**The Institute of Chartered Accountants of Pakistan**

**Multi Subject Assessment Stage Examination**

2 December 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 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 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 examinees do not have a detailed knowledge of the types of organisations to which they relate. No additional mark will be given to examinees displaying such knowledge.
7. Only **FIVE** original books duly bound are allowed.

# QUESTION 1

You are Taaj Shah, working as an audit manager for A&F Chartered Accountants (A&F). You have been assigned as the manager on the audit of TH Engineering Group for the year ending 31 December 2019. TH Engineering is a listed company. A&F have audited TH Engineering and its subsidiaries for a number of years. You are about to commence the planning stage of the audit.

In Appendix 1, the audit partner, Saeed Chaudhry, has emailed you the information about a change in the group structure and detailed instructions as to what he requires you to do. Appendix 2 contains some background information on the group and details of transactions that have been entered into during the year.

In Appendix 3, there is an email from the director of TH Engineering requesting advice on proposed financing arrangements and the potential request for an assurance engagement.

**Requirements**

(a) Identify and explain the key audit risks arising from the review of Appendix 1 and Appendix 2 for the year ending 31 December 2019. Also explain how each audit risk would impact the financial statements of group and individual companies.

**(36 marks)**

(b) Explain the financial reporting treatment of the proposed financing arrangements referred to in Appendix 3.

**(08 marks)**

(c) Discuss the ethical and professional issues of the request in Appendix 3 to report on the forecast information.

**(06 marks)**

**Total: 50 marks**

**APPENDIX 1 – EMAIL FROM AUDIT PARTNER**

**To:** Taaj Shah
**From:** Saeed Chaudhry
**Subject:** Audit of the TH Engineering Group
**Date:** 2 December 2019

Hi Taaj,

Thank you for agreeing to be the audit manager of TH Engineering, its subsidiaries and the group financial statements. This is a large client that is important to the firm.

The only change in the group structure during the year is the acquisition of a new subsidiary, Ghazi Motors (Private) Limited which will not only enhance the group financially, but will secure the supply of key components in the group's manufacturing process. As part of the negotiation process, it was agreed that TH Engineering would make an additional payment of Rs. 1,000 million on 31 March 2020, if Ghazi Motors successfully completes a contract negotiation with a new client by 1 March 2020. This negotiation is still ongoing. An additional reason for the group being so keen to acquire Ghazi Motors is that it is in the early stage of research into a new piece of technology that could be helpful for the whole group.

At this stage of audit planning, I would like you to explain in detail the key audit risks and impact of each risk on the financial statements of group and individual companies, as this will enable us to plan the audit in more detail.

Once I have received your notes, we can meet to discuss our response to the risks that you have identified and begin resource allocation.

Regards,

Saeed

## APPENDIX 2 – BACKGROUND INFORMATION AND DETAIL OF TRANSACTIONS

**Group structure**
TH Engineering has a controlling interest in RV Construction, First Motors and Pakistan Fabrication. All of these companies have been owned by the group for a number of years and are audited by A&F. On 1 May 2019, TH Engineering acquired 80% interest in Ghazi Motors. The audit of Ghazi Motors will be conducted by its existing auditor.

The projected figures for the parent and each subsidiary for the year ending 31 December 2019 are as follows:

| | Profit before tax | Total assets |
|---|---|---|
| | --- Rs. in million --- | |
| TH Engineering | 4,250 | 28,500 |
| RV Construction | 2,700 | 15,500 |
| First Motors | 640 | 2,200 |
| Pakistan Fabrication | 220 | 1,100 |
| Ghazi Motors | 2,810 | 17,200 |

The profit before tax of Ghazi Motors represents the post-acquisition profit that will be consolidated into the group financial statements.

After consolidation adjustments, the draft profit before tax and total assets of the group are expected to be Rs. 9,500 million and Rs. 58,600 million respectively.

**Acquisition of Ghazi Motors**
TH Engineering has provided us the following calculation of the goodwill arising on the acquisition of Ghazi Motors:

| | Rs. in million |
|---|---|
| Cash paid | 6,000 |
| Non-controlling interest at fair value | 1,200 |
| Acquisition costs | 150 |
| | 7,350 |
| Carrying value of net assets | 5,000 |
| Fair value adjustment of property | 650 |
| | (5,650) |
| Goodwill | **1,700** |

The financial statements of Ghazi Motors for the year ended 31 December 2018 included a disclosure note for a contingent liability of Rs. 250 million for a court case. Ghazi Motors had legal advice that the chance of paying this amount was assessed as possible. The court case was settled in November 2019 and Ghazi Motors was ordered to pay Rs. 500 million which it will pay in December 2019. Ghazi Motors will recognise this as an expense in profit or loss, but the group plans to adjust the goodwill calculation for this payment.

**Investment property**
At the beginning of the year, TH Engineering acquired a building which is rented out under a series of short-term leases as commercial offices. TH Engineering has not previously owned any investment properties and has chosen to account for the investment property using the fair value method. The valuation was performed by an independent valuer, based on its use as a residential property and shows that the fair value has increased by 25% since acquisition.

**Leases**

On 1 January 2019, TH Engineering entered into two separate and significant lease agreements to obtain the use of a factory and an office building for 10 years. The terms of both leases require that the lease payment will increase every year in line with inflation. TH Engineering has calculated the lease liabilities by estimating the future lease payments, based on inflation of 10% per annum.

RV Construction needs new assets and has decided not to purchase them outright. It has instead decided to enter into lease agreements which will enhance the efficiency of the business. The agreements also include the servicing of the assets. RV Construction signed the lease agreements on 1 November 2019. The present value of lease payments, for the lease component is Rs. 2,400 million which is the amount that the lease liability is recorded at. The present value of the total lease payments including the service component is Rs. 3,000 million.

**New business area**

RV Construction entered into a new business area by constructing pieces of specialised machinery for customers, which on average takes over two years. Revenue from such customers represents over 50% of the revenue of the company. RV Construction recognises revenue based on the value of work certified at the year end.

RV Construction has capitalised contract costs of Rs. 300 million comprising of staff costs, external consultant fees and commission payments to staff for securing the contracts.

**Bond purchase**

Pakistan Fabrication acquired a bond on 1 April 2019 for Rs. 165 million. The bond attracts an interest rate of 6% per annum and is repayable in five years' time. Pakistan Fabrication would receive an additional payment each year if gold prices are higher than an agreed rate.

**Future contracts**

Ghazi Motors has entered into a three-year contract for the purchase of key raw material that it uses in its manufacturing process. The contract permits Ghazi Motors to take physical delivery of the material or can be settled net in cash. It is the first time that any group company has entered into an agreement like this. The directors are pleased with the contract, as the price of the material has significantly increased since signing of the contract.

**Redundancy**

In November 2019, the board of directors of TH Engineering met to discuss the possible redundancy plan for some administrative staff. The board discussed that the expected payments would be Rs. 300 million. Though this amount has not yet been accrued, TH Engineering is planning to create a provision in the year-end financial statements of Rs. 300 million.

## APPENDIX 3 – CLIENT EMAIL

**To:** Saeed Chaudhry
**From:** Sana Khan
**Subject:** Proposed financing arrangements
**Date:** 27 November 2019

Hi Saeed,

With reference to our recent audit planning meeting, here are the details of proposed financing arrangements. I would like you to explain the accounting treatment of these. We have following two options to raise funds:

**Sale and leaseback**
A financial institution has agreed to pay us above the current market value for our factory and to lease it back to us for a period of five years. The directors are keen on this option, as they think it will increase the profits next year.

**Loan notes**
The loan notes would be issued at a nominal value of Rs. 4,500 million carrying interest of 8% per annum, and would be repayable at a premium in five years' time.

For the loan notes, we would be required to provide a formal report, containing forecasts. I would like your firm to report on these forecasts to reduce costs rather than us using a different firm.

Regards,

Sana

# QUESTION 2

You are Isha Hussain, an ICAP qualified chartered accountant. You have been recently appointed as group financial controller at Passun Limited, a listed company. Passun owns 80% of the ordinary share capital of both PAK and ETH. Passun has a policy of valuing non-controlling interest using the proportionate method.

The finance director, Mehdi Shah, is also new to the role and has asked for your assistance in finalising the interim consolidated financial statements for the six months period ended 31 October 2019.

Appendix 1 contains an email from the finance director containing background information and details of the assistance he requires. Appendix 2 is the draft interim consolidated financial statements for the six months period ended 31 October 2019 prepared by previous group financial controller and Appendix 3 gives additional information about the areas of concern identified by the finance director.

**Requirements**

(a) Explain the correct financial reporting treatment of the transactions identified in Appendix 3 for inclusion in the interim consolidated financial statements for the six months period ended 31 October 2019. Your answer should include adjusting entries, where relevant.

**(18 marks)**

(b) Redraft, taking into account the adjustments prepared at (a), the interim consolidated financial statements for the six months period ended 31 October 2019.

**(05 marks)**

(c) Explain any ethical or other relevant professional issues arising from your review of all the Appendices.

**(07 marks)**

**Total: 30 marks**

## APPENDIX 1 – EMAIL FROM FINANCE DIRECTOR

**To:** Isha Hussain
**From:** Mehdi Shah
**Subject:** Interim financial statements
**Date:** 30 November 2019

Hi Isha,

Welcome to Passun Group. As you know, I have just been appointed and my first task is to ensure the interim financial statements are prepared at the earliest as we have to send them to the relevant authorities within 45 days of the period end.

Your predecessor, Izad Reza, had prepared draft interim financial statements. I was able to speak to Izad and discussed identified areas of concern arising from my review. I have outlined these areas in Appendix 3 and would like you to review the current financial reporting treatment that Izad has used in the draft. At this stage, ignore any impact on taxation, as we can consider this later.

Izad told me that as the previous finance director left over three months ago, he was given direction by the chief executive of the Passun Group, explaining that he often felt unable to question any financial reporting treatment that was proposed by the chief executive.

The chief executive and I recently had a conversation in which he expressed that he hoped I would have more commercial awareness, as my predecessor was frequently challenging the board. The chief executive further explained that it is in everyone's best interest to ensure that we consider the market expectations. In particular, he raised concerns relating to the forecasted profit for the next 18 months, which is lower than the market expectations. Finally, I was told that the relationship with the external auditors has been challenging and he hoped I would be able to manage the relationship better, especially during the interim review, as this should be no more than a high-level review, without the need for lots of questions.

I look forward to receiving your work as requested.

Regards,

Mehdi

## APPENDIX 2 – DRAFT INTERIM CONSOLIDATED FINANCIAL STATEMENTS

**Passun Group draft consolidated statement of profit or loss for the six months period ended 31 October 2019**

| | Rs. in million |
|---|---|
| Revenue | 1,400 |
| Cost of sales | (305) |
| **Gross profit** | 1,095 |
| Distribution costs | (63) |
| Administration expenses | (490) |
| **Operating profit** | 542 |
| Finance costs | (95) |
| Finance income | 45 |
| **Profit before tax** | 492 |
| Taxation | (98) |
| **Profit after tax** | **394** |

**Passun Group draft consolidated statement of financial position as at 31 October 2019**

| | Rs. in million |
|---|---|
| **Non-current assets** | |
| Property, plant and equipment | 5,550 |
| Intangibles | 825 |
| Investment property | 145 |
| | 6,520 |
| | |
| **Current assets** | |
| Inventory | 26 |
| Trade and other receivables | 136 |
| Cash | 1,250 |
| | 1,412 |
| **Total assets** | **7,932** |
| | |
| **Equity** | |
| Share capital | 1,800 |
| Retained earnings | 1,181 |
| Non-controlling interest | 260 |
| | 3,241 |
| | |
| **Non-current liabilities** | |
| Loan | 2,350 |
| Provisions | 860 |
| Deferred tax | 1,050 |
| | 4,260 |
| | |
| **Current liabilities** | |
| Trade and other payables | 145 |
| Provisions | 195 |
| Taxation | 91 |
| | 431 |
| **Total equity and liabilities** | **7,932** |

## APPENDIX 3 – AREAS OF CONCERN

**(1) Impairment of subsidiary PAK**

At 31 October 2019, Izad has calculated the recoverable amount of PAK as being equal to its value in use of Rs. 980 million. Based on this, he calculated the impairment as follows:

| | Rs. in million |
|---|---|
| Carrying amount of goodwill | 50 |
| Carrying amount of net assets | 1,015 |
| | 1,065 |
| Recoverable amount | (980) |
| Impairment loss | 85 |

Izad then allocated the impairment loss to goodwill and the remainder to property, plant and equipment (PPE) included in the net assets of PAK. Upon consolidation, the impairment had not been allocated to the non-controlling interest.

Izad also explained that the value in use calculations included a cash outflow for a future restructuring at a present value of Rs. 87.5 million. The other cash flows in calculation of value in use had not been adjusted for any future restructuring. Izad explained that this amount was not included in the financial statements of PAK. The chief executive wanted the amount to be reflected in calculation of value in use because they might not do any restructuring, so the impairment could still be reversed.

Izad explained that the chief executive was clear that the auditors would not be concerned by the inclusion of this amount for restructuring, as it had no impact on the full year financial statements, as a result of the reversal.

Neither the interim financial statements nor the directors' report refer to the impairment.

**(2) Investment property**

On 1 October 2019, Passun began own use of a building that had been previously classified as an investment property. The property was included in the prior year financial statements at its fair value of Rs. 650 million.

The property has been transferred to PPE at this value, and depreciation has been calculated on the building element of Rs. 500 million over a useful life of 50 years. The directors have discussed that they plan to occupy the building only for a few years. Property prices in the location have seen significant increase in the past year and this is expected to continue. Passun's accounting policy is to measure PPE at cost.

**(3) Bonus**

ETH has recognised an expense and a corresponding short-term provision of Rs. 85 million for a bonus payment to certain staff. The details of the bonus scheme were discussed by the directors before 31 October 2019 and those discussions formed the basis for the inclusion of the amount. The bonus scheme was announced to the entitled staff on 3 November 2019. The amount has been included because based on the interim figures, the staff have reached the half year targets in the bonus scheme.

**(4) Planned major works**

Passun has recognised an expense of Rs. 110 million and a corresponding short-term provision for the planned expenditure on safety guards for existing equipment that are required as a result of changes to the law in October 2019. The changes in law apply immediately to all new items of equipment, and all old equipment must be compliant with the law by 1 April 2020.

Passun intends to fully comply with the new legislation after considerable press coverage. Staff have also raised their concerns about the safety of the equipment.

The provision includes Rs. 5 million for cost of staff training that will be required to ensure staff can correctly operate the equipment after the new safety guards have been installed.

**(5) Foreign purchases**

In September 2019, Passun bought some goods from a foreign supplier for USD 0.28 million. The transaction was recorded at the spot rate on the date the goods were acquired and has not been retranslated. This is because Passun expects the exchange rate to change by the time the amount is settled so on a yearly basis the gain or loss would be reversed.

# QUESTION 3

You are Ibrahim Ali and work as an audit senior for a firm of chartered accountants based in Karachi.

You have been assigned to replace the existing audit senior on the audit of Karachi Textiles (Private) Ltd, which is a subsidiary of a public company, for the year ended 30 September 2019. You were previously involved in the planning phase for this client and are now working on the audit field work, which is close to completion. The audit manager, Zakia Ahmed, has asked for your assistance in the finalisation of some areas before the final client meeting.

Appendix 1 is an email from Zakia with the details of the work required while Appendix 2 provides extracts from the draft financial statements. In Appendix 3, the outstanding issues have been summarised.

**Requirements**

(a) Prepare a note that:

(i) Identifies and explains the financial reporting implications of the issues identified in Appendix 3, on the financial statements of Karachi Textiles for the year ended 30 September 2019. Outline any actions required prior to signing of the audit report.

**(08 marks)**

(ii) Evaluates the impact of the issues identified in (a) (i) on the auditor's report. Consider each issue separately.

**(10 marks)**

(b) Evaluate the completeness of directors' report in accordance with the Companies Act 2017.

**(02 marks)**

**Total: 20 marks**

## APPENDIX 1 – EMAIL FROM AUDIT MANAGER

**To:** Ibrahim Ali
**From:** Zakia Ahmed
**Subject:** Audit completion of Karachi Textiles
**Date:** 30 November 2019

Hi Ibrahim,

Thank you for agreeing to help with the completion of the audit of Karachi Textiles as the audit sign off is close. The audit senior has had to go on study leave. You are ideally placed to take over as you were involved in the planning of the audit.

The previous audit senior has provided a summary of some areas that we need to consider before we sign the audit report. I would like you to provide a summary of the financial reporting implications of each of the issues and the actions that we need to take before signing off.

I would then like you to explain the potential impact of each of the issues on the auditor's report but consider each issue separately at this stage.

Finally, I have reviewed the draft directors' report and noted that there is no information on any defaults that have occurred in the year, nor is there any statement about the adequacy of internal controls.

Regards,

Zakia

## APPENDIX 2 – EXTRACTS FROM THE DRAFT FINANCIAL STATEMENTS

**Statement of profit or loss for the year ended 30 September 2019**

| | **Rs. in million** |
|---|---|
| Profit before tax | 495 |

**Statement of financial position as of 30 September 2019**

| | **Rs. in million** |
|---|---|
| **Current assets** | |
| Inventory | 75 |
| Trade receivables | 120 |
| Cash | 15 |
| | **210** |
| | |
| **Non-current liabilities** | |
| Bank loan | 625 |
| Provisions | 325 |
| Deferred tax | 86 |
| | **1,036** |
| | |
| **Current liabilities** | |
| Overdraft | 290 |
| Bank loan | 60 |
| Trade and other payables | 86 |
| Income tax payable | 25 |
| | **461** |

## APPENDIX 3 – OUTSTANDING ISSUES

The following is the summary of the outstanding issues on the audit of Karachi Textiles:

**(1) Long-term loan**

Included within Karachi Textiles' bank loans is a loan of Rs. 250 million, of which Rs. 190 million is currently classified as non-current liabilities. The amounts and classification are in agreement with the original repayment schedule.

During the year, Karachi Textiles defaulted on a payment, which as per the loan agreement, means the whole loan balance becomes immediately repayable on demand. Audit evidence has been obtained that confirms the default, the loan agreement terms and correspondence with the bank.

Negotiations with the bank were concluded on 15 November 2019 and the bank agreed not to demand full and immediate repayment as a result of the breach. As the waiver was agreed before authorising the financial statements, the finance director has not amended the financial statements and the liability of Rs. 190 million is classified as a non-current liability.

Karachi Textiles has not even disclosed the details of the breach in its financial statements.

**(2) Bank overdraft**

Karachi Textiles is reliant on a bank overdraft from another bank that is due for renewal in January 2020. Correspondence with the bank was reviewed and whilst renewal of the overdraft facility is under discussion, audit evidence concluded that Karachi Textiles is a going concern provided the overdraft facility is renewed. However, this uncertainty needs to be disclosed.

**(3) Fraud**

A fraud was discovered in November 2019. A member of staff had been misappropriating raw materials as a result of lack of controls over goods leaving the building. He had managed to conceal the fraud by falsifying the inventory count sheets. Karachi Textiles has calculated that the amount of inventory at year end is overstated by Rs. 0.5 million but no adjustment has been made to the financial statements. We have sufficient audit evidence to confirm that the extent of the fraud is not greater than this amount.

**(4) Inventory valuation**

The audit on inventory valuation has identified items in inventory that have not been sold by the date of testing. These items relate to fashion clothing that Karachi Textiles sells to resellers, which had an original cost of Rs. 20 million when it was produced in June 2019. The audit team's review of sales during the year shows that, on average, similar fashion items which are held for more than four months, sell for 20% of the original cost.

The sales manager was confident that these items would sell for more than they cost but could not produce any additional evidence. The directors were not interested in discussing this as they said they left these decisions to the sales manager who has much greater knowledge of these items and the selling price.

**(THE END)**