The Institute of Chartered Accountants of Pakistan

Multi Subject Assessment Stage

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

Financial Reporting and Assurance Professional Competence

CRN:

Name: ______________________________

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 scripts.

4. Answer each question in black pen only.

5. You are allowed to write notes/comments on the question paper. However, you must write your CRN and name on the question paper at the space provided above before starting to write any notes/comments.

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 are allowed.

QUESTION 1

You are Deeba Chand and work as Audit Senior for Habib and Company, a firm of Chartered Accountants. The Audit Manager, Omer Kazim is beginning to plan the audit of TA Healthcare group (TAH) for the year ended 30 November 2018. You have been assigned to work on the audit of TAH.

Omer has explained that the group has expanded significantly this year and this will impact on the audit approach and risk assessment of TAH. Omer has provided you with draft consolidated financial statements for the year ended 30 November 2018 in Appendix 1 and details of the changes in the group structure in Appendix 2. Some of the key financial information has been provided in Appendix 3 whereas Appendix 4 contains details of some specific transactions.

The Audit Partner, Ibrahim Khan received an email (Appendix 5) from Soraya Zafar, the Finance Director of TAH. Ibrahim Khan requires a response to this email and Omer would like you to prepare a draft response for his review.

Requirements
Prepare the following documents as requested by the audit manager:

(a) To assist with the planning, review the information provided in Appendices 1, 2, 3 and 4. With regard to each issue identified by you during the review:

(i) Evaluate the key audit risks pertaining to the audit of the TAH and where relevant for the individual companies for the year ended 30 November 2018. **(12 marks)**

(ii) Explain any financial reporting issues, and where relevant, prepare calculations to aid this explanation. Ensure you are specific about the impact on the group and the individual companies. **(18 marks)**

(iii) Explain the impact of the issues on our audit approach. Audit procedures are not required. **(15 marks)**

Note: Ignore taxation

(b) Prepare a draft response to the finance director's email. **(05 marks)**

Total: 50 marks

APPENDIX 1 – DRAFT CONSOLIDATED FINANCIAL STATEMENTS

TA Healthcare draft consolidated statement of financial position as at 30 November 2018

	2018	2017
	--------- Rs. in million ---------	
Non-current assets		
Property, plant and equipment	26,176	16,789
Intangibles excluding goodwill	29,500	17,450
Goodwill	7,890	2,500
	63,566	36,739
Current assets		
Inventory	9,782	4,340
Trade and other receivables	10,450	5,670
Cash	1,100	5,500
	21,332	15,510
	84,898	**52,249**
Equity		
Share capital	18,000	15,000
Share premium	4,500	2,500
Retained earnings	10,763	6,254
	33,263	23,754
Non-current liabilities		
Loan	22,935	10,350
Provisions	5,200	3,506
Deferred tax	1,400	1,200
Defined benefit plan	6,250	5,350
	35,785	20,406
Current liabilities		
Trade and other payables	13,250	6,789
Contingent consideration	1,000	–
Taxation	1,600	1,300
	15,850	8,089
	84,898	**52,249**

TA Healthcare draft consolidated statement of comprehensive income for the year ended 30 November 2018

	2018	2017
	-------- Rs. in million --------	
Revenue	78,520	55,678
Cost of sales	(26,697)	(16,056)
Gross profit	51,823	39,622
Operating expenses	(31,408)	(28,671)
Research and development	(11,778)	(5,979)
Operating profit	8,637	4,972
Profit on disposal	187	–
Finance costs	(1,468)	(724)
Finance income	25	67
Profit before taxation	7,381	4,315
Taxation	(1,456)	(907)
Profit for the year	5,925	3,408
Other comprehensive income:		
Remeasurement gains/(losses) on defined benefit plans	897	(250)
Total comprehensive income	**6,822**	**3,158**

APPENDIX 2 – GROUP STRUCTURE

TAH is the parent company and owns the following subsidiaries:

Lahore Medical and Chiniot Healthcare
Lahore Medical and Chiniot Healthcare are wholly-owned subsidiaries which were acquired many years ago. The subsidiaries have been audited by Habib and Company for many years. Lahore Medical has expanded during the year by beginning to supply larger medical equipment to hospitals.

During the year, TAH sold 5% of its shareholdings in Lahore Medical.

Cosmetic Care
Cosmetic Care is a newly acquired subsidiary that was purchased as TAH wanted to diversify into the cosmetics market. Cosmetic Care is a market leader in this area and TAH acquired it with the intention of replacing the existing management. TAH expected to make significant cost savings by combining management teams, and on acquisition, Cosmetic Care's predicted profit was Rs. 1,700 million for the year ended 30 November 2018 and Rs. 2,500 million for the year after.

TAH acquired 100% shareholdings in Cosmetic Care and gained control from 1 December 2017. Habib and Company was appointed as auditor of Cosmetic Care during the year.

The post-acquisition performance of Cosmetic Care has been disappointing. The main reason is that TAH have struggled to make the expected cost savings and a range of Cosmetic Care's products have seen decline in sales as a result of negative publicity.

TAH is highly confident that all of the issues will be resolved and that Cosmetic Care will meet its predicted profit for the year ended 30 November 2019. TAH also expects new publicity to reverse the trend.

Sukkur Pharmaceuticals
Sukkur Pharmaceuticals is a 100% owned subsidiary and control was obtained on 1 December 2017. The key reasons for the acquisition were to gain access to Sukkur Pharmaceuticals' on-going research & development and to save costs by sourcing pharmaceutical products that are used by TAH for a cheaper price.

Sukkur Pharmaceuticals is audited by another firm of auditors as Sukkur Pharmaceuticals is based in an area where we have no offices.

APPENDIX 3 – ADDITIONAL FINANCIAL INFORMATION

	Revenue		Profit before tax		Assets	
	2018	2017	2018	2017	2018	2017
	---------------------------- Rs. in million ----------------------------					
TAH	25,773	25,055	2,489	2,392	25,351	19,789
Lahore Medical	23,487	18,790	2,651	1,600	23,456	21,254
Chiniot Healthcare	12,125	11,833	350	323	12,806	11,206
		55,678		**4,315**		**52,249**
Cosmetic Care	5,882	6,500	560	1,560	9,876	9,320
Sukkur Pharmaceuticals	11,253	9,480	1,331	1,612	13,409	12,140
	78,520		**7,381**		**84,898**	

APPENDIX 4 – SPECIFIC TRANSACTIONS

Equipment sale
On 1 October 2018, Lahore Medical signed a contract to supply medical equipment to a customer for Rs. 900 million. The contract included a clause that allows the customer to purchase 80,000 units of consumables for the equipment for a period of 12 months for a price of Rs. 1,500 per unit. Once they have purchased 80,000 units or after 12 months the customer will have to pay the normal market price of Rs. 3,000 per unit.

Lahore Medical normally sells such equipment for Rs. 1,000 million and the expectation is that the customer will buy around 170,000 units of the consumables within one year.

Lahore Medical has recognised revenue of Rs. 900 million upon delivery on 1 November 2018.

Cosmetic Care
The acquisition of Cosmetic Care was made through a share exchange. TAH also agreed to pay Rs. 1,000 million in cash on 30 November 2019 if the profit exceeds Rs. 2,000 million for the year ending 30 November 2019.

At acquisition the management estimated that the amount would be payable and the full amount has been included as contingent consideration.

Sukkur Pharmaceuticals
Sukkur Pharmaceuticals was acquired as TAH was keen to utilise the promising research that Sukkur Pharmaceuticals had been undertaking and as a result the goodwill arising on the acquisition was high. The due diligence undertaken by TAH on the acquisition identified that Sukkur Pharmaceuticals had previously received offers to buy the research.

Research is still on-going and all costs have been expensed to profit or loss.

Forward currency contract
In September 2018, TAH entered in to a forward currency contract for the first time to hedge against the risk of fluctuations in future purchases in the foreign currency. The directors are currently proposing not to include any amounts for this forward contract in the financial statements as the current forward is at a loss. They explain that this will be matched against the saving when they make the purchases.

Sale of shares
The Rs. 187 million profit relates to the sale of 5% of TAH's shares in Lahore Medical.

Pension
TAH operates a defined benefit pension plan and the break-up of remeasurement gain for the year is as follows:

	Rs. in million
Remeasurement gain on fair value of plan assets	350
Loss on transfer to defined contribution scheme	(397)
Remeasurement gain on plan obligation	944
	897

During the year, TAH offered some staff members the opportunity to transfer to a defined contribution scheme and they were offered a significant payment to entice them to transfer. Moreover, TAH was dissatisfied with the work of its previous actuary and has appointed a new actuary during the year.

APPENDIX 5 – EMAIL FROM CLIENT

Dear Ibrahim

For the first time we are intending to include a section on the group's key performance indicators within our Annual Report as that information is now required by key stakeholders.

The information will include key financial ratios, health & safety information and our ethical standpoint.

I hope that as the financial statements are audited, it will give credibility to these figures without any additional costs.

I would be grateful if you could outline the impact this will have on your audit and how the audit report can be amended to ensure that the stakeholders can gain assurance over the information.

Kind regards

Soraya

QUESTION 2

You are Azra Bukhari (FCA), the group Financial Accountant for Multan Health Group (MHG) which operates in the healthcare technology sector. MHG has developed an app that will enable users to upload electronic health information direct to their doctor. The app receives data from a microchip that is implanted in the patients' upper arm which then provides accurate, real time information about the patient's heart rate and blood pressure. MHG does not manufacture microchips and therefore requires to secure the supply of the microchips from another company.

The group Financial Controller, Hassan Alvi, has sent you an email (Appendix 1) requesting your assistance in preparing information for inclusion in a report to the Board of Directors regarding two options available for the supply of the microchips.

Requirements

(a) Prepare the projected consolidated statement of profit or loss of MHG for the year ending 30 November 2019 and the projected consolidated statement of financial position as at that date under each of the following situations:

(i) Contract with MS Manufacturing for supply of microchips;
(ii) Acquisition of AK Engineering which manufactures such microchips.

Note: Ignore the impact of tax. **(10 marks)**

(b) Analyse and explain the possible impact of each of the two options on the financial position and financial performance of MHG for the year ending 30 November 2019. **(10 marks)**

(c) Discuss the ethical implications of Hassan Alvi's suggestion that the report should be presented in such a way as to influence the decision of the directors and identify an appropriate course of action in response to his suggestion. **(05 marks)**

Total: 25 marks

APPENDIX 1 – EMAIL CONTAINING INSTRUCTIONS

To: Azra Bukhari
From: Hassan Alvi
RE: Microchip options

Hi Azra

As you know, we have been evaluating the options available to secure the supply of the microchips needed to allow us to launch our new app.

Extracts from the projected consolidated financial statements of MHG and relevant information relating to MHG are included in Appendix 2.

We have identified two alternatives:

- Enter into a contract with a supplier, MS Manufacturing to supply the microchips to MHG for a two-year period. More information regarding the terms of the contract is included in Appendix 3.
- Acquire AK Engineering which is a manufacturer of the microchips. More information relating to this option is included in Appendix 4.

The Board of Directors has asked me to prepare a report to understand the effect of each alternative on the consolidated financial statements of MHG. I have asked another colleague to look at the strategic implications and risks associated with the proposals, so you can focus on the financials.

As you know, staff bonus is based on profits, my initial thoughts are that we should present the report in a manner that makes the Board favour the alternative which results in the highest profits.

Kind regards

Hassan Alvi

APPENDIX 2 – PROJECTED SUMMARISED FINANCIAL STATEMENTS FOR MULTAN HEALTH GROUP

Consolidated statement of financial position as at 30 November 2019

	Rs. in million
Non-current assets	
Property, plant and equipment	894
Intangibles	196
Current assets	212
	1,302
Share capital	400
Share premium	120
Retained earnings	337
Non-current liabilities	250
Current liabilities	195
	1,302

Consolidated statement of profit or loss for the year ending 30 November 2019

	Rs. in million
Revenue	789
Cost of sales	(434)
Gross profit	**355**
Operating expenses	(87)
Finance cost	(25)
Profit before tax	**243**
Income tax	(61)
Profit for the year	**182**

Additional information:

(i) The projected financial statements of MHG do not take into account the proposed contract with MS Manufacturing or the potential acquisition of AK Engineering.

(ii) The projected financial statements of MHG do not take into account any revenue from the sale of the app and the microchip costs. MHG has estimated that the projected revenue from the app would be Rs. 245 million for the year ending 30 November 2019.

(iii) Included within intangibles are unamortised development costs of Rs. 96 million that relate to the development of the app. The useful life of the app is estimated to be four years.

APPENDIX 3 – PROPOSED CONTRACT WITH MS MANUFACTURING

An agreement is being considered with MS Manufacturing for the exclusive supply of microchips to MHG for a period of two years from 1 December 2018.

Under the contract, MHG will have to pay MS Manufacturing Rs. 136 million for the year ending 30 November 2019. All purchases will be paid immediately. MS Manufacturing will supply the microchips direct to the doctors when the app is purchased.

APPENDIX 4 – PROPOSED ACQUISITION OF AK ENGINEERING

MHG will purchase 100% of the equity shares of AK Engineering, manufacturer of microchips, for Rs. 180 million in cash on 1 December 2018, gaining a controlling interest from that date.

The cash required for the acquisition will be raised by issuing convertible debt with a nominal value of Rs. 180 million that will be redeemable in three years or converted to 1 million ordinary shares in MHG at the redemption date. The convertible debt carries interest at 5% and the interest rate for a similar non-convertible debt is 9%.

The projected summarised financial statements and associated notes for AK Engineering are as follows:

Statement of financial position as at 30 November 2019

	Rs. in million
Non-current assets	368
Current assets	58
	426
Share capital	100
Share premium	25
Retained earnings	75
Non-current liabilities	125
Current liabilities	101
	426

Statement of profit or loss for the year ending 30 November 2019

	Rs. in million
Revenue	289
Cost of sales	(151)
Gross profit	138
Operating expense	(37)
Finance cost	(15)
Profit before tax	86
Income tax	(17)
Profit for the year	**69**

Additional information:

(i) AK Engineering’s share capital comprises 10 million shares at Rs. 10 each.

(ii) Assume that the purchase of shares of AK Engineering and issuance of convertible debts would take place on 1 December 2018.

(iii) The fair values of AK Engineering's net assets are the same as their carrying amounts at 1 December 2018.

(iv) During the year, no dividends are expected to be paid by AK Engineering.

(v) AK Engineering’s cost of producing the required number of microchips is Rs. 90 million. The microchips would be sold to MHG for Rs. 150 million, all of which are expected to be sold outside the group by 30 November 2019. The projected financial statements of AK Engineering do not take into account any revenue/cost from the sale of microchips to MHG.

QUESTION 3

You are working as an audit senior at Ahmad and Company, Chartered Accountants.

The audit of Air Indus Pakistan (AIP) for the year ended 30 September 2018 is close to completion. The audit senior assigned to this audit has gone on study leave and you have been asked to help with the completion stage of the audit as you have previous experience of auditing AIP.

Before going on study leave, the audit senior provided you with extracts from the draft financial statements for the year ended 30 September 2018 (Appendix 1). The audit senior has prepared a summary of outstanding issues relating to the audit (Appendix 2).

Requirements
The audit manager has asked you to review the Appendices and prepare a working paper in which you:

(a) Explain any additional financial reporting issues that have not been identified by the audit team. Include journals where relevant. **(13 marks)**

(b) Explain how you would resolve the outstanding issues related to the audit for the year ended 30 September 2018. **(12 marks)**

Total: 25 marks

APPENDIX 1 – EXTRACTS FROM THE DRAFT FINANCIAL STATEMENTS AS AT 30 SEPTEMBER 2018

	Rs. in million
Profit before tax	15,795
Tax	(4,264)
Profit after tax	**11,531**

	Rs. in million
Property, plant and equipment	78,142
Current assets	29,452
	107,594
Equity	35,152
Non-current liabilities	56,252
Current liabilities	16,190
	107,594

APPENDIX 2 – SUMMARY OF OUTSTANDING ISSUES

Share option scheme
On 1 October 2017, AIP issued 2,000 share options to each of its 1,250 key staff members to improve staff motivation and efficiency. The terms of the scheme were as follows:

- Staff must stay in employment for three years
- Share options will vest if share price of AIP increases by an average of 10% per year
- Exercise price of the options is Rs. 600

AIP calculated the fair value of each share option at Rs. 1,000 on the grant date. On 1 October 2017, AIP estimated that 125 staff members will leave over the three-year period. By 30 September 2018, 45 members of staff have left – and the estimate of 125 was still considered reasonable. AIP's share price was Rs. 1,715 at 1 October 2017 and Rs. 1,800 at 30 September 2018.

The audit files review suggests that sufficient evidence has been gained over the scheme by confirming the relevant details to the share option agreement. The calculation of fair value of the option is based on an option pricing model and testing has confirmed that use of the model was appropriate and in accordance with the requirements of IFRS 2 *Share-based Payment*. The inputs to the model were all confirmed to be satisfactory.

The audit team has discussed the average number of staff that leave with Human Resources and confirmed this with reference to payroll records. This shows that the estimate of 125 leavers appears reasonable and the records also show 45 staff have left by the year end.

The share price of AIP was verified from the stock exchange quotations and it has been confirmed that the share price had increased by 5% over the year.

The audit assistant concluded that AIP was therefore correct to not recognise any accounting entries for the share based payment scheme as the vesting conditions had not been met at the year end.

Aircraft bodies
The movement in carrying amount of aircraft bodies is as follows:

	Rs. in million
Aircraft body:	
Cost at 1 October 2017	35,163
Accumulated depreciation at 1 October 2017	(7,033)
Carrying amount at 1 October 2017	28,130
Depreciation expense (28,130/20 years)	(1,406)
Carrying amount at 30 September 2018	**26,724**

All of the above aircrafts were acquired on 1 October 2014 and were being depreciated over an estimated useful life of 15 years with no residual value. At the beginning of the year, AIP reviewed their useful life after becoming aware that other airlines were depreciating aircrafts over a longer period. The review concluded that a useful life of 23 years was more consistent with competitors.

I am satisfied with our testing related to depreciation expense and the carrying amount of the aircraft bodies based on a revised useful life of 23 years. The audit junior has checked that other airline companies depreciate their aircraft bodies over periods of between 20 and 25 years and concluded that AIP's use of 23 years is correct. The finance director was not available to discuss this further.

Flight delays

The review of Board minutes identified that AIP is being taken to court by a group of customers over significant flight delays that occurred in March 2018. The minutes show that the Board accepts that customers did experience significant delays, but AIP will defend the claim as the delays were a result of circumstances outside of their control. The total claim is Rs. 1,264 million.

The audit team had a brief discussion with the finance director who was clear that the case would be defended and that they would not be disclosing the claim in the financial statements. The finance director was not prepared to provide any documentation due to sensitivity of the matter.

Deferred tax

	Carrying amount	Tax base	Temporary difference
	------------------ Rs. in million ------------------		
Property, plant and equipment	78,142	62,492	15,650
Provisions	(725)	–	(725)
			14,925
Deferred tax liability (14,925 × 25%)			3,731
Opening deferred tax liability			(2,800)
Increase			931

The deferred tax liability was recalculated to confirm that all calculations have been performed correctly.

The tax department, who have prepared the tax calculation, agreed that share option scheme is the only other area where there is a difference between the tax treatment and the accounting treatment. As per tax laws, deduction for share option scheme is allowable on exercise of the options on the basis of their intrinsic value at that date.

The tax department have agreed that AIP will pay tax for the year at the rate of 30%. Deferred tax was calculated at 25% and this rate has been checked with the Finance Act which was enacted on 31 October 2018.

(THE END)