The Institute of
Chartered Accountants
of Pakistan

**Multi Subject Assessment Stage**

6 December 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 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 Surya Abba. You work as an audit manager for LT & Co, a firm of chartered accountants. The audit of your client, SS Engineering (SS) Group, for the year ended 31 October 2021 is close to completion and the audit partner has asked for a summary of all of the audit findings so far.

**Appendix 1** includes extracts from SS Group's draft consolidated financial statements for the year ended 31 October 2021.

In **Appendix 2**, the audit senior, Zakia Ahmed, has prepared a summary of the SS Group structure and **Appendix 3** includes a summary of audit evidence in respect of ongoing areas of concern. Zakia is now on study leave and has not explained why these areas were identified as being of concern. **Appendix 4** contains an email to you from a component auditor.

SS has also requested an explanation of the financial reporting implications of two proposed share-based remuneration schemes, the details of which are provided in **Appendix 5**.

**Requirements**

(a) Prepare a summary for the audit partner in which you:

(i) explain the financial reporting issues arising from the review of the audit evidence for the year ended 31 October 2021. **(16 marks)**

(ii) prepare, as far as the information permits, a summary of the uncorrected misstatements and assess their impact on the group's assets, liabilities and profit for the year ended 31 October 2021. **(07 marks)**

(iii) explain the actions that the auditors need to take in the light of any misstatements identified in (i) above. **(17 marks)**

(b) Explain the financial reporting implications of the proposed changes to the share-based remuneration scheme in the first year. **(10 marks)**

**Total: 50 marks**

## APPENDIX 1 – EXTRACTS FROM DRAFT GROUP FINANCIAL STATEMENTS

### SS Engineering Group

**Extracts from the draft consolidated statement of financial position as at 31 October 2021**

| | **Rs. in million** |
|---|---|
| Total assets | 11,538 |
| Total liabilities | 5,753 |

**Draft consolidated statement of profit or loss and other comprehensive income for the year ended 31 October 2021**

| | **Rs. in million** |
|---|---|
| Revenue | 8,696 |
| Cost of sales | (4,432) |
| **Gross profit** | **4,264** |
| Net operating costs | (2,547) |
| **Operating profit** | **1,717** |
| | |
| Finance costs | (170) |
| Other income | 114 |
| **Profit** | **1,661** |
| | |
| **Other comprehensive income:** | |
| Items that will not be reclassified to profit or loss | |
| Remeasurement gain on defined benefit plans | 56 |
| Items that may subsequently be reclassified to profit or loss | |
| Cash flow hedges | 28 |
| | 84 |
| **Total comprehensive income** | **1,745** |

## APPENDIX 2 – GROUP STRUCTURE

SS is the parent of a number of subsidiaries based mainly in Pakistan. SS Group provides engineering solutions for industries operating within the pharmaceuticals sector.

SS has owned 100% of Steam Power and Thermal Energy for a number of years.

On 1 November 2020, SS acquired a 75% subsidiary, TT Technology (TT), which is based in England. Goodwill on the acquisition of TT has been impaired during the year.

On 31 October 2021, SS reduced its shareholding in MM Manufacturing (MM) from 70% to 60%. On 1 November 2019, SS acquired 70% of the equity shares of MM for a cash consideration of Rs. 450 million. The fair value of MM's identifiable net assets at the acquisition date, was Rs. 480 million. This was Rs. 50 million more than the carrying amount due to an item of plant, which is depreciated on the straight-line basis and has a five-year remaining life at the date of acquisition.

The only subsidiary that is not audited by LT & Co is Lahore Energy and we have conducted all necessary procedures to confirm the independence and expertise of the component auditor.

SS accounts for the non-controlling interest at the proportionate share of net assets.

## APPENDIX 3 – SUMMARY OF AUDIT EVIDENCE

**Goodwill**
The audit working papers show the following calculation of the goodwill of TT. As goodwill is calculated at the date of acquisition, it has been translated at the rate of exchange applicable at that date.

| | GBP in million | Rate (Rs. : GBP 1) | Rs. in million |
|---|---|---|---|
| Consideration | 25.00 | 216 | 5,400 |
| Non-controlling interest | 4.75 | 216 | 1,026 |
| Less: fair value of net assets at acquisition | (19.00) | 216 | (4,104) |
| Goodwill at acquisition | 10.75 | | 2,322 |
| Impairment | (2.75) | 216 | (594) |
| **Goodwill at 31 October 2021** | **8.00** | | **1,728** |

The audit team have traced the amounts included in the goodwill calculation to the underlying financial statements and to the relevant consolidation schedules to confirm that the amounts in this calculation are correct. The exchange rates have been vouched to external sources and the impairment has been recognised in profit or loss. The exchange rate at 31 October 2021 is Rs. 200 : GBP 1.

**Partial disposal of subsidiary**
On 31 October 2021, SS disposed of part of its holding in MM for a cash consideration of Rs. 102 million, reducing its shareholding to 60%. The carrying amount of the net assets of MM as presented in its financial statements at 31 October 2021 was Rs. 630 million and goodwill has been impaired by 20% since acquisition.

The audit working papers have agreed the goodwill figure for MM to the prior year financial statements and to the consolidation schedule. The carrying amount of the net assets of MM at 31 October 2021 have been satisfactorily agreed to its audited financial statements at that date.

The receipt of Rs. 102 million has been vouched to the bank statement and the terms of sale agreement, which also confirms that SS now owns 60% of MM. Cash received of Rs. 102 million has been presented as deduction in net operating costs.

The non-controlling interest in the group accounts at 31 October 2021 is calculated based on the 70% holding of SS, which the directors believe to be appropriate as the partial disposal took place on the last day of the year.

**Defined benefit pension obligations**
On 1 November 2020, Steam Power announced to staff that it improved the pension benefits of all staff who have worked for the company for at least three years at the date the benefit is claimed. The actuary calculated the present value of the additional obligation to be Rs. 80 million on 1 November 2020; however, the directors of Steam Power decided not to account for the additional pension obligations as no improved benefits have been paid to the staff in the year. As a result, the present value of the additional obligation has not yet been included in the total liabilities presented in the extracts from the draft financial statements at 31 October 2021. The interest rate applied to pension obligations is 5% per annum.

The working papers show that the present value of the additional pension obligations was agreed to the actuarial report and the interest rate was agreed as being consistent with the rate on high-quality corporate bonds. They also confirm that no improved benefits were paid to employees and that the additional obligation has not been reflected in the financial statements at 31 October 2021.

**Metal inventories**
Thermal Energy holds inventories of metal and is concerned that the value of the inventories may decline. The inventories were acquired on 1 May 2021 and, on the same day, Thermal Energy entered into a futures contract to sell metal equivalent to the quantity it was holding in inventory.

The audit evidence shows that the criteria to apply hedge accounting under IFRS 9 was met at inception and this was documented in board meetings. The directors of Thermal Energy wish to recognise the fair value hedge in the financial statements.

The futures contract had a fair value of Rs. 50 million at the year-end and third-party evidence confirms this value based on market information. The contract originally had a value of zero at inception and the increase in fair value has been agreed to profit or loss for the year ended 31 October 2021.

The audit team has verified that the metal was acquired for Rs. 200 million and that the purchased quantity is still held at the year-end. The audit working papers show that closing inventory remains measured at its cost of Rs. 200 million. The fair value of the inventory has been fallen by Rs. 40 million.

**Alternative performance measures**
In the draft annual report, the directors have disclosed an adjusted operating profit of Rs. 1,979 million as an alternative performance measure. The adjusted operating profit is reported as a key performance indicator and has been used to show improvement in the underlying profitability of the business. The directors have also used the adjusted operating profit when calculating the operating profit margin.

The audit team have discussed this with the directors, but they were firmly told that auditing alternative performance measures was outside the terms of the audit which should only focus on compliance with IFRS.

## APPENDIX 4 – EMAIL FROM COMPONENT AUDITOR

**To:** Surya Abba
**From:** Sara Abbas
**Subject:** Lahore Energy
**Date:** 21 November 2021

Hi Surya,

As part of our duty to report to you as component auditors, we wish to inform you that the audit report will be qualified in respect of the financial statements of Lahore Energy for the year ended 31 October 2021 due to management refusing to recognise a provision totalling Rs. 87 million in respect of an outstanding court case.

We have obtained legal opinions which confirm it is likely that Lahore Energy will be found liable and the amount can be estimated reliably, but the directors refused to amend the financial statements and have disclosed the amount as a contingent liability.

The draft profit of Lahore Energy is Rs. 350 million and, therefore, the refusal to create a provision is material to our opinion.

If you require any additional information on this, do ask.

Regards,

Sara

## APPENDIX 5 – PROPOSED SHARE-BASED REMUNERATION SCHEMES

SS is planning to cancel its existing share option scheme and implement a new remuneration scheme that is based on providing longer-term rewards. It is currently proposing to offer one of the following two options:

**Proposal one**
The scheme will allow each employee the choice in five years' time to receive either:

(i) 10,000 share options in SS; or
(ii) A cash amount equal to the fair value of 8,500 shares in SS.

**Proposal two**
The scheme will grant 15,000 share options in SS in five years' time, but the share options will only vest if the profit of SS increases by 10% over the five-year period.

**Existing scheme**
The existing equity settled scheme operated by SS has two more years to vest but this will be cancelled and a cash settlement will be paid to employees as compensation.

# QUESTION 2

You are Ibrahim Ali and you are the recently appointed financial accountant at PK Retail (PK).

The finance director Nida Sana, who is also new to her role, has requested that you assist with analysing information to allow her to prepare for a loan application that she will shortly make to the bank. **Appendix 1** contains an email from Nida in which she provides further information about her request.

**Appendix 2** provides information regarding PK's expansion and information relating to the profit or loss and cash flow which was provided in handover notes prepared by the previous financial accountant.

**Appendix 3** contains the profit or loss and cash flow information for the period ended 30 November 2021 that has been extracted from the accounting software. The information has not been subject to audit, as the statutory audit for the year has not yet commenced. Nida is keen to complete the loan application before the audit commences in order that the external auditors can review the loan application when they are on site to carry out the statutory audit. She has commented that the external auditor will agree to this as she is a close friend of the audit manager.

**Requirements**

(a) (i) Prepare analysis of the financial information as requested by the finance director. **(12 marks)**

(ii) Explain any areas of concern that will require further investigation. **(11 marks)**

(b) Explain whether the external auditors may review the loan application. You should reflect on any ethical concerns that may arise. **(07 marks)**

**Total: 30 marks**

## APPENDIX 1 – EMAIL FROM FINANCE DIRECTOR

**To:** Ibrahim Ali
**From:** Nida Sana
**Subject:** Bank loan application
**Date:** 5 December 2021

Hi Ibrahim,

Many thanks for your assistance in preparing information in support of the bank loan application. I appreciate that, like me, you have only joined PK very recently. I did not receive any handover as the previous finance director left several months ago, and therefore we do not have a great understanding of the business but we have been provided with some notes from the previous financial accountant relating to the expansion undertaken by PK during the year ended 30 November 2021 and the financial information extracted from our accounting software at the year-end.

As I have only limited experience in financial statements prepared under IFRS, I require your assistance in this regard. This will be helpful to me in preparing information in support of the loan application.

Initial conversations with the bank have indicated that it requires a comprehensive bank loan application to be completed which provides an analysis of the financial information for the period ended 30 November 2021. Should the bank accept the loan application, it will put in place covenants requiring that gearing must not exceed 35% and interest cover must not fall below 4.5 times, and for an unmodified audit opinion relating to the financial statements be reported by 31 December of each year.

Regards,

Nida

## APPENDIX 2 – EXPANSION DETAILS AND INFORMATION RELATING TO PROFIT OR LOSS AND CASH FLOW

PK was founded as a family business and has always been funded via organic growth rather than borrowings. During 2020, the family decided that they could not grow the business further and new management was appointed on 1 December 2020 to initiate growth.

PK has an overdraft facility for the purpose of working capital management and has previously relied on organic growth to fund any expansion. In order to finance the continued expansion of its own furnishings range and its online sales, there are plans to shortly apply for a Rs. 1,000 million loan that will carry an interest rate of 13% per annum, repayable over five years.

Until 30 November 2020, PK's only source of revenue came from selling homeware products such as furnishings and decorative accessories in its retail stores. All of the products were sourced from manufacturers. One of PK's key competitive advantages was the product displays within its stores; many of its shop assistants were also home designers who were able to offer bespoke advice to customers. This competitive advantage allowed PK to sell the products at above average prices, which PK had always managed to achieve. A price increase of 5% across all in-store product ranges was applied in 2021.

Historically, PK has successfully increased revenue but its profit margins have been reduced in recent years due to a variety of cost increases. Concerns about profit margins and a desire to grow the business led to the appointment of new management on 1 December 2020. Following their appointment, PK expanded into producing and selling its own product range which it began to sell online. The new management has indicated that further financing is needed to continue to expand and, therefore, PK is required to raise bank funding.

During the first quarter of 2021, the new management entered into an exclusive contract with a key supplier for the launch of PK's own home furnishings range. This range was designed to appeal to a wider market as the prices charged are more competitive than those for the products that have historically been sold. The 'own-brand' products are sold within the traditional retail stores and the new management also decided that PK's market share would be increased by selling these products online. The new management worked quickly, making changes which included a reduction of the number of staff allocated to the bespoke service offered in the retail stores and a focus on the launch of a basic e-commerce website, which began to accept orders from 1 March 2021.

Online sales have been lower than expectation. There have been problems with the delivery of goods to customers and a significant number of customers requested refunds as the quality of goods is not what they expected from PK. The new management have no experience of online sales and did not make any significant changes to the systems and technology used by PK to integrate the online sales. In September 2021, the company recruited a website developer to make improvements to the website and a marketing manager to raise the profile of the company and its products. The marketing manager immediately began promotions by placing advertisements in lifestyle magazines and by engaging social media influencers. It is hoped that these changes will increase online sales significantly over the next three years. There are no immediate plans to integrate the accounting and inventory systems associated with the online business with those of the traditional retail business.

PK owns premises which houses its head office along with its warehousing facility. There is sufficient space in the warehouse for the online sales at present, but additional storage space will be required if online sales increase as expected.

## APPENDIX 3 – PROFIT OR LOSS AND CASH FLOW INFORMATION

### Statement of profit or loss for the year ended 30 November 2021

| | Unaudited 2021 | Audited 2020 |
|---|---|---|
| | ---------- Rs. in million ---------- | |
| Sales – stores | 2,855 | 3,100 |
| Sales – online | 1,300 | - |
| **Total sales** | **4,155** | **3,100** |
| Direct costs | (540) | (485) |
| Staff costs | (250) | (315) |
| Depreciation and amortisation | (440) | (145) |
| Administrative | (380) | (325) |
| Distribution | (414) | (155) |
| **Operating profit** | **2,131** | **1,675** |
| Interest | (270) | (140) |
| Taxation | (540) | (380) |
| **Profit** | **1,321** | **1,155** |

### Statement of cash flows for the year ended 30 November 2021

| | Unaudited 2021 | Audited 2020 |
|---|---|---|
| | ---------- Rs. in million ---------- | |
| Operating profit | 2,131 | 1,675 |
| Depreciation and amortisation | 440 | 145 |
| Increase in receivables | (250) | (55) |
| Increase in inventory | (750) | (350) |
| Increase/(decrease) in payables | (125) | 25 |
| Taxation paid | (380) | (325) |
| Interest paid | (270) | (140) |
| **Net cash inflow from operating activities** | **796** | **975** |
| Capital purchases | (600) | (225) |
| Dividend paid | (800) | (1,100) |
| **Net cash outflow** | **(604)** | **(350)** |
| Opening cash | (245) | 105 |
| **Closing cash** | **(849)** | **(245)** |

# QUESTION 3

You are Atfah Shah, an audit manager for an ICAP-registered audit firm based in Lahore. You are currently involved in the planning stage of the audit of the Paktech Group. The audit partner has asked you to use the information provided in the following Appendices:

**Appendix 1** provides you with background information relating to the client and contains brief extracts from the draft consolidated statement of profit or loss of the Paktech Group for the year ended 30 November 2021.

**Appendix 2** provides details of key transactions that the Paktech Group has entered into during the year.

**Requirements**

(a) Identify and explain the key audit risks for the audit of the Paktech Group for the year ended 30 November 2021. **(10 marks)**

(b) Explain financial reporting issues. Show all relevant calculations. **(10 marks)**

**Total: 20 marks**

## APPENDIX 1 – BACKGROUND INFORMATION AND EXTRACTS FROM THE DRAFT CONSOLIDATED STATEMENT OF PROFIT OR LOSS

**Background information**

Paktech Group has been an audit client for a number of years. The parent company, Paktech, is a listed software development company. The biggest challenges facing the group are the rate of technological change and the high levels of competition which both have an impact on the popularity of the software services offered by the group.

The group has grown rapidly in recent years with the parent company, Paktech, having followed an aggressive acquisition policy which has continued in the current year. The Paktech Group includes a number of wholly owned and partly owned subsidiaries, associates and joint ventures with other companies which also operate in the technology sector. During the current year, Paktech has acquired a new subsidiary and has entered into an arrangement with another company to form a new company. We are satisfied with the controls in place at the parent company but there are ongoing concerns as to how the parent company has integrated the acquired companies into the group as different systems and controls are in place in each company. Not all of the group companies are audited by our firm.

The group has outperformed expectations in recent periods and the management is under significant pressure to continue to report good results in the current year. The board have set an aggressive target to increase consolidated revenue by at least 15% and to increase consolidated profit for the year by at least 10% in order to approve management's bonuses. The draft consolidated statement of profit or loss indicates that the targets have been achieved.

Following the resignation of the previous finance director in May 2021, a new finance director was appointed in October 2021. The new finance director has experience in other accounting standards but does not have significant experience in IFRS. There were also a number of resignations and replacements of other finance department staff in the year. The directors are very pleased with the draft financial statements despite staffing issues in the finance team.

**Extracts from the draft consolidated statement of profit or loss**

| | 2021<br>Draft | 2020<br>Published |
|---|---|---|
| | ------- Rs. in million ------- | |
| Revenue | 11,289 | 9,787 |
| Cost of sales | (5,804) | (5,194) |
| Gross profit | 5,485 | 4,593 |
| Share of profit of associates | 412 | 618 |
| Profit for the year | 1,811 | 1,641 |

## APPENDIX 2 – KEY TRANSACTIONS ENTERED INTO BY PAKTECH GROUP

**Sale of new inventory management software**

During the current year, Paktech completed the development of new inventory management software which allows food retailers to reduce wastage on perishable inventory. The new software is a cloud-based service which was made available for sale from August 2021 under two-year service contracts. Under the terms of the contracts, customers will have access to the software from their remote locations and will access data which allows them to proactively manage their inventory. For the software to be effective, small scanners are required to be installed on the customers' shelves and in refrigerators which send information to the cloud on a real-time basis. The software cannot be used without the scanners and the scanners serve no purpose on their own and are not sold separately from the software.

To encourage retailers to purchase the new software, Paktech sells the software on a 'buy now, pay later' agreement under which the customer pays a deposit when they enter into the contract but will then have nothing further to pay until the end of the two-year service contract, at which point the balance is payable. This payment option has proven popular with customers due to challenging economic circumstances and the fact that Paktech has offered this to customers on an interest-free basis.

In August 2021, Paktech entered into a contract with a large supermarket chain for the immediate installation of the scanners and commencement of the software service contract. Paktech received a deposit of Rs. 100 million in respect of the contract and the supermarket chain will pay the balance of Rs. 700 million in August 2023. The prevailing rate for lending to customers with a credit rating similar to the supermarket is 7% per annum. The finance director has instructed to recognise the total amount of revenue under the contract in full in the draft financial statements. She has argued that the contract was signed before the year-end and, as it is legally binding, the revenue is guaranteed. At the date of signing the contract, the supermarket was considered highly likely to pay amounts when they fall due and therefore no allowance has been created in respect of the trade receivable. Paktech will earn a profit margin of 30% on this contract.

**Start-up of SCN**

Paktech lacked the expertise and resources needed internally to manufacture the scanners required for the new software but did not want to fully outsource the manufacture. To achieve this, Paktech has entered into an arrangement with Karachi Manufacturing, a hardware manufacturer.

In January 2021, Paktech and Karachi Manufacturing each invested initial capital of Rs. 850 million in SCN, a newly formed company. SCN was set up for the initial purpose of manufacturing the scanners but is also expected to undertake the manufacturing of similar hardware and components in the future. The shares of SCN are held equally by Paktech and Karachi Manufacturing. Under the terms of the contract, neither Paktech nor Karachi Manufacturing have an interest in the assets or obligation for the liabilities of SCN.

The capital invested was not sufficient to allow SCN to purchase the assets it required, and it had to raise additional finance by taking out substantial bank loans and entering into lease agreements to fund its assets. Paktech purchased scanners from SCN totalling Rs. 200 million in the period to 30 November 2021, which has not been settled at the year-end. Paktech has used 60% of the scanners purchased from SCN in the supermarket contract; the remaining 40% remain in inventory at the year-end.

Although SCN earns a margin of 30% on the sales, it incurs substantial other operating and finance costs and SCN has reported a draft loss of Rs. 160 million for the year ended 30 November 2021. Paktech accounted for its investment in SCN as non-current asset. Paktech has not updated the carrying amount to take into account the performance of SCN during the year.

**Acquisition of subsidiary**
In September 2021, Paktech acquired 100% of the equity share capital of HAQ for cash consideration of Rs. 460 million. The fair values of the recognised net assets at the date of acquisition were equivalent to their carrying amounts which was Rs. 350 million. Paktech acquired HAQ principally to access the value of the customer relationships that HAQ had built up over time with sports teams and athletes, which is a sector of the market that has a growing need for performance software and is a sector that Paktech has no prior experience with. In addition to the intangible assets of HAQ recognised in its financial statements at the date of acquisition, the directors of Paktech believe the value of HAQ's customer lists to be in the region of Rs. 40 million. HAQ is subject to strict data protection laws which safeguard against customer information being sold, transferred or exchanged. HAQ does not have any exclusive rights to customer information.

In its financial statements, HAQ had disclosed a contingent liability in respect of a data protection court case filed by a client. It is not yet known whether HAQ will lose the case but, if it does, it is estimated that damages of Rs. 25 million will be payable. The finance director of Paktech plans to continue to disclose the contingent liability in the group accounts.

**(THE END)**