The Institute of Chartered Accountants of Pakistan

Multi Subject Assessment Stage

7 December 2020
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.

NOTICE TO EXAMINEES

Throughout this exam the implications of Coronavirus, if any, should be ignored and no marks will be awarded for any such reference on the issues outlined in the questions.

QUESTION 1

You are Umar and work as an audit manager for MAAN & Co. Chartered Accountants. The audit partner, Riaz, has asked for your assistance for the completion of the group audit of Saba Laboratories (SL), a listed company, for the year ended 31 October 2020. Riaz explained that the previous audit manager did not have sufficient time to work on all his engagements.

In Appendix 1, you are provided with the background information on SL, and the draft group financial statements are provided in Appendix 2. The previous audit manager has performed his review of the audit working papers, and has identified areas requiring your attention, as presented in Appendix 3. No explanation has been provided as to why these areas have been highlighted.

An email from Jana Sheikh, the chief executive of SL, is presented in Appendix 4 in which Jana has asked for MAAN & Co.'s assistance on the appointment of a non-executive director. You have been asked to prepare a response to this request for Riaz's review.

Finally, in preparation for the independent review of the audit of SL and the subsidiaries after reviewing all of the information, prepare a summary that explains any quality control issues in respect of the group audit of SL.

Requirements

(a) Review the information presented in Appendix 1, Appendix 2 and Appendix 3, then:

(i) Explain any financial reporting issues that have not been correctly accounted for in the group financial statements for the year ended 31 October 2020. Prepare journals where possible. **(20 marks)**

(ii) Explain any audit issues that need to be resolved before the completion of the group audit for the year ended 31 October 2020. Outline actions required by the audit team for each of the audit issues identified. **(22 marks)**

(b) Prepare a response to the request for assistance on the appointment of a non-executive director at SL. **(05 marks)**

(c) Prepare a summary that explains any quality control issues identified in the group audit of SL. **(03 marks)**

Total: 50 marks

APPENDIX 1 – BACKGROUND INFORMATION

SL Group operates in the pharmaceuticals and healthcare market. The following subsidiaries have been owned by SL for a few years and are all audited by MAAN & Co.:

- Karachi Research (KR)
- Multan Manufacturing (MM)
- Gujrat Vitamin (GV)

During the year ended 31 October 2020, SL acquired two new subsidiaries:

- Quetta Pharmaceuticals (QP) was identified as a significant component at the audit planning stage. This year's audit of QP has been performed by its existing auditors, Hamid & Co. As part of the planning process, Hamid & Co. was contacted and has agreed to provide MAAN & Co. with a report that summarises the results of the audit.

- Peshawar Health (PH) is also a significant component of SL Group. MAAN & Co. was appointed as its auditor for the year ended 31 October 2020.

These two acquisitions have increased the SL's consolidated profit after tax by just over 25%. The profitability of the other group companies has remained relatively stable with GV as the sole exception. GV's customers sell vitamins within the domestic market and they have been negatively impacted by changes in the economy.

Group materiality has been assessed as Rs. 80 million, which is a low amount to reflect the increased risk due to the changes in the group structure. The key risk area for the group is the treatment of research and development expenditures, which is an inherently risky area with the potential to impact on the consolidated profit.

APPENDIX 2 – DRAFT FINANCIAL STATEMENTS

Saba Laboratories draft consolidated statement of profit or loss for the year ended 31 October 2020

	Rs. in million
Revenue	15,580
Cost of sales	(5,453)
Gross profit	**10,127**
Research and development costs	(1,527)
Administration expenses	(5,472)
Operating profit	**3,128**
Finance costs	(404)
Finance income	15
Profit before tax	**2,739**
Tax	(657)
Profit after tax	**2,082**

Saba Laboratories draft consolidated statement of financial position as at 31 October 2020

	Rs. in million
Non-current assets	
Property, plant and equipment	6,277
Investment in associates	123
Intangible assets	8,569
	14,969
Current assets	
Inventories	2,801
Trade and other receivables	3,201
Cash	1,252
	7,254
Total assets	**22,223**
Equity	
Share capital	4,337
Retained earnings	5,212
Non-controlling interest	812
	10,361
Non-current liabilities	
Loan	6,955
Provisions	895
Deferred tax	287
	8,137
Current liabilities	
Trade and other payables	2,750
Provisions	450
Taxation	525
	3,725
Total equity and liabilities	**22,223**

APPENDIX 3 – SUMMARY OF AUDIT WORKING PAPERS

Component auditor QP

Hamid & Co. had not identified an audit risk arising from share-based payments in its audit planning; however, during conversation with client staff, it became clear to the audit team that there was an arrangement in place. Hamid & Co.'s report contained the following summary of the audit testing performed:

> The audit team asked QP's finance director for details of the share-based payment arrangement and these details have been placed on file. The finance director explained that the share-based payment contains a performance condition that requires QP's revenue to increase by 10% over the three-year vesting period. As QP's revenue had only increased by 2% in the current year, the finance director had concluded that the likelihood of meeting this condition was low and therefore no expense had been included.
>
> The audit team had agreed the detail of the performance condition to the share-based payment agreement and had recalculated the revenue increase of 2%. As such, they agreed with the finance director's conclusion that an expense was not required to be recognised.
>
> In conclusion, the audit evidence is sufficient to support the non-recognition of expense, especially as the amount involved is likely to be immaterial on a group basis.

Outsourcing of payroll function

The payroll function of SL and the existing subsidiaries was previously administered by the central finance function at SL's head office. Prior year audit testing of payroll controls had been satisfactory and MAAN & Co. had historically placed reliance on these controls.

During the audit, the team identified that the central payroll function had been outsourced to a service provider since 1 November 2019. The total payroll expense of Rs. 2,456 million for SL and the existing subsidiaries has been tested in line with the previous year's approach of performing substantive analytical procedures. Results of the analytical procedures were satisfactory and support the total payroll expense.

Development costs

KR obtained regulatory approval for a newly developed drug in Pakistan and have incurred Rs. 65 million of additional development costs necessary to seek regulatory approval for the drug in UK. KR has capitalised all of these additional costs on the basis that the drug has been granted approval in Pakistan.

The audit team has obtained evidence that the drug has been approved in Pakistan and has carefully reviewed the projected forecasts that show the drug will generate an economic benefit if it is approved for the UK market. The additional costs applicable to regulatory approval for the UK have been verified from supporting document to confirm that all of the costs relate to development activities required to obtain this approval.

Exchange of development

SL has been developing a cough relief drug for the French market. It had incurred development costs of Rs. 60 million, which had been correctly capitalised in prior periods. During the year, SL agreed with a French pharmaceutical company to exchange the development of this drug for the development of a pain relief drug within Pakistan. The agreement was made as both parties considered they could use their own expertise within the different markets to gain regulatory approval. The amount already incurred by the French company for development of the pain relief drug equates to Rs. 40 million, but this was still agreed as a fair exchange by both parties.

SL has continued to hold the development costs at Rs. 60 million and has provided evidence of the pain relief drug's technical feasibility to the audit team, as well as its probable future economic benefit. The review of the audit testing confirms that it is appropriate to continue to recognise the development costs at Rs. 60 million, as there is sufficient and appropriate evidence that it meets the criteria for recognition under IAS 38 *Intangible Assets.*

Goodwill on acquisition of PH

The goodwill arising from the acquisition of PH was recalculated and the cash consideration in the calculation was vouched to the share purchase agreement and PH's bank statement. The review of the agreement and discussion with the client confirmed that no other consideration was payable. On acquisition, PH had net assets of Rs. 3,458 million and these amounts were agreed to management information and due diligence information. The only fair value adjustment was in respect of acquired in-process development relating to a production method that will enhance many of the group's production activities. The development did not meet the criteria for recognition in the financial statements of PH. The fair value of the development was estimated to be Rs. 150 million at acquisition, and this amount has been evidenced by the due diligence report and a detailed review of the negotiations between SL and PH.

The goodwill calculation has been recalculated and traced to the consolidation schedule to ensure that the correct journals have been processed. The testing of the consolidation schedule also confirmed that the post-acquisition results of PH have been appropriately consolidated.

Since acquisition, PH has incurred Rs. 55 million on this development but has expensed them. However, in the group financial statements the amount has been capitalised in line with the fair value adjustment. No amortisation has been charged on the balance as the production process is not yet in use. The audit team has not carried out any additional testing on the balance as the amounts incurred since acquisition are immaterial.

Sale agreement

During the year, GV negotiated a new agreement to sell a pharmaceutical product to an existing client. The negotiations were prolonged as the client felt that given the large number of units being purchased, it should gain favourable terms.

Finally it was agreed that for the year to 30 June 2021, each unit sold would initially be invoiced at Rs. 12,000 then, if the units purchased reached the agreed level, the client would be entitled to a rebate on all units purchased as per the following table:

Units purchased within a year	Probability of purchase level	Client rebate
0 - 199,999	25%	0%
200,000 - 249,999	60%	7%
Greater than 250,000	15%	20%

The audit team have agreed the terms to the signed contract. Since the contract was signed, the client has purchased 50,000 units and receipt of Rs. 600 million had been recognised as revenue. The audit team has completed controls and system testing over recording of invoices, which was all satisfactory. The team also agreed the 50,000 units sold from the accounting system and confirmed that all were related to this particular client.

Trade receivables – GV

The customers of GV are all based in Pakistan. They are all assessed as having similar risk factors and balances are usually received within 60 days, so GV uses the simplified approach to measure expected credit losses.

GV has calculated the impairment allowance at the year end and the movement for the year as follows:

Receivable age	Receivables balance	Loss rate	Expected credit loss
	Rs. in million		Rs. in million
Less than 30 days	100	1.5%	1.50
31-59 days	90	2.5%	2.25
60-89 days	140	4.0%	5.60
Greater than 90 days	150	6.0%	9.00
Total	480		18.35
Prior year balance brought forward			(6.00)
Movement charged to P/L			12.35

The current year's amounts have been checked against the current year's financial records and the previous year's balance checked against the previous year's working papers. The movement charged to P/L also matches the expense in the current year's financial statements. The matrix used was confirmed to prior year working papers. The previous year's working papers confirm that, based on historic information, the estimates used were all reasonable and the team concluded that, as the amounts involved were immaterial, no additional audit work was required.

Segmental reporting

The group financial statements previously reported an operating segment in relation to nutrition, but this year the segment has been aggregated into the healthcare segment. The audit files show that the results of nutrition are still reported to the executive team and that it still meets the size criteria to be a reportable segment. The executive team is considered to be the chief operating decision-maker in the group. The files show that the audit team questioned the client over this aggregation and were informed that separately disclosing information relating to nutrition would now be commercially sensitive and would help the company's competitors.

Revenue – MM

On 1 November 2019 MM made a sale for a total contract price of Rs. 1,200 million, receivable in three annual instalments of Rs. 400 million beginning 1 November 2020. MM have recognised revenue of Rs. 1,200 million and included the same amount within trade receivables.

The audit team have agreed the amounts into the relevant contract and traced the amounts into the financial records. Review of the contract confirmed the only obligation was for a shipment of pharmaceutical products, and sufficient evidence was obtained that all the products were delivered to the customer on 1 November 2019 and that the customer obtained legal title to the goods. The audit team concluded that recognition of the revenue at the beginning of the year was correct.

The first annual instalment has not yet been received and the team have reviewed up-to-date correspondence from the customer, which confirms that the instalment will be paid within 30 days, as they are waiting for receipt of a government grant.

The discount rate adjusted to reflect the risks of the customer would be 8%.

Uncorrected adjustments

The review of other audit areas did not identify any areas of concern and any adjustments identified by the team were immaterial. Consequently, they have not been considered further.

APPENDIX 4 – EMAIL FROM CLIENT

To: Riaz
From: Jana Sheikh
Subject: Appointment of non-executive director
Date: 1 December 2020

Hi Riaz,

I would like your firm's help with the recruitment of a non-executive director. One of the current non-executive directors is due to retire and he is our only non-executive with significant financial expertise, so his retirement will leave the board lacking experience.

Our suggestion is that one of the audit partners at MAAN & Co. could replace the director, as their experience would be exactly what we need. Alternatively, would you be able to assist with the recruitment of a candidate and attend candidate interviews, as your experience would be of assistance in any decision making.

I look forward to a response as soon as possible.

Regards

Jana

QUESTION 2

You are Ibrahim Ali, working at Raza Motors (RM), a listed company within the automobile industry. You have recently been promoted to group accountant.

Fozan Ghalib, the finance director, has asked you to assist in the preparation of the consolidated financial statements for the year ended 31 October 2020. Appendix 1 contains the email with his instructions.

Requirements

(a) Explain the financial reporting implications of the transactions in Appendix 3 on the group financial statements of RM for the year ended 31 October 2020. **(13 marks)**

(b) Prepare the draft summarised consolidated statement of financial position for RM for the year ended 31 October 2020. **(12 marks)**

(c) Explain any ethical issues arising from the preparation of the financial statements for the year ended 31 October 2020. **(05 marks)**

Total: 30 marks

APPENDIX 1 – EMAIL FROM FINANCE DIRECTOR

To: Ibrahim Ali
From: Fozan Ghalib
Subject: Draft consolidated financial statements 31 October 2020
Date: 15 November 2020

Hi,

I am delighted to confirm your promotion. There was strong competition for the role but my recommendation convinced the board to approve your promotion.

I would like you to get started on your new role immediately so that you can take on some of my workload. I have prepared draft financial statements of the group companies, which are presented in Appendix 2, along with additional details required for consolidation in Appendix 3.

I need you to prepare a summary of the financial reporting implications of the transactions on the consolidated financial statements. In particular, you should highlight the impact on the group profit for the year. You are also required to prepare the draft summarised consolidated statement of financial position as at 31 October 2020.

Please ignore the impact of any adjustments on tax, as we can consider this after we have agreed the draft figures. The individual financial statements have included a tax expense based on a tax rate of 25% as an initial estimate.

Finally, I am delighted that from next year you will be included within our senior management bonus scheme. Despite tough trading conditions and a reduction in the gross profit margin, the senior managers are all pleased that RM has achieved profit before tax target of Rs. 14,000 million for this year's bonus.

Regards

Fozan

APPENDIX 2 – DRAFT SUMMARY FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 OCTOBER 2020

	Raza Motors	Imran Automotive	Lahore Cars	Spares UK
	-------------- Rs. in million		--------------	£ in million
Non-current assets				
Property, plant & equipment	25,789	4,899	4,852	5.80
Investments	8,800	460	-	-
Intangible assets	1,200	120	346	1.20
	35,789	5,479	5,198	7.0
Current assets	1,647	1,350	1,156	2.58
	37,436	**6,829**	**6,354**	**9.58**
Equity				
Share capital	10,500	1,500	2,000	3.15
Retained earnings	16,186	3,190	1,739	1.95
	26,686	4,690	3,739	5.10
Non-current liabilities	8,900	800	1,700	3.00
Current liabilities	1,850	1,339	915	1.48
	37,436	**6,829**	**6,354**	**9.58**

Extract from statement in changes in equity

	Raza Motors	Imran Automotive	Lahore Cars	Spares UK
	-------------- Rs. in million		--------------	£ in million
Retained earnings at 1 November 2019	5,175	1,699	1,163	0.6
Profit after tax	11,011	1,491	576	1.35
Retained earnings at 31 October 2020	**16,186**	**3,190**	**1,739**	**1.95**

Profits accrue evenly for all of the group companies.

APPENDIX 3 – GROUP STRUCTURE AND TRANSACTION DETAILS

Imran Automotive
Imran Automotive is an 80% owned subsidiary of RM that was acquired several years ago. It was acquired for cash consideration of Rs. 1,800 million when its retained earnings were Rs. 320 million and the fair value of the non-controlling interest was Rs. 410 million. The fair value of the net assets acquired was equal to the carrying amount and goodwill has not been impaired.

In October 2020, RM sold goods to Imran Automotive for Rs. 900 million at cost plus 100%. At year-end, all the goods were still held in inventory by Imran Automotive. This was the only intra-group transaction with Imran Automotive during the year.

Lahore Cars
RM acquired 60% of Lahore Cars on 1 August 2019 for consideration of Rs. 2,150 million. The fair value of non-controlling interest at the date of acquisition was Rs. 1,400 million.

During the year ended 31 October 2019, Lahore Cars made a profit of Rs. 425 million and did not pay any dividend.

On 1 August 2019, a factory of Lahore Cars had a carrying amount of Rs. 2,600 million and the land element was Rs. 650 million. On acquisition, an independent valuation of Lahore Car's factory was arranged but was not received by the time the previous year's financial statements were authorised for issue, so a provisional fair value of Rs. 2,900 million with a Rs. 725 million value attributable to the land element was used. At acquisition date, the factory had a remaining useful life of fifteen years.

On 15 February 2020, the independent valuation was received which valued the factory at Rs. 3,000 million with Rs. 750 million attributable to the land. The valuation did not change the remaining useful life of the factory.

Spares UK
RM acquired 75% shareholding of Spares UK on 1 June 2020 for cash consideration of £4.25 million. Spares UK is located in UK and has a functional currency of £. The fair value of the non-controlling interest was valued at £1.35 million at acquisition date.

On 1 July 2020, RM advanced a loan of £3 million to Spares UK. RM has presented the loan within investments in statement of financial position. The loan was translated at the spot rate at that date and has not been amended at the year-end. The loan has an interest rate of 13%, payable annually in arrears and there is no set repayment date. Spares UK have paid the interest at the year-end and both companies have correctly accounted for the interest. Spares UK has no plans to repay the loan as RM's acquisition of Spares UK is part of a long-term strategic plan.

Following exchange rates are available:

	Exchange rates
1 June 2020	£1 : Rs. 197
1 July 2020	£1 : Rs. 200
31 October 2020	£1 : Rs. 202
Average for the year ended 31 October 2020	£1 : Rs. 180
Average for the five months ended 31 October 2020	£1 : Rs. 198

Motor Trucks
On 1 November 2019, RM set up a new entity, Motor Trucks, with another venturer. Motor Trucks has been set up to acquire and operate an automobile manufacturing facility. Under the arrangement, both RM and the other venturer has a 50% holding in Motor Trucks at following terms:

- Motor Trucks owns the manufacturing facility.
- Neither RM nor the other venturer is liable for the borrowings incurred by Motor Trucks.
- Either party is free to sell their holding in Motor Trucks.
- Each party is entitled to 50% of the profit for the year of Motor Trucks.

The statement of financial position of Motor Trucks as at 31 October 2020 is presented below:

	Rs. in million
Non-current assets	
Property, plant and equipment	2,732
Intangible assets	985
	3,717
Current assets	754
Total assets	**4,471**
Equity	
Share capital	1,000
Retained earnings	141
	1,141
Non-current liabilities	2,500
Current liabilities	830
Total equity and liabilities	**4,471**

RM subscribed for 50% of the share capital of Motor Trucks, paying the par value. RM has also granted a loan of Rs. 1,000 million to Motor Trucks.

During the year ended 31 October 2020, RM bought goods from Motor Trucks for a total value of Rs. 100 million, on which Motor Trucks earned a profit margin of 20% and half the goods remained unsold at the year-end.

Till the year-end, RM had not paid for any of the goods purchased from Motor Trucks.

QUESTION 3

You are Mariam Bucha and work as an audit senior for Munir & Co., an audit firm based in Lahore. You have recently been assigned to the audit of a long-established client, Abbas Textiles (AT). The audit partner has returned from a preliminary planning meeting with AT's Chief Executive Officer (CEO) and Finance Director (FD) and has asked you to begin the audit planning for the year ended 30 November 2020.

The partner has provided you with some background information in Appendix 1 and notes from the meeting in Appendix 2 along with some financial information in Appendix 3.

Requirements

(a) Review the information provided in Appendices and perform analytical procedures to identify the audit risks for the audit of AT for the year ended 30 November 2020. **(15 marks)**

(b) For the audit risks identified, outline any additional information required to have a better understanding of the risks. **(05 marks)**

Total: 20 marks

APPENDIX 1 – BACKGROUND INFORMATION

All companies within the textiles industry have suffered from an increase in the cost of raw materials, inflationary pressures, depreciation of the Rupee and the general downturn in the economy.

AT has a bank covenant attached to its borrowings that requires it to maintain gearing at or below 40%.

AT has following divisions:

- Silk division manufactures silk which is sold to fashion companies.
- Home textiles division makes fabrics used for products such as rugs and blankets. Home textiles makes sales to the domestic as well as foreign markets.
- Industry division manufactures industrial fabric which is sold to manufacturer of a variety of products.
- Sportswear division manufactures sporting apparel.

APPENDIX 2 – NOTES OF MEETING WITH CEO AND FD OF ABBAS TEXTILES

They acknowledged the general economy has been challenging, but the results of AT compare favourably to last year. They are pleased with the increase in revenue by 10% and they have managed to control costs so that the gross profit has held up well to market pressures.

In August 2020, AT launched its first product aimed at the sportswear market after successfully developing a new type of fabric. Whilst the product has received good publicity, especially in the sporting press, sales to retailers have been slower than expected. In October 2020, AT agreed terms with the major retailers that AT would fund the in-store marketing activities and allow the retailers to return any unsold products within three months. This is the first time AT has entered into such arrangement.

The retailers reacted favourably to the arrangement and the sales volume increased significantly in October and November. The production of the sportswear has been outsourced to another company, as this enabled AT to produce the goods without any additional capital outlay.

Home textiles division has been impacted by delivery issues to foreign customers. Items despatched since September 2020 have frequently taken over three weeks to reach foreign customers.

A significant customer of Industry division is Medhi Manufacturing. Unfortunately, AT was unable to source a material used in the manufacture of specific fabric for Mehdi Manufacturing. AT has been working to find an alternative supply; but this is likely to be at a much higher price, especially if the components are sourced from overseas. Without the supply of the component, AT will not be able to fulfil its agreement with Medhi Manufacturing, which could result in penalty payments.

The business of another key client in the Industry division, Gujrat Furniture, was lost when the contract went out to tender. Gujrat Furniture had historically represented approximately 27% of Industry division's business and had been more profitable than other contracts. The directors were optimistic about a new contract signed with Pazzu Motors for supplying fabric for car seats. The initial manufacturing was challenging but they were confident that this contract would fully recover the loss of Gujrat Furniture.

APPENDIX 3 – KEY FINANCIAL INFORMATION

	Silk	Home Textiles	Industry	Sportswear	Total
	---------------------------- Rs. in million ----------------------------				
Revenue 2020	2,692	4,401	4,037	2,326	**13,456**
Gross profit 2020	673	662	807	1,046	**3,188**
Revenue 2019	3,096	4,269	4,886	-	**12,251**
Gross profit 2019	1,084	555	1,329	-	**2,968**

	Silk	Home Textiles	Industry	Sportswear	Total
PPE 1 December 2019	5,048	6,093	5,724	1,278	**18,143**
Additions	-	333	-	-	**333**
Disposals	(708)	(224)	(959)		**(1,891)**
Depreciation expense	(520)	(1,178)	(909)	(126)	**(2,733)**
PPE 30 November 2020	3,820	5,024	3,856	1,152	**13,852**

	Silk	Home Textiles	Industry	Sportswear	Total
Depreciation expense 2019	872	1,218	1,030	-	**3,120**

Extracts from the draft statement of financial position as at 30 November 2020

	2020	2019
	---------- Rs. in million ----------	
Long-term loan	10,450	8,700
Total equity	15,200	16,451

(THE END)