACTS FROM DRAFT FINANCIAL STATEMENTS OF SP

Statement of profit or loss for the year ended 31 October 2017

	2017 draft	2016 audited
	-------- Rs. in million --------	
Revenue	1,130	800
Cost of sales	(788)	(360)
Gross profit	342	440
Administrative expenses	(70)	(65)
Profit from operations	272	375
Taxation	(54)	(75)
Profit for the year	218	300

Statement of financial position as at 31 October 2017

	2017 draft	2016 audited
	-------- Rs. in million --------	
Assets		
Non-current assets		
Property, plant and equipment	1,885	1,700
Current assets		
Inventories	190	100
Receivables	247	152
Cash and cash equivalents	60	100
	497	352
Total assets	2,382	2,052
Equity and liabilities		
Equity		
Share capital	1,500	1,500
Retained earnings	585	367
	2,085	1,867
Non-current liabilities		
Deferred tax liabilities	18	15
Current liabilities		
Trade and other payables	228	100
Tax liabilities	51	70
	279	170
Total equity and liabilities	2,382	2,052

APPENDIX 2 – DETAILS OF THE ACQUISITION OF SP

KL acquired 100% of the share capital of SP on 1 November 2016 for an agreed cash payment of Rs. 2,500 million, which was raised by taking out a bank loan. A further payment of Rs. 500 million was agreed which is payable on 1 November 2018. KL has a cost of capital of 5%.

SP is a niche manufacturer of bicycles and KL acquired the company as it wanted to be able to secure the supply of these bicycles within its stores, feeling that it would encourage sales to a different category of customer. SP had created brand loyalty by historically only supplying products to small retailers, so KL had been unable to buy these bicycles in the past.

KL engaged a different audit firm to perform due diligence on SP and two facts from this due diligence are outlined below:

(1) At the date of acquisition there was an ongoing dispute with an ex-employee. SP's lawyers had advised that they were confident that SP could win the case and therefore SP had not created a provision. The case was settled on 31 March 2017 and SP had to pay Rs. 5 million.

(2) The fair value of property, plant and equipment was calculated to be Rs. 1,900 million at the date of acquisition. The accounting policy of SP is to record PPE at historic cost.

Goodwill calculation
In the draft consolidated financial statements goodwill has been included at Rs. 633 million and the client has calculated this as follows:

	----- Rs. in million -----	
Consideration paid		2,500
Less: net assets at acquisition		
Share capital	1,500	
Retained earnings	367	(1,867)
Goodwill		633

APPENDIX 3 – KEY DETAILS FROM GROUP FINANCIAL STATEMENTS

The following are extracts from the group financial statements:

	31 October 2017	31 October 2016
	--------- Rs. in million ---------	
Revenue	12,300	10,500
Gross profit	4,096.5	3,360
Finance cost	450	200
Profit before tax	1,450	2,250
Equity	7,000	6,500
Non-current liabilities	6,000	3,500

During the year SP made sales to KL of Rs. 700 million and these sales were made at a gross profit margin of 15%. SP's usual gross profit margin is 55%.

APPENDIX 4 – CANCELLATION OF SHARE BASED SCHEME

Whilst planning our audit of KL the finance director asked for our advice over the accounting for the cancellation of the share option scheme. As I am not familiar with the accounting treatment I would like you to prepare a briefing note for me that outlines the required treatment. Ensure you include any relevant calculations.

Share option scheme
The directors of KL have a share option package that was granted to them on 1 February 2016. Each director was entitled to 4,000 share options at an exercise price of Rs. 5,500. There were 7 directors and the share options only vest in those directors who remain in the employment of KL at the vesting date 4 years later.

In the year ended 31 October 2016 an expense of Rs. 42 million was recognised based on a grant date fair value of Rs. 8,000 and the assumption that all of the directors would still be employed at the end of the 4 year period.

During the current financial year KL decided to introduce new compensation schemes based around specific performance targets and so the share option scheme was cancelled. The only entries that have been recorded in the financial statements are an expense of Rs. 280 million. This was based on the compensation of Rs. 10,000 per option that was paid to the directors.

The fair value of each option on the cancellation date was Rs. 9,000 and the market value of each of KL's shares was Rs. 12,000.

APPENDIX 5 – COVENANTS

The following are the details of covenants that are contained in the bank loan:

The gearing ratio must be less than 90% and the ratio is calculated as follows:

$$\frac{\text{Non - current liabilities}}{\text{Equity}} \times 100$$

The interest cover must be greater than 4 and is calculated as follows:

$$\frac{\text{Profit before finance cost}}{\text{Finance costs}} \times 100$$

The figures must be based on the group financial statements.