The Institute of Chartered Accountants of Pakistan

Multi Subject Assessment Stage

4 June 2018
3 hours and 30 minutes – 100 marks
Additional reading time – 15 minutes

Financial Reporting and Assurance – Professional Competence

CENTRALISED REGISTRATION NUMBER (CRN)

INSTRUCTIONS

Read the instructions carefully before answering the questions:

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 Ejaz Rana, an ICAP Chartered Accountant working for an audit firm, Hassan & Co. You are the senior assigned to the audit of Kalpar Automobiles (KA), a group of 100% owned companies who manufacture automobile parts at several sites across Pakistan.

You are currently completing the audit of the KA group for the year ended 31 December 2017. The date is now the 17 February 2018.

Your Audit Manager, Osman Khan calls you into his office and briefs you:

'Most of the audit work has now been completed, but we need to finalise issues that have arisen in KA, the parent company of the group, before I meet with the audit partner. In Appendix 1, you will find some notes prepared by Fatima Vali, the Audit Junior, on the outstanding points that she was unable to resolve on her own. In Appendix 3, Fatima has also summarised the audit testing that has been performed to date on the key outstanding areas. I have provided you with the draft consolidated financial statements for the KA group in Appendix 2.

One of our partners sent me an email about KA. It explains that the site in Karachi has suffered a major fire. I'm slightly concerned that we didn't receive this from the management at KA. Maybe they don't think it will affect the audit as it happened after the year end. The email and my comments thereon are attached as Appendix 4.

Finally, Fatima performed some testing on an investment that KA has accounted for under the equity method. I have not yet reviewed this work. I have provided you with this work in Appendix 5.'

Please can you do the following:

(a) Using the notes from Fatima (Appendix 1), assess the key audit risks and ensure you consider the materiality of the issues on the group financial statements. Where there are areas that need to be adjusted, explain the correct accounting treatment so that we can report this back to the Board in the completion meeting. **(24 marks)**

Note: Ignore taxation

Also explain where additional audit procedures that need to be completed in order to obtain sufficient audit evidence on these matters. Please also set out these so Fatima can complete the work. **(06 marks)**

(b) Prepare for me a briefing note explaining the impact, if any, that the incident of fire will have on the completion of the group audit. **(10 marks)**

(c) Assess the audit risks arising from the audit juniors work (Appendix 5) on the associate acquired during the year on the group financial statements.

Outline the key issues that need to be addressed for the associate but I do not need a list of detailed procedures. **(10 marks)**

Requirement
Prepare the documents requested by the audit manager.

Total: 50 marks

APPENDIX 1 – NOTES FROM FATIMA VALI

Outstanding points I am unable to resolve:

(1) **Long-term contract**

KA has a contract with Chenab, a car manufacturer, to supply parts for their new model, which is being released to the market in 2018. The contract was signed in February 2017 with an arrangement to deliver a range of specialist parts over the following schedule:

Delivery date	Units	Price per unit
30 June 2017	75,000	Rs. 17.50
30 September 2017	90,000	Rs. 30.00
31 December 2017	100,000	Rs. 25.00
31 March 2018	80,000	Rs. 30.00
30 June 2018	60,000	Rs. 17.50

The units were delivered in June and September, however Chenab requested that KA keep the December units at their Islamabad factory as they had storage issues at their site. Chenab agreed that they would be responsible for the units, inspected and accepted the units and agreed to pay KA a fixed sum of Rs. 50,000 for storage. Chenab can move the parts to their own premises when they require them.

Currently KA has invoiced Chenab Rs. 8,962,500 (including the Rs. 50,000 storage fee and Rs. 2,400,000 for March 2018 deliveries), of which they have paid Rs. 6,512,500. KA has recognised all of the Rs. 8,962,500 as revenue in 2017 financial statements, with the outstanding amount included in trade receivables. The contract to supply parts past June 2018 has not yet been negotiated.

I am slightly confused as to whether this is correct.

(2) **Investment in Khan Limited**

A new investment of 5,000 shares (5% of total share capital) in Khan Limited was made on 8 September 2017 and recorded at a cost of Rs. 408,800. At the year end, this investment has been valued at Rs. 350,000 and the loss has been recognised in other comprehensive income.

(3) **Website**

KA intended to launch a new website on 1 May 2017. The development of the website has been quite a lengthy process as they fell out with the original developers and wasted a lot of money in the process. Overall, they spent Rs. 110,000 on the original design (of which Rs. 50,000 was spent in 2016 and Rs. 60,000 in 2017). However, that project was abandoned. KA then spent a further Rs. 205,000 with the new developers who created the final site which was launched to the public on 1 November 2017.

The main function of the website is to allow the new customers to find out about their products. There is also an ordering portal to allow existing customers to submit new orders and raise queries, but it does not accept payments.

The website is expected to be functioning for the next four years, so KA have capitalised all the costs of the website, as stated above, and amortised on this basis.

(4) **Leases**

During the year, KA acquired two new pieces of manufacturing equipment under lease for use in the Islamabad factory. The first, is a press that was built specifically for KA and then acquired under an arrangement with V Capital. The arrangement which commenced on 1 July 2017 has an annual interest rate of 7% and requires four annual payments of Rs. 950,000, the first payable on commencement of the arrangement. The initial payment has been recorded as a prepayment. The agreement does not transfer title of the press over to KA at the end of the lease.

The second arrangement, also commenced on 1 July 2017 with the same supplier, was to add 10 drills to the existing small tool supply. The agreement requires nine monthly payments of Rs. 200,000 each for the use of the drills. By the end of December 2017, a total of Rs. 1,000,000 has been expensed under this arrangement.

APPENDIX 2 – FINANCIAL STATEMENTS

KA consolidated statement of financial position as of 31 December 2017 (draft)

	Rs. in '000
Non-current assets	
Property, plant and equipment	94,781
Investment in associate	1,679
Investment in shares	350
Website development costs	302
Current assets	
Trade receivables and prepayments	7,751
Inventory	11,451
Cash	78
	116,392
Equity	
Share capital	55,000
Other component of equity	(59)
Retained earnings	21,500
Non-current liabilities	
Debentures	19,500
Provisions	4,500
Current liabilities	
Trade and other payables	13,451
Taxation	2,500
	116,392

KA consolidated statement of profit or loss for the year ended 31 December 2017 (draft)

	Rs. in '000
Revenue	80,840
Cost of sales	(65,287)
Gross profit	15,553
Operating costs	(3,970)
Income from associate	479
Finance costs	(450)
Finance income	97
Profit before tax	11,709
Taxation	(2,750)
Profit for the year	8,959

APPENDIX 3 – AUDIT WORK

Long-term contract
I have agreed the schedule of items to be delivered and prices to the signed contract and I have agreed the Rs. 6,512,500 of cash received prior to the year end.

Investment in Khan Limited
I have agreed the purchase of the 5,000 shares with the statement received from Central Depository Company and a cash payment of Rs. 408,800 to the bank. I have found official stock exchange information showing the share price was Rs. 70 at the year end. I have re-performed the calculation and traced the amounts to the statement of financial position.

I have also agreed the purchase of the shares to the Board Minutes.

Website
I have obtained copies of the invoices for the website development and have agreed the total costs spent this year. I have also agreed that these have all been paid and processed through the bank. I have also looked at the new website and confirmed that it contains the functions described by the management.

Leases
I have agreed the terms of both the arrangements, confirmed that the terms are as described by management and agreed the cash payments to the bank. The new press is in the factory and I have observed it working.

APPENDIX 4 – INTERNAL EMAIL AND DETAILS

To: Osman Khan
From: Aeisha Agha
Subject: KA group – fire at Karachi factory
Date: 13 February 2018

Hi Osman,

I have heard that there was a significant fire at one of your client's factories and wanted to make sure you knew about it. Here are the details taken from today's newspaper:

In the early hours of Saturday, 12 February the Karachi Fire Department was called to tackle a large blaze at the KA manufacturing facility in the Sindh Industrial and Trading Estate (SITE), Karachi. Fire support from eight fire engines were tackling the fire for over 11 hours in what was described by the fire service as 'the worst industrial fire we have seen in recent years in Karachi'.

Fire crews fought through the morning and the coming day to get the blaze under control however, the factory was completely destroyed. Two security staff who were working overnight at the factory died this morning in the local hospital as a result of smoke inhalation.

Regards

Aeisha

Further details provided by Osman Khan to Ejaz Rana:

I have checked the audit files and this factory was one of KA's largest plants, representing 30% of KA group's property plant and equipment and they hold just over 35% of group inventory in this plant.

Given the significance of this, I am concerned about the group's ability to maintain their level of production. I have checked the audit files and KA does have an insurance policy that covers loss of business and fire damage.

APPENDIX 5 – AUDIT WORK

Associate

On the 1 July 2017, the parent company of the KA group acquired 45% of the shares in AH Motors which is a small but important competitor in their market. In the draft consolidated financial statements they have equity accounted for this investment based on having significant influence. The investment in associate was calculated:

	Rs. in '000
Cost of investment	1,200
Share of post-acquisition profits	479
Total	1,679

I have agreed the purchase to Board Minutes which confirmed that the purchase was authorised at an agreed amount of Rs. 1,200,000. Whilst reviewing the Board Minutes I noticed them discussing their option to acquire shares that would increase their shareholding to 75%. The Board agreed that they would be exercising this option as they are very keen to have a controlling shareholding in AH Motors as it will allow them to enter new market and make cost savings. I also agreed the amount paid to the bank statement and to the calculation of the investment in the associate that is included on the consolidated statement of financial position.

I also reviewed the purchase agreement that confirmed the acquisition of the 45% holding. I did notice that this agreement also mentioned that KA has the option to acquire an additional 30% of the shares for Rs. 960,000.

The financial controller provided me with a memo from the auditors of AH Motors confirming that they will be issuing an unmodified audit report on AH. He also provided me with the financial statements of AH Motors. AH Motors made a profit after tax of Rs. 2,128,888.

I used the financial statements to confirm that the client has correctly included 45% of the post-acquisition results of AH Motors in the equity accounting calculations.

QUESTION 2

You are Amir Jan, the Financial Controller at Rahma Media, a group of companies engaged in print, online and TV media. The Financial Director, Saad Raja has sent you an email about the consolidated financial statements for the group:

To: amir.jan@rahma-media.com
From: saad.raja@rahma-media.com
Subject: Year end 30 April 2018

Hi Amir,

As you know it is the year end and we need to prepare the consolidated financial statements and the document for the Board explaining the key financial reporting implications of the changes to the group during the year. I would like you to prepare a first draft of these for my review. Please can you make sure you explain the changes in the group and the impact that they have on the financial statements in clear language so that the Board will understand? In addition, can you prepare a summarised statement of financial position to accompany the presentation?

In Appendix 1, I have provided you with summarised statements of financial position for the group companies at the year end, a working paper with the equity transactions for each of the companies in Appendix 2 and details of the intragroup transactions in Appendix 3.

Thanks

Requirement

(a) Prepare a report for the Board of Rahma Media that explains the financial reporting implications of the changes in group shareholdings (Appendix 2) and intragroup transactions (Appendix 3) that have occurred in the year ended 30 April 2018.
(14 marks)

(b) Prepare a summarised statement of financial position for the Rahma Media group as on 30 April 2018. **(06 marks)**

Total: 20 marks

APPENDIX 1 – SUMMARISED STATEMENTS OF FINANCIAL POSITION AS AT 30 APRIL 2018

	Rahma Media	R Print	ZTV	Vali Vali
	Rs. in million			
Non-current assets				
Property, plant and equipment	350	201	423	98
Investments	425	-	-	7
Loan to R Print	20	-	-	-
Current assets	125	37	165	49
	920	238	588	154
Equity				
Share capital (Re. 1 each)	250	80	40	50
Retained earnings	80	97	331	22
Non-current liabilities	125	20	20	45
Current liabilities	465	41	197	37
	920	238	588	154

APPENDIX 2 – EQUITY TRANSACTIONS IN THE YEAR

ZTV
During the year it was decided that ZTV, the traditional broadcasting arm of the business, was to be partly sold off, as the main focus of the group was to move towards new online media. On 1 December 2017, Rahma Media sold 8.4 million of its 28 million shares in ZTV for Rs. 350 million, and resigned all but one of its five Board seats. Rahma Media estimated that the fair value of the remaining shares still held was Rs. 35 per share.

At the date of disposal of the shares the carrying value of net assets of ZTV was Rs. 301 million.

The shares were held in the books of Rahma Media at cost and they had recorded the cash proceeds in a suspense account that is included within current liabilities.

Vali Vali
Rahma Media decided that it needed to move into more online services to keep up with the changing media markets, therefore they decided to purchase Vali Vali, an online media business that operates a social media platform. The negotiations were long and resulted in a complex purchase arrangement that was completed on 31 December 2017, when the retained earnings were Rs. 12 million.

Rahma Media agreed to pay the existing shareholders of Vali Vali Rs. 50 million cash immediately for all of the shares, and a guaranteed further amount of Rs. 100 million on 31 December 2018. It was also agreed that the existing chief executive and operations director would stay with the business and if Vali Vali met a complex range of targets over the coming five years, a further payment of Rs. 80 million would be payable to the existing shareholders. The likelihood of this payment being made was assessed as 75% at the date of the purchase. No entries had been made to the financial statements other than for the cash consideration of Rs. 50 million.

The relevant discount rate is 9% per annum.

APPENDIX 3 – INTRAGROUP TRANSACTIONS

In a planned expansion of printing facilities, R Print borrowed Rs. 20 million from Rahma Media in 2016 on which they pay 10.8% interest per year. At the year end all interest had been paid.

During the year ended 30 April 2018, ZTV purchased printing services from R Print of Rs. 0.5 million per month. At any point, ZTV is in debt to R Print the total of three months' services.

APPENDIX 4 – HISTORICAL INFORMATION

R Print

R Print is the printing arm of Rahma Media which prints publications for magazine and newspaper publishers as well as providing printing services to group companies. All of the shares of R Print were purchased some years ago for Rs. 180 million when the retained earnings of the company were Rs. 40 million. R Print has performed well since acquisition and there has been no impairment of goodwill.

ZTV

In 2012, Rahma Media purchased 28 million shares in ZTV for Rs. 195 million when the retained earnings were Rs. 40 million. The non-controlling interest was valued using the proportionate share of net assets. Over the past three years the goodwill has been impaired by 20%.

QUESTION 3

Hub Airlines is a large unlisted business. Its head office is based in Islamabad, but it also has operations in Colombo and Abu Dhabi. You are Rostam Rais, an Audit Senior working for Sultan & Sultan, a firm of chartered accountants. Hub Airlines has approached Sultan & Sultan to provide audit services for the coming year ending 30 June 2018.

Nasreen Ahmed, a partner in your firm, has left you a note:

'We need to complete all of the acceptance procedures for Hub Airlines to ensure that we are happy to take them on as a client. Hub Airlines' chief executive is a close family friend of the managing partner and he is very keen for us to accept this engagement.

Please could you review the attached information, including management accounts for the six months to 31 December 2017 and financial statements for the years ended 30 June 2016 and 2017 (Appendix 1), an email from the previous auditor (Appendix 2), my notes from the initial meeting with the directors of Hub Airlines (Appendix 3) and a report on the directors of Hub Airlines (Appendix 4).'

Using this information can you prepare:

(a) A briefing note to support our acceptance decisions, including an initial assessment of risk areas from your analysis of the financial statements (Appendix 1). Also prepare a summary of facts that we should consider in our acceptance decision, further information you might need and an initial conclusion on whether we should accept the audit.

Ensure you include any ethical considerations within the briefing note. **(22 marks)**

Note: You are not required to adjust the management accounts for any financial reporting issues in Appendix 3.

(b) An explanation of any financial reporting impacts of the information contained in Appendix 3 and 4. **(08 marks)**

Requirement
Respond to the audit partner's request.

Total: 30 marks

APPENDIX 1 – FINANCIAL STATEMENTS

Statement of financial position as at

	31 December 2017 Management	30 June 2017 Audited	30 June 2016 Audited
	---------------------- Rs. in million	----------------------	----------------------
Non-current assets			
Property, plant and equipment	3,000	2,520	1,080
Intangible assets	168	120	120
Current assets			
Trade receivables	144	156	96
Inventories	240	300	120
Cash	-	-	108
	3,552	3,096	1,524
Equity			
Share capital	1,200	1,200	1,200
Retained earnings	186	168	144
Revaluation surplus	408	-	-
Non-current liabilities			
Loan	1,200	1,200	-
Current liabilities			
Overdraft	216	204	-
Trade and other payables	336	276	156
Tax	6	48	24
	3,552	3,096	1,524

Statement of profit or loss and other comprehensive income

	6 months to 31 December 2017 Management	Year ended 30 June 2017 Audited	Year ended 30 June 2016 Audited
	---------------------- Rs. in million	----------------------	----------------------
Revenue	1,800	3,000	2,160
Cost of sales	(1,560)	(2,400)	(1,800)
Gross profit	240	600	360
Operating expenses	(168)	(312)	(264)
Finance costs	(48)	(96)	-
Profit before tax	24	192	96
Tax	(6)	(48)	(24)
Profit for the year	18	144	72
Other comprehensive income Revaluation	408	-	-
Total comprehensive income	426	144	72

APPENDIX 2 – EMAIL TO NASREEN AHMED

From: tkhan@mhpw.com
To: nasreen.ahmed@sultansultan.com
Subject: Hub Airlines

Further to your request for information regarding our provision of audit services to Hub Airlines for the three years ended 30 June 2015, 2016 and 2017 we have the following statements:

- We have been given permission by Hub Airlines to correspond with you.
- We will not be providing you with access to our audit files.
- We encountered some areas of difficulty in our audits, however all audit opinions were issued unmodified.
- We have unpaid audit fees from the 30 June 2017 audit of Rs. 56 million.

APPENDIX 3 – NOTES FROM NASREEN AHMED ON INITIAL MEETING WITH DIRECTORS OF HUB AIRLINES

Below are the notes from my meeting on 1 February 2018 with Laila Kamal the Finance Director and Irfan Mir the Chief Executive.

(1) **Business performance**

Laila Kamal reported that the six months to 31 December 2017 have been successful and growth in revenue is continuing. In an effort to improve profitability and improve shareholder returns, the company has gone through a rationalisation process in the first six months of the year, resulting in a restructure and redundancies of non-essential operations crew.

(2) **Financial reporting – Premier Business Travel**

In an effort to provide a more appealing service to its business customers who want a one-stop shop for their travel needs, Hub Airlines entered into an arrangement with Chen Hotels, a hotel chain, to supply package deals of flights and hotels at reduced prices under the name of Premier Business Travel.

The contractual arrangement was set up in August 2017 with Hub Airlines and Chen Hotels agreeing to share control of the project. Any decisions have to be agreed between both parties. Hub Airlines provide the flights and Chen Hotels provide the hotels, with the agreement that all costs and revenues of the arrangement would be split 60:40 in the favour of Hub Airlines, with any reconciling payments made from one party to the other at the end of each six month period.

By the end of December 2017 Premier Business Travel had made sales of Rs. 541 million, all of which was collected by Hub Airlines and recorded as revenue, with the cost to Hub Airlines of flights provided being Rs. 280 million and the cost of providing hotels incurred by Chen Hotels of Rs. 176 million.

(3) **Financial reporting – inventory**

Hub Airlines holds inventories of fuel for emergencies and recently purchased a large consignment on 12 November 2017 for US$ 500,000 when the exchange rate was USD 1 = Rs. 112. At 31 December 2017, the net realisable value of the inventory had risen to USD 600,000. The exchange rate at 31 December 2017 was USD 1 = Rs. 116 and no change had been made to the financial statements.

APPENDIX 4 – REPORT OF DIRECTORS' INTERESTS

Company: Hub Airlines
Date: 27 February 2018

Position	Name	Years in post	Shares in Hub Airlines held	Other directorships	Other information
Chief Executive	Irfan Mir	7	15%	Okra Airlines	
Finance Director	Laila Kamal	3	5%	Okra Airlines	
Operations Director	Reza Begum	7	5%	None	
HR Director	Haroon Emir	2	None	None	Hub Airlines advanced Haroon Emir a loan of Rs. 3 million in September 2017. The amount was repaid in December 2017.