The Institute of
Chartered Accountants
of Pakistan

Multi Subject Assessment Stage

7 June 2021
3 hours and 45 minutes – 100 marks

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 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 Ibrahim Ali. You work as an Audit Senior for A&H and are working on the audit of a new client, Lahore Builders, for the year ended 31 May 2021. Lahore Builders is a listed company that develops and manages commercial offices and mixed-use developments. The Audit Manager, Sara Hussain, has provided you with the following information required to perform the initial planning for the audit of Lahore Builders:

Appendix 1 contains the draft financial statements for the year ended 31 May 2021.

Appendix 2 provides a summary of discussion with the finance director.

Appendix 3 contains information on Lahore Builders' bank covenants and loan negotiations.

Appendix 4 provides an email the audit manager received from the Audit Partner, Fozan Arain, regarding potential professional and ethical issues associated with accepting Lahore Builders as an audit client. Additionally, the client is considering the purchase of another company that has only one asset, an office building. They have requested our assistance in valuing the office building.

Requirements

(a) Using the information contained in Appendices 1, 2 and 3, prepare a briefing note that:

(i) explains financial reporting implications of the transactions contained in Appendix 2. Include any potential adjustments where the information permits. **(12 marks)**

(ii) reviews and analyses the draft financial statements. Include the impact of any potential adjustments in the analysis. **(12 marks)**

(iii) identifies and explains the audit risks for Lahore Builders for the year ended 31 May 2021. **(11 marks)**

(b) Prepare a note that:

(i) explains the financial reporting implications of Lahore Builders' potential purchase. **(04 marks)**

(ii) explains the ethical issues, and any potential safeguards, arising from the request to perform the property valuation outlined in Appendix 4. **(06 marks)**

(c) Discuss the other professional and ethical issues arising from the information in Appendix 4 and the implications for the audit of Lahore Builders. **(05 marks)**

Total: 50 marks

APPENDIX 1 – DRAFT FINANCIAL STATEMENTS

Statement of profit or loss for the year ended 31 May 2021

	2021	2020
	---- Rs. in million ----	
Revenue	655	747
Operating costs	(344)	(265)
Operating profit	311	482
Fair value movements on investment properties	356	410
	667	892
Finance costs	(290)	(400)
Profit	**377**	**492**

Statement of financial position as at 31 May 2021

	2021	2020
	---- Rs. in million ----	
Non-current assets		
Property, plant and equipment	1,250	1,800
Investment properties	5,400	5,200
	6,650	7,000
Current assets		
Inventories	987	1,500
Trade and other receivables	525	497
Cash	250	750
	1,762	2,747
Total assets	**8,412**	**9,747**
Equity		
Share capital	1,500	1,500
Retained earnings	2,301	2,200
	3,801	3,700
Non-current liabilities		
Loan	3,114	3,440
Current liabilities		
Trade and other payables	607	915
Overdraft	890	1,692
	1,497	2,607
Total equity and liabilities	**8,412**	**9,747**

APPENDIX 2 – SUMMARY OF DISCUSSION WITH THE FINANCE DIRECTOR

Sale and leaseback
On 1 June 2020, Lahore Builders sold its head office to its bank and immediately leased it back under a ten-year lease contract. Lahore Builders received Rs. 484.5 million for the head office, which the finance director believes to be a good deal, as it has significantly increased the company's cash flow for the year and will increase its reported profit. He indicated that the fair value of the head office was Rs. 585 million at the date of the sale and that future lease payments are lower than market rates.

The lease payment is Rs. 23.8 million per annum, payable in arrears commencing on 31 May 2021. The present value of the future lease payments on commencement of the lease is Rs. 170 million and the implicit interest rate in the lease is 6.6%. Under the terms of the lease, the bank can cancel the lease agreement and take full control of the head office with six months' notice.

At 1 June 2020, the head office had a carrying amount of Rs. 408 million and had a remaining useful life of 30 years. The transaction has been recorded by removing the asset and recognising a gain of Rs. 76.5 million. The lease payment of Rs. 23.8 million has been recorded as an expense.

Development of co-working space and serviced apartment
Lahore Builders purchased land for Rs. 150 million in June 2020, which was recognised as an investment property from that date, as the intention was to build a property that will be used as a mixed residential and office space, in line with many other developments.

In 2021, Lahore Builders has submitted the construction plans with the Building Control Authority to create the offices that will take the form of co-working spaces, in which several small businesses will rent a desk or area within the overall larger office. The change to co-working spaces reflects a change in demand in the sector and means that Lahore Builders will be responsible for providing a wide range of services to those that rent a space. Construction plans have also been submitted regarding the residential apartments, which will be rented out as serviced apartments when the development is complete. Serviced apartments are more like a hotel service when the apartments will be cleaned and maintained by Lahore Builders.

The construction plans are close to being approved and the board is confident that the plans will be accepted.

Transfer to investment properties
Lahore Builders has been developing an office block for sale and has classified the development within inventory. As a result of market changes in the local area, the directors decided on 1 January 2021 to change their plans and to rent out the offices as each floor is completed.

On 1 January 2021, the completed office block was transferred out of inventory and was reclassified as an investment property at its fair value at that date. As the fair value exceeded the carrying amount of the inventory, a gain of Rs. 125 million was recognised in profit or loss as a reduction in operating costs. At the year end, the investment property remains measured at its fair value at the date of transfer of Rs. 1,200 million.

The finance director confirmed that at the year-end they had still not signed any rental agreements because of the uncertain economic environment.

APPENDIX 3 – BANK COVENANTS AND LOAN NEGOTIATIONS

Lahore Builders has banking covenants in respect of loans of Rs. 1,000 million. The covenants require:

- gearing (calculated as long-term debt over debt plus equity) to be below 50% and
- interest cover (calculated based on operating profit) to be above one.

The consequence of a breach in the covenants is that a penalty is payable and the interest rate is increased.

The finance director explained that, whilst Lahore Builders does not have sufficient finance in place at the moment, it had managed to repay some debt during the current year and is negotiating the current loans with the bank. Lahore Builders is seeking additional finance to invest in further improvements to its portfolio of assets.

APPENDIX 4 – EMAIL FROM AUDIT PARTNER

To: Sara Hussain
From: Fozan Arain
Subject: Previous auditors and valuation request
Date: 4 June 2021

Hi Sara,

Thank you for taking on the role of Audit Manager on the audit of Lahore Builders. As you know, I was not involved in the tender and acceptance of this audit, but I know that the fee quoted was highly competitive and that the firm wanted to move into the real estate sector.

I would appreciate your assistance with an issue.

Whilst reviewing the letter from the previous auditor I noticed the following comment:

> Our audit of Lahore Builders was impacted by the client's reluctance to discuss areas of significant management judgement. Whilst eventually we were able to obtain sufficient evidence, we incurred additional costs that we were not able to recoup.

Can you explain any professional and ethical issues of this and the implications for this year's audit?

Additionally, the client is considering acquiring 100% shareholding in a company. The only asset of the company is an empty office building, and it has no employees or contracts. The directors of Lahore Builders are concerned that they will have to begin preparing group financial statements and would like our advice on how to account for the acquisition. The directors have also asked us to provide a valuation service for the proposed purchase and they are keen for us to accept, as they see cost savings arising if we perform the valuation. As a new audit client, I want to ensure that we can meet their request.

Regards

Fozan

QUESTION 2

You are Amal Khan. You work as the group accountant of PK Television, a listed company and the parent company of a group that produces television shows.

Appendix 1 contains an email from Syed Ali, the Group Financial Controller, who is about to go on annual leave. He has drafted the consolidated financial statements for the year ended 31 May 2021; however, the effect of some outstanding issues have not been incorporated.

In Appendix 2, the group financial controller has provided you with the relevant background information.

In Appendix 3, he has provided the draft consolidated statement of profit or loss and other comprehensive income.

Appendix 4 provides the details of the issues that are outstanding.

Requirements

(a) Explain the impact of the outstanding issues on the consolidated financial statements for the year ended 31 May 2021. Also prepare journals and show supporting calculations, where possible. **(17 marks)**

(b) Prepare the revised consolidated statement of profit or loss and other comprehensive income for the year ended 31 May 2021. **(05 marks)**

(c) Calculate earnings per share (EPS) for the year ended 31 May 2021 and discuss whether any of the outstanding issues will impact on diluted EPS. **(03 marks)**

(d) Discuss any ethical issues that arise in the scenario and describe any required actions. **(05 marks)**

Total: 30 marks

APPENDIX 1 – EMAIL FROM GROUP FINANCIAL CONTROLLER

To: Amal Khan
From: Syed Ali
Subject: Group financial statements
Date: 6 June 2021

Hi Amal,

I have prepared first draft of the consolidated financial statements. I am about to go on annual leave so I would like your assistance with finalising the consolidated statement of profit or loss and other comprehensive income.

There are some outstanding issues which I have not yet dealt with, particularly deferred tax which I don't fully understand. I would like you to explain the financial reporting treatment for the outstanding issues and to prepare the required adjustments. You should then use the adjustments to redraft the consolidated statement of profit or loss and other comprehensive income.

Please clearly show the impact of the proposed adjustments on the group's profit, as the group is under pressure to maintain EPS of Rs. 155. Please calculate the EPS for me and I will then consider whether the adjustments should be processed or not.

Can you also outline whether any of the outstanding issues would require us to disclose diluted EPS separately?

Regards

Syed Ali

APPENDIX 2 – BACKGROUND INFORMATION

Group Structure

New subsidiary – Creative Productions
PK Television acquired 75% shareholding in Creative Productions on 1 December 2020.

Existing holdings
SCT Productions – 100% owned subsidiary
New Studios – 60% owned subsidiary
MK Sports – 30% holding with significant influence

Additional information
Deferred tax has been accounted for using a tax rate of 29%.

The accounting policy of the group is to value the non-controlling interest on all acquisitions at its proportionate share of fair value of identifiable net assets.

All property, plant and equipment are subsequently measured using the cost model.

PK Television has 75 million shares in issue at the beginning of the year and no changes have been made during the year.

APPENDIX 3 – DRAFT CONSOLIDATED STATEMENT OF PROFIT OR LOSS AND OTHER COMPREHENSIVE INCOME FOR THE YEAR ENDED 31 MAY 2021

	Rs. in million
Revenue	74,365
Cost of sales	(34,679)
Gross profit	39,686
Operating costs	(14,523)
Finance income	1,267
Finance costs	(8,750)
Share of profit of associate	6,750
Profit before tax	24,430
Tax expense	(5,863)
Profit for the year	**18,567**
Other comprehensive income (net of tax)	3,989
Comprehensive income for the year	**22,556**
Profit for the year attributable to:	
Owners of the parent	11,780
Non-controlling interests	6,787
	18,567
Comprehensive income for the year attributable to:	
Owners of the parent	15,769
Non-controlling interests	6,787
	22,556

APPENDIX 4 – DETAILS OF OUTSTANDING ISSUES

Creative Productions

Goodwill on acquisition of Creative Productions has been calculated as follows:

	Rs. in million
Consideration	3,110
75% net assets at acquisition (Rs. 2,200 million × 75%)	(1,650)
	1,460

Goodwill was calculated before the following information was obtained.

- Creative Productions owns an office building that was included in net assets at acquisition of Rs. 75 million based on its carrying amount at that date. A valuation report was received in May 2021 which showed its fair value at acquisition of Creative Productions to be Rs. 435 million and that the office building has a remaining useful life of 15 years at the same date.
- Creative Productions has been depreciating the office building over a significantly shorter period and, in the post-acquisition period, it has charged depreciation of Rs. 3.7 million.

I have not adjusted for the late valuation as I do not want to process adjustments that negatively impact on the results of the group.

Transactions with New Studios
New Studios sold disks used to broadcast television shows to PK Televisions during the year. At the reporting date, the intragroup transaction gave rise to an unrealised profit of Rs. 159 million. I have only reduced the group's profit and inventory with this amount.

PK Television
PK Television operates a cash settled share-based payments scheme for its employees. The share appreciation scheme was correctly accounted for at the previous reporting date. A deferred tax asset of Rs. 290 million was created at the previous reporting date, as the future tax deduction will be based on the intrinsic value of the options at the exercise date.

My technical knowledge in this area is out of date and I have made no adjustments to the liability reported last year. Below is all of the information on the scheme and the changes made:

- PK Television granted cash-settled share appreciation rights to its 200 employees on 1 June 2019 and the scheme contained the following details:

Number of rights to each employee	10,000
Fair value of each right at grant date	Rs. 2,600
Vesting period	Four years from 1 June 2019

- At 31 May 2020, an expense and liability had been recognised based on the fair value at that date of Rs. 3,000 per right and it was expected that 95% of staff would remain in employment till vesting date.
- On 1 June 2020, the scheme was amended to be an equity-settled scheme and all other terms remained the same. The option price that the employees will pay was set low to compensate them for the change to equity settled. The fair value of each share option at the date of change was calculated as Rs. 3,200.
- I understand that each share option has a fair value of Rs. 3,400 at 31 May 2021 and that ten eligible employees have already left. The human resources department expect another ten eligible employees to leave over the next two years.
- At 31 May 2021, the intrinsic value of each share option was Rs. 2,700.

QUESTION 3

You are Zoha Jabeen and work as an audit manager. You have been asked to assist on the completion stage of the audit of More Manufacturing for the year ended 31 March 2021, as the existing manager is on unexpected leave.

In Appendix 1, the Audit Partner, Rehan Aseem, has provided you with detailed instructions.

Appendix 2 provides background information and a summary of the audit testing performed over certain areas.

Appendix 3 summarises two issues for which audit procedures have already been completed, but whose impact on the audit report needs to be considered.

Requirements

(a) Using the information contained in Appendices 1 and 2, prepare a briefing note that:

(i) explains any financial reporting issues that the audit team have not identified. **(09 marks)**

(ii) identifies and explains any areas where there is a lack of sufficient and appropriate audit evidence. **(06 marks)**

(b) Outline the potential impact of the issues in Appendix 3 on the audit report. **(05 marks)**

Total: 20 marks

APPENDIX 1 – DETAILED INSTRUCTIONS FROM AUDIT PARTNER

To: Zoha Jabeen
From: Rehan Aseem
Subject: Completion of More Manufacturing audit
Date: 6 May 2021

Hi Zoha,

Firstly, thank you for agreeing to assist in the completion stage of audit of More Manufacturing, who is a new audit client. More Manufacturing has year-end of 31 March.

I would like you to review the results of audit testing, as I understand that there are some areas of concern that were raised when the previous audit manager reviewed the working papers.

You should prepare a briefing note that explains any financial reporting issues and any areas for which there is a lack of sufficient and appropriate evidence.

We are under pressure to sign the audit report as soon as possible so ensure you make it clear to me how material each issue is.

I met with the client today to discuss two issues for which the audit procedures have already been completed. I have also provided you with a summary of these as I need to understand their impact on the audit report. The client will be highly dissatisfied if we are modifying our audit report.

Regards

Rehan

APPENDIX 2 – BACKGROUND INFORMATION AND SUMMARY OF AUDIT TESTING

Background Information
More Manufacturing produces domestic appliances that are sold to retailers and large scale machines that are sold directly to industry.

The company is owned and controlled by Hamid family, but they are in the process of seeking external investors which is why they have changed the auditors. Their previous auditors had been appointed for over ten years.

At the planning stage of the audit, it was determined that controls in the business were not sufficient in some areas and not operating effectively in others so a substantive approach to the audit should be taken. Materiality was assessed at Rs. 20 million to reflect the high risk associated with a new audit and the business being managed by the owners directly.

The revenue and profit before tax for the year ended 31 March 2021 are Rs. 35,500 million (2020: Rs. 29,600 million), and Rs. 1,545 million (2020: Rs. 1,350 million) respectively.

Summary of Audit Testing

Property, plant and equipment
At 1 April 2020, a warehouse (included in property, plant and equipment) had a carrying amount of Rs. 450 million and the client decided to reduce its remaining useful life to ten years.

The financial accountant of More Manufacturing calculated that the carrying amount would have been Rs. 355 million if the total revised useful life would have been used from the first year, adjusting for the difference of Rs. 95 million by reducing retained earnings. The depreciation charge for the year ended 31 March 2021 was Rs. 35.5 million. This amount has been included as an expense in profit or loss for the year.

The audit team have agreed the carrying amounts to the prior year and current year financial statements and have recalculated the amount of the adjustment and depreciation expense.

Safety equipment
On 1 September 2020, More Manufacturing capitalised expenditure of Rs. 300 million, which it incurred on adding new safety features to the machines used in a production line. The audit team have agreed the amount to a contract that was signed with a safety specialist, which provides evidence that the amounts are correctly capitalised.

Whilst reviewing the contract to supply the safety features, the audit team noted that the safety features will only last for three years. The contract and discussions provide evidence that the safety features are required by law. The results of impairment testing indicate that the production line is not impaired.

More Manufacturing has depreciated the safety expenditure over 12 years which is the same as the remaining useful life of the machine at the 1 September 2020.

Lease modification
More Manufacturing leases a property on a 10-year term and has correctly accounted for a right-of-use asset and corresponding lease liability. The annual lease payment is Rs. 420 million, payable on 31 March each year.

On 1 December 2020, the lessor agreed to a rent concession for a four-month period from that date. As a result, More Manufacturing paid Rs. 280 million on 31 March 2021 and recognised the amount saved of Rs. 140 million as a rent concession in profit or loss.

The team agreed the payment of Rs. 280 million to the bank statement and traced the entries into the financial records to confirm they have been correctly recorded.

Revenue

In January 2021, More Manufacturing signed a contract with a new client to supply them with a large machine for a price of Rs. 3,000 million. As part of the negotiation, More Manufacturing agreed to provide three years' servicing in which More Manufacturing's engineers will perform monthly visits. Historically, More Manufacturing has not performed any servicing of machinery it supplies; clients would arrange a contract themselves.

Audit evidence was obtained by reviewing the contract, which confirms the terms and price. The machine was delivered to the customer on 1 February 2021 as confirmed by despatch notes. Receipt of Rs. 3,000 million was agreed to bank statements in February 2021.

The audit senior discussed the contract with the financial controller who said that there will be no additional costs to More Manufacturing for providing the three-year servicing, as its existing engineers will perform the servicing as part of their normal workload. The financial controller recorded Rs. 3,000 million received as revenue.

Regulatory action

More Manufacturing received a notice from the environmental authorities that it had contaminated nearby river in December 2020 as a result of leak at one of its factories. The notice states that the fine payable is Rs. 190 million if More Manufacturing is found to have caused the damage.

The client has engaged a legal team who are strongly contesting the notice and, on that basis, a provision has not been recognised in the financial statements and no disclosure note has been added. Evidence from the lawyers and discussions with the client support the view that it is probable that they will successfully defend the notice.

APPENDIX 3 – IMPACT OF ISSUES ON THE AUDIT REPORT

Contract

More Manufacturing completed construction of a significant asset for a client in December 2020. It recognised Rs. 3,560 million of revenue on completion of the construction, which resulted in a profit of Rs. 80 million for the year ended 31 March 2021.

The contract commenced in December 2019 and, after discussions, it is clear that the revenue should have been recognised over the 12-month construction period rather than on completion. We discussed this and they provided details of the costs incurred on the construction at 31 March 2020, which relative to the total expected costs to construct the asset shows that the contract was 45% complete at that date using the input method.

The client does not understand why this is an issue as we did not audit last year's financial statements.

Material provision

I had a detailed conversation with the client over the wording of a disclosure note relating to an employment tribunal case. Whilst there are material uncertainties, I am comfortable with the amount of the provision in the financial statements and that the disclosure note is sufficiently detailed to ensure the user is clear about the level of uncertainty.

(THE END)