The Institute of Chartered Accountants of Pakistan

Multi Subject Assessment Stage

10 June 2019
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:

1. Answer all **THREE** questions.

2. Write your Name and CRN on the front page of the **MAIN ANSWER SCRIPT** and CRN on the front page of the **SUPPLEMENTARY ANSWER SCRIPT.** Do not write your Name, CRN or any other identification mark on any other portion of the main or supplementary answer script.

3. Answer to each part of the 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 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 Jabeer Aslam, working as an audit manager for Zafar and Co, a firm of Chartered Accountants. JG Telecoms is the parent company of a group of companies all operating in the telecoms industry and is listed on the Pakistan Stock Exchange. The previous audit manager of the JG Telecoms Group cannot continue in his role as he has unexpectedly been unwell. The audit partner, Sara Hussain, has asked for your urgent assistance with a number of matters relating to the audit of the JG Telecoms Group for the year ended 30 April 2019.

Sara has emailed you to explain the assistance required in Appendix 1. She has also provided you with the draft consolidated financial statements of the JG Telecoms Group for the year ended 30 April 2019 in Appendix 2, background information relating to the group in Appendix 3 and the summary of the issues identified by the previous audit manager in Appendix 4.

Finally, your help is also required with an email received from the group finance director, Haniya Qureshi, which is included in Appendix 5.

Requirements

(a) Read the information provided in Appendices 1 to 4 and respond to the request for assistance from the audit partner by completing the following:

(i) Explain the financial reporting issues arising and recommend adjustments where relevant to the group financial statements for the year ended 30 April 2019. **(20 marks)**

(ii) Explain the group audit issues which need to be addressed before the audit report can be signed. Include any relevant actions required. **(20 marks)**

Note: Ignore taxation as this will be considered separately.

(b) Explain any professional and ethical issues for Zafar and Co arising from the audit of JG Telecoms Group for the year ended 30 April 2019 and the email from the finance director included in Appendix 5. **(10 marks)**

Total: 50 marks

APPENDIX 1 – EMAIL FROM SARA HUSSAIN

To: Jabeer Aslam
From: Sara Hussain
Re: JG Telecoms Group 30 April 2019

Dear Jabeer,

Many thanks for agreeing to assist with the completion of the audit of the JG Telecoms Group. This is a very important client and we wish to maintain the strong relationship we have developed with the group over the years.

The previous audit manager had performed his detail review of the audit working papers and the audit team had cleared his review points. The manager has prepared a summary of outstanding that has not provided any explanation as to why he has identified these as issues. The summary is included in Appendix 4.

I have not provided you with the consolidated statement of cash flows but an important figure is cash generated from operation of Rs. 11,750 million for the year ended 30 April 2019.

I need you to review the summary prepared by the previous audit manager and clearly explain the financial reporting issues and any audit implications to me as we are under pressure to get the audit report signed as soon as possible.

JG Telecoms Group is a demanding client and I am aware that there is a possibility that they might put the audit out to tender in the near future. There is also pressure from our ethics partner as to whether we should continue to act as auditors for the JG Telecoms Group. These concerns are over the increasing recurring audit fee levels and familiarity issues.

Regards

Sara

APPENDIX 2 – DRAFT CONSOLIDATED FINANCIAL STATEMENTS

JG Telecoms Group draft consolidated statement of comprehensive income for the year ended 30 April

	2019	2018
	------ Rs. in million ------	
Revenue	67,554	45,210
Cost of sales	(56,314)	(37,525)
Gross profit	11,240	7,685
Operating expenses	(4,931)	(4,300)
Operating profit	6,309	3,385
Finance costs	(2,456)	(1,900)
Finance income	967	867
Share of results of associates	405	(350)
Profit before taxation	5,225	2,002
Income tax	(1,464)	(580)
Profit for the year	3,761	1,422
Other comprehensive income:		
Remeasurement gains on defined benefit plans	250	175
Investment in equity instruments	(20)	10
Total comprehensive income	**3,991**	**1,607**
Profit for the year attributable to:		
Owners of the parent	2,820	924
Non-controlling interest	941	498
	3,761	**1,422**
Total comprehensive income for the year attributable to:		
Owners of the parent	3,050	1,109
Non-controlling interest	941	498
	3,991	**1,607**

JG Telecoms Group draft consolidated statement of financial position as at 30 April

	2019	2018
	------ Rs. in million ------	
Non-current assets		
Property, plant and equipment	49,219	38,243
Investment property	10,500	10,100
Intangible assets excluding goodwill	27,305	19,566
Goodwill	30,245	31,400
Investments in associates	6,553	4,120
Trade and other receivables	3,805	2,400
Financial assets	-	100
	127,627	105,929
Current assets		
Inventory	900	1,500
Trade and other receivables	21,005	17,600
Cash	2,936	4,500
	24,841	23,600
Total assets	**152,468**	**129,529**
Equity		
Share capital	70,000	60,500
Retained earnings	13,770	12,200
Other reserves	-	20
Non-controlling interest	1,453	1,800
	85,223	74,520
Non-current liabilities		
Long-term borrowings	21,582	15,000
Provisions	5,245	4,200
Deferred tax liabilities	2,129	2,500
Post-employment benefits	6,104	6,500
	35,060	28,200
Current liabilities		
Short-term borrowings	5,070	4,680
Trade and other payables	26,248	21,569
Taxation	867	560
	32,185	26,809
Total equity and liabilities	**152,468**	**129,529**

APPENDIX 3 – BACKGROUND INFORMATION

JG Telecoms is the parent company and owns the following subsidiaries:

Phone Shops
Phone Shops was a 100% owned subsidiary until 30 April 2019 when JG Telecoms disposed of 75% of its holding as it wanted to move out of the retail business. As part of the sale agreement, JG Telecoms agreed that a director would remain on the board of directors at Phone Shops who would regularly attend meetings and participate in strategic decision making.

An external valuations expert has estimated that the fair value of the 25% holding that was retained is Rs. 1,900 million.

Planning materiality was set at Rs. 150 million.

Karachi Communications
Karachi Communications is a 65% owned subsidiary and there has been no change in the shareholding during the year.

Planning materiality was set at Rs. 100 million.

ACG Telecoms
ACG Telecoms is a 100% owned subsidiary and there has been no change in the shareholding during the year.

Planning materiality was set at Rs. 50 million.

Quetta Technology
Quetta Technology is a newly acquired 65% owned subsidiary.

Planning materiality was set at Rs. 20 million.

All subsidiaries are audited by Zafar and Co.

Audit risk
JG Telecoms Group's results over the last few years have been disappointing. The group had been highly optimistic that the results would improve, and market expectations of its performance is high.

The group planning materiality has been set at Rs. 200 million, which is low in order to reflect the level of risk set at the planning stage.

Covenants
JG Telecoms has a bank loan of Rs. 15,000 million that contains covenants based on the group audited financial statements. The covenants are as follows:

Interest cover	$\frac{\text{Operating profit (excluding non-recurring items)}}{\text{Finance cost}}$
Ratio of cash to operating profits	$\frac{\text{Cash generated from operations}}{\text{Operating profit (excluding non-recurring items)}}$

JG Telecoms is required to maintain an interest cover of 2.5 times and the ratio of cash to operating profits should be 1.75. The covenants are calculated by reference to the group financial statements.

A breach of the covenants means that the loan becomes renegotiable with the potential for higher interest rates to be charged.

APPENDIX 4 – SUMMARY PREPARED BY THE PREVIOUS AUDIT MANAGER

Revenue
The audit team obtained details of all contracts entered into during the year in which Karachi Communications supplies and installs telecoms equipment and provides servicing of the equipment over a period of 24 months. This represents a new area of business for Karachi Communications. All of the contracts were entered into during the year ended 30 April 2019.

Karachi Communications has recognised revenue of Rs. 5,750 million for the year ended 30 April 2019. The audit team tried to discuss revenue recognition with the finance team at Karachi Communications but the finance team was adamant that the accounting treatment was correct and would not discuss this any further.

The audit team prepared the following analysis of transaction price:

	Rs. in million
Telecoms equipment	4,285
Installation	775
Servicing for the year ended 30 April 2019	250
Servicing for the year ending 30 April 2020	368
Servicing for the year ending 30 April 2021	72
Total	**5,750**

The audit team has used information on the standalone pricing arrangements for the equipment, installation and servicing contracts to prepare this analysis.

Investment property
JG Telecoms leases out its investment property under short-term leases. Its accounting policy is to measure investment property at fair value. The valuation of the investment property has been undertaken by a firm of property experts that JG Telecoms has used for many years, and Zafar and Co has always placed reliance on them as experts. A valuation exercise was carried out on 30 April 2019 and the resulting valuation of Rs. 10,500 million was included in the financial statements from that date. A fair value gain of Rs. 400 million was taken to profit or loss account.

The audit team has agreed the valuation of Rs. 10,500 million to the external valuation and audit procedures on this valuation have all been satisfactory. The valuation has been based on commercial use of the property. They have also noted that the fair value gain is included within operating expenses.

JG Telecoms obtained an additional valuation for the investment property as at 30 April 2019. The new valuer placed a valuation of Rs. 11,000 million on the property based on the use of the property being residential not commercial. JG Telecoms has no intention of changing the way in which it uses this property. The directors of JG Telecoms wish to process a late adjustment to reflect this new valuation in its financial statements.

Leasehold premises
During the year, ACG Telecoms entered into a 12-year lease for a property and this has been correctly accounted for as a right-of-use asset of Rs. 500 million and a corresponding lease liability. ACG Telecoms incurred a cost of Rs. 60 million in altering the property to meet its specifications and this amount has been correctly capitalised.

The audit team has reviewed the terms of the lease and noted a clause that requires ACG Telecoms to restore the property to its original condition at the end of the lease period. The client has informed that no estimate has been made for such cost and consequently no amounts have been included within the financial statements.

Phone Shops
On consolidation, JG Telecoms Group has included the profit on disposal of Rs. 766 million within operating expenses and has presented a balance for associates in the consolidated statement of financial position representing the 25% share of net assets and the goodwill. The group profit on disposal has been calculated as follows:

	Rs. in million
Proceeds	7,600
Less: 75% of net assets of Phone Shops	(5,600)
75% of goodwill	(1,234)
	766

Trade receivables
The group accounting policy for trade receivables is to recognise an allowance for lifetime expected credit losses from initial recognition. The group policy includes the following matrix to calculate the loss allowance:

Days overdue	**Expected loss allowance**
Nil	2%
1–30 days	5%
31–60 days	10%
60 days plus	15%

Audit of Quetta Technology revealed that a balance of Rs. 500 million had been included as being nil days overdue but the receivable was actually 60 days plus overdue according to the invoice date.

This was discussed with the credit controller who explained that the invoice had been sent out earlier than agreed with the customer and therefore the amount was not actually overdue. The audit team asked for correspondence with the customer over this amount but the credit controller was not able to provide any. The amount is still outstanding.

Financial asset
During the year Karachi Communications sold all of its 5% shareholdings in another entity and had elected to recognise the financial asset as fair value through other comprehensive income. At the date of disposal, the financial asset had a carrying amount of Rs. 100 million. A profit of Rs. 10 million was calculated based on the difference between the proceeds of Rs. 110 million and the carrying amount. An amount of Rs. 20 million was released from other comprehensive income at the date of disposal and included within operating expenses to give a total profit of Rs. 30 million.

The audit team has agreed the proceeds received to appropriate third-party documentation and has traced all amounts to the current and previous financial statements. The working papers show that the proceeds of Rs. 110 million have been included as an operating cash flow within the statement of cash flows. The team followed this up with the client which responded that as the purchase of the shares was part of its trading activities, this was the appropriate classification.

Restructuring and pensions
JG Telecoms has currently recognised a provision for restructuring of Rs. 500 million which relates to the closure of a division that was announced just before the year end. The audit working papers show that sufficient and appropriate evidence over this provision has been obtained.

The audit team noted that as part of the restructuring, a group of employees were guaranteed an additional payment to compensate them for the loss of future pension payments. The total amount of the payment is Rs. 150 million and is payable in July 2019. The team asked the finance department why this had not been included within the provision and they explained that the actuary would adjust for this amount when the payment to employees is made next year.

A review of the audit working papers of the group's defined benefit scheme found no mention of this event.

Cyberattack
The audit team overheard a discussion between employees of JG Telecoms in which they mentioned that the company had been subject to a recent cyberattack. They mentioned that JG Telecoms had not reported this incident to the relevant authorities which concerned them as this was a breach of legal regulations.

The audit team did not discuss this matter with the client as they did not identify any audit implications and were concerned that they would be seen to have overheard a private conversation.

APPENDIX 5 – EMAIL FROM CLIENT

To: Sara Hussain
From: Haniya Qureshi
Re: Secondment and tax service

Dear Sara,

As you know we value our relationship with Zafar and Co and we are hoping you can help us with two important areas.

(i) Our group financial controller is taking a sabbatical and we would like you to second a member of the audit team to us for six months. This would save us time in training a temporary member of staff who would have no prior knowledge of our business and systems.

(ii) A key member of our finance team has just resigned, and this means we lack the required skills in-house in relation to advising us on the tax implications of a proposed transaction. We would like Zafar and Co to provide this tax service to us.

There has been some discussions about putting our audit out to tender as some of the directors feel that Zafar and Co is too small to meet the demands of our group. I feel this is unfair and wanted to make you aware of this as we have such a good working relationship.

I look forward to hearing from you.

Kind regards

Haniya

QUESTION 2

You are Nadeem Omar and have recently been appointed as a financial controller for EM Pakistan (EMP) which is a listed company operating in the engineering sector.

The finance director, Ali Iqbal, has sent you an email, included in Appendix 1, asking for your assistance in finalising the financial statements of EMP for the year ended 31 May 2019. Ali also requires you to analyse the performance and financial position of EMP in preparation for his presentation to the board.

Ali has provided you with the draft financial statements of EMP in Appendix 2 and information relating to specific transactions that have not yet been accounted for in Appendix 3.

Requirements

(a) Prepare, providing relevant explanations, the adjustments required to the financial statements of EMP for the year ended 31 May 2019 that arise from the specific transactions in Appendix 3. **(10 marks)**

(b) Prepare the revised financial statements of EMP for the year ended 31 May 2019 after taking into account the adjustments prepared in (a). **(05 marks)**

Note: Ignore the tax impact of these transactions.

(c) Analyse the performance and financial position of EMP based on the revised financial statements for the year ended 31 May 2019 prepared in (b). Include any areas where additional information is required to enable the finance director to complete this analysis.

(15 marks)

Total: 30 marks

APPENDIX 1 – EMAIL REQUESTING ASSISTANCE

To: Nadeem Omar
From: Ali Iqbal
Subject: Assistance for the year ended 31 May 2019

Hi Nadeem,

Welcome to EMP. The draft financial statements have been prepared and I have provided these for you in Appendix 2.

I have also identified three transactions for which I think additional adjustments are required. I would like you to prepare any adjustments along with explanation.

After preparing the revised financial statements, I would like your help in preparing for my presentation to the board on EMP's performance and position. Please ensure that you identify any areas of concerns that the board might have.

To aid your analysis, here are a few key points about EMP:

- EMP has implemented a strategy of disposing of PPE. This was the result of a decision to outsource some areas of production in an attempt to save costs.
- This strategy has resulted in a profit on disposal of PPE of Rs. 1,850 million in the year, which have been included in operating costs.
- Research costs for the current year and previous year were Rs. 2,100 million and Rs. 5,500 million respectively.
- EMP has negotiated new contracts with suppliers to enable additional cost savings.
- A dividend of Rs. 12,000 million was paid this year and the dividend paid in 2018 was Rs. 4,000 million.

Kind regards

Ali

APPENDIX 2 – DRAFT FINANCIAL STATEMENTS

Statement of profit or loss for the year ended 31 May 2019

	2019	2018
	-------- Rs. in million --------	
Revenue	75,300	73,041
Cost of sales	(33,132)	(40,173)
Gross profit	42,168	32,868
Operating costs	(13,091)	(15,820)
Finance income	494	290
Finance costs	(6,387)	(6,700)
Profit before tax	23,184	10,638
Income tax expense	(6,232)	(3,200)
Profit for the year	**16,952**	**7,438**

Summarised statement of financial position as at 31 May 2019

	2019	2018
	-------- Rs. in million --------	
Non-current assets		
Property, plant and equipment	81,770	87,450
Intangible assets	36,527	43,170
Investments	3,500	-
	121,797	130,620
Current assets		
Inventories	1,724	3,990
Receivables	4,528	4,395
Cash	10,976	1,300
	17,228	9,685
Total assets	**139,025**	**140,305**
Equity		
Share capital	32,000	32,000
Retained earnings	35,932	30,980
	67,932	62,980
Non-current liabilities		
Loan	58,431	60,000
Deferred tax	5,550	6,500
	63,981	66,500
Current liabilities		
Trade payables	1,912	3,100
Income tax	4,500	3,500
Overdraft	700	4,225
	7,112	10,825
Total equity and liabilities	**139,025**	**140,305**

APPENDIX 3 – TRANSACTIONS

Debt factoring

On 31 May 2019, EMP sold trade receivables to a factoring company for their full carrying amount of Rs. 3,500 million. EMP agreed to reimburse the factoring company if it is unable to collect the Rs. 3,500 million after four months. EMP has derecognised the trade receivables. The factoring fee arising on set up has been included within operating costs.

Sale and leaseback

EMP sold one of its office buildings to a financial institution on 1 June 2018 and then immediately leased it back for a period of 15 years. The office building had a carrying amount of Rs. 2,800 million at the date of sale. The remaining useful life of the office building at 1 June 2018 was 40 years. The office building had a fair value at that date of Rs. 3,400 million and this was the same as the sale price. EMP has the exclusive right to use the asset across the lease term and there are no restrictions associated with the terms of use. At the end of the 15-year lease, the building will transfer back to EMP at no cost.

Under the terms of the lease, an instalment of Rs. 320 million is payable in arrears, the present value of the of the future lease payments is Rs. 3,400 million and the interest rate implicit in the lease is 4.65%.

This transaction was accounted for on 1 June 2018 as a disposal of PPE and the lease payment of Rs. 320 million is included within operating expenses.

Investments

On 1 January 2019, EMP acquired equity shares in RB plc, a company based in the United Kingdom, for a cost of £19.71 million. The shares were translated at the spot rate on the date of purchase and are currently included at Rs. 3,500 million in EMP's financial statements.

As the shares are intended to be held for the long term, the election was made to classify them as fair value through other comprehensive income. At 31 May 2019, the shares of RB plc were valued at £22.67 million. The exchange rate at that date was £1 = Rs. 178.87. The shares have been held at cost and not retranslated as they are non-monetary asset.

QUESTION 3

You are Ibrahim Ali working as an audit senior for Alvi and Co, a firm of chartered accountants. You have been asked to assist with planning the audit of a new client for the year ending 30 June 2019.

In Appendix 1, the audit manager, Zakia Ahmed, provides background information and instructions on the work that is required. Appendix 2 provides the key extracts from the budgeted financial statements for the year ending 30 June 2019.

Appendix 3 includes the specific transactions that Alvi and Co identified after the initial audit strategy was determined.

Requirements
Read the information provided in Appendices and prepare a working paper in which you:

(a) explain the financial reporting issues arising from your review of the transactions included in Appendix 3. **(08 marks)**

Note: Ignore the tax impact of these transactions.

(b) identify and explain the audit risks arising from the financial reporting issues and discuss the impact of the issues on our audit strategy, including resources and budget implications. **(12 marks)**

Total: 20 marks

APPENDIX 1 – BACKGROUND INFORMATION AND INSTRUCTIONS FROM AUDIT MANAGER

To: Ibrahim Ali
From: Zakia Ahmed
Re: Audit planning AG Textiles

Dear Ibrahim,

AG Textiles is a new audit client and consequently we have begun the audit planning process well before the year-end. The audit was put out to tender as the previous auditor was a small audit firm. The previous auditor gave us professional clearance and also granted us access to review their working papers.

AG Textiles is a non-listed company that designs and manufactures textiles that are sold to wholesale customers. The company is currently family owned but they have plans to seek additional investment to grow the business. The only investment of AG Textiles is in MM Silk which produces the silk that AG Textiles uses in its manufacturing process.

We have identified that the controls in place at AG Textiles are weak and our audit approach is to rely on substantive testing.

The planning process for AG Textiles has identified some specific transactions that we were not aware of when we accepted the engagement and have not been included in our current assessment of risk and audit strategy. I am particularly concerned that there may be implications for resources and the audit budget.

I would like you to review the specific transactions in Appendix 3 and explain the financial reporting implications, identify and explain the key audit risks and discuss the impact on the audit strategy. At this stage I do not require any audit procedures apart from your assessment of the significance of the transactions and the implications for our audit planning and budget.

Regards

Zakia Ahmed

APPENDIX 2 –EXTRACTS FROM BUDGETED FINANCIAL STATEMENTS

	30 June 2019 Budgeted	**30 June 2018 Actual**
	-------- Rs. in million --------	
Total assets	1,200	815
Revenues	800	680
Profit before tax	360	224

APPENDIX 3 – TRANSACTIONS

Foreign sales
In May 2019, AG Textiles began to make sales to wholesalers located in a variety of foreign countries. AG Textiles has previously sold only in the domestic market. AG Textiles agreed that it would invoice the customers in their local currency and this area of business has expanded more than expected.

Acquisition of investment
On 1 June 2019, AG Textiles acquired a controlling interest in MM Silk for Rs. 300 million. AG Textiles had previously owned 25% of the issued shares of MM Silk and had previously accounted for this investment using equity method as it had significant influence over MM Silk.

The initial planning work was carried out before the acquisition was undertaken. MM Silk was identified as an associate and the audit strategy was developed on this basis. Our initial planning shows the following figures for MM Silk:

	30 June 2019 Budgeted
	Rs. in million
Total assets	345
Revenue	180
Profit before tax	86

MM Silk is audited by another firm who will perform the audit for the year ending 30 June 2019.

Development costs
As part of our audit planning, the review of management information identified an unusual cost during January 2019. This was discussed with management and they explained that it related to a failed development project. The costs relate to development of a new waterproof fabric and management explained that they had encountered technology problems that meant the waterproofing qualities were no better than existing products.

In January 2019, AG Textiles judged that the development would be halted and it expensed all of the costs incurred to date of Rs. 34 million, of which Rs. 22 million relates to amounts that had been capitalised as development costs in the prior year.

Our review of the previous auditor's working papers indicates that the audit evidence gathered was based on discussing the technical feasibility with the production team. The auditors obtained evidence over early prototypes that showed promising waterproof qualities. Management additionally provided the auditors with a management representation that, in their judgement, all of the criteria within IAS 38 *Intangible Assets* had been met to allow capitalisation.

No additional evidence was found in our review of previous auditor's working paper.

(THE END)