The Institute of
Chartered Accountants
of Pakistan

Multi Subject Assessment Stage

6 June 2022
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 an audit senior with Gulshan Farooq & Co. and are involved in planning the year end audit of a listed client, Sabz Auto Limited (SA). SA is a manufacturer and distributor of components used in the growing automotive industry in Pakistan. You have been provided with the following information relating to the upcoming audit of SA by the audit partner, Yusuf Abbas.

Appendix 1 provides background information on SA.

Appendix 2 contains the draft financial statements of SA for the year ended 30 April 2022.

Appendix 3 contains minutes of meeting with SA finance team which outline four financial reporting issues identified by the audit team.

Appendix 4 contains an email from Usman Ahmed, the financial controller at SA, requesting advice on the potential impact of a hedging arrangement on SA's financial statements.

Appendix 5 comprises notes from a phone call between Yusuf Abbas and Zainab Hassan, the finance director at SA. Zainab has requested that Gulshan Farooq & Co. perform an additional engagement and has some questions on partner rotation.

Requirements

(a) Review the background information (Appendix 1), SA's draft financial statements (Appendix 2) and the financial reporting issues outlined in the meeting minutes (Appendix 3) and identify the audit risks for the audit of SA for the year ended 30 April 2022. **(15 marks)**

(b) Explain the correct financial reporting treatment for the issues identified in Appendix 3 and prepare journal entries for any necessary adjustments. **(20 marks)**

(c) Explain the impact of the proposed arrangement described in Appendix 4 on the financial statements for the six months ending 31 October 2022 and for the year ending 30 April 2023. **(09 marks)**

(d) Discuss the professional and ethical issues raised in Appendix 5 and recommend the appropriate action to take. **(06 marks)**

Total: 50 marks

APPENDIX 1 – BACKGROUND INFORMATION

SA manufactures and distributes components used in the automotive industry such as exhausts, brakes, gears, batteries and suspension systems. Components are sold to:

- Automotive manufacturers for the manufacture of new vehicles; and
- Garages for maintaining and repairing existing vehicles.

Raw materials for the production of the components include metal, plastic and rubber which are stored at SA's manufacturing plant. SA has a periodic inventory system and an inventory count takes place at the year end. Once a manufacturing run of a component has started, it cannot be paused and therefore manufacturing continues during the inventory count. The cost of raw materials and sales prices of components have been relatively stable for the past twelve months.

Components for new vehicles
SA has contracts with four large automotive manufacturers in Pakistan. During the year, SA entered a contract with a new customer, Khan Motorcycle Manufacturing Limited.

The components that SA manufactures in relation to these contracts are usually specific to a particular vehicle for each manufacturer, and cannot be used for another manufacturer's vehicles. Lead times are typically four months from the automotive manufacturer placing an order.

When an automotive manufacturer places an order for components, they are required to pay an advance of 40% of the agreed price, with the remainder of the balance being due on delivery.

Inventory
SA produces extra components in each manufacturing run. These extra components are held in SA's warehouses as inventory which are later sold to garages. SA managers use their experience to calculate how many extra components to produce.

Industry trends
Demand for eco-friendly vehicles is increasing as the general public is becoming more environmentally conscious. The production of electric and hybrid vehicles has grown and the sale of petrol and diesel vehicles is decreasing.

SA's revenue from the components used in electric vehicles such as rechargeable batteries has grown in the past few years. This is the case for components sold to both automotive manufacturers and garages. SA has also reported falling sales from components used solely in petrol and diesel vehicles such as fuel tanks.

3D printing
The draft financial statements for the year ended 30 April 2022 contain an intangible asset of Rs. 3,000 million which relates to the development of a new 3D-printing technology by SA. The management of SA is hoping that the company will be able to start the 3D printing of certain vehicle parts in early 2023. Development of similar technologies by SA's competitors have resulted in problems with the quality of components and have not generated the cost savings originally planned by them.

APPENDIX 2 – DRAFT FINANCIAL STATEMENTS OF SABZ AUTO LIMITED

Draft statement of profit or loss for the year ended 30 April:

	2022	2021
	------- Rs. in million -------	
Revenue	19,375	15,450
Cost of sales	(11,385)	(9,400)
Gross profit	**7,990**	**6,050**
Distribution and marketing costs	(2,820)	(2,450)
Administrative expenses	(1,345)	(1,302)
Other income	405	453
Operating profit	**4,230**	**2,751**
Finance costs	(1,235)	(945)
Profit before tax	**2,995**	**1,806**
Taxation	(450)	(355)
Profit for the year	**2,545**	**1,451**

Draft statement of financial position as at 30 April:

	2022	2021
	------- Rs. in million -------	
Non-current assets		
Property, plant and equipment	25,670	27,470
Intangible assets	5,504	-
	31,174	**27,470**
Current assets		
Inventories	2,344	1,560
Receivables	1,927	1,680
Cash	410	930
	4,681	**4,170**
Total assets	**35,855**	**31,640**
Equity		
Ordinary share capital	4,000	4,000
Preference share capital	1,000	-
Retained earnings	10,050	7,813
	15,050	**11,813**
Non-current liabilities		
Loans	4,130	4,046
Lease liabilities	5,804	5,760
Deferred tax	3,360	3,240
	13,294	**13,046**
Current liabilities		
Trade payables	3,217	2,551
Other payables	3,134	3,210
Lease liabilities	650	540
Current taxes	510	480
	7,511	**6,781**
Total equity and liabilities	**35,855**	**31,640**

APPENDIX 3 – MINUTES OF MEETING HELD ON 21 MAY 2022 WITH THE SA FINANCE TEAM

The audit team has noted the following transactions taking place in the year ended 30 April 2022. These have been recognised in the draft financial statements as indicated.

(i) SA signed a three-year supply contract to manufacture a highly customised part for one of its major customers, Batura Autos Limited (BA). The contract guarantees that BA will order a minimum number of parts over the three years from 1 May 2022 and is expected to be highly profitable. In anticipation of the start of the contract, SA has developed a new project management system to manage contracts such as that with BA, has trained its staff in the use of the system and has built a technology platform to migrate BA's databases containing the technical information needed to manufacture the part. Although it is specific to the BA contract, the technology platform is not transferred to BA.

Associated costs are as follows:

	Rs. in million
Development of project management system	1,525
Staff training	100
Technology platform	900

All associated costs have been recognised as an intangible asset and are being amortised over an estimated useful life of 10 years. The project management system and technology platform were ready for use on 1 April 2022 and staff training was completed on this date.

(ii) SA entered a contract with a new customer, Khan Motorcycle Manufacturing Limited (KMM) on 1 March 2022 that requires it to deliver a specific number of standard brake components to KMM's warehouse every six months based on KMM's forecast production plan. SA is entitled to payment only when the brake components are transferred from KMM's warehouse to its assembly line.

The components are not specialised and SA has the right to require KMM to return any brake components that have not yet transferred to the assembly line so that they can be used to meet other orders. KMM has the right to return any unused components to SA. SA transferred components that cost Rs. 94.2 million to manufacture and with a sales value of Rs. 125.8 million to KMM on 1 April 2022 and recognised the transaction as a credit sale on this date. During April 2022, KMM used 15% of the brake components delivered in the assembly of motorcycles.

(iii) In order to incentivise senior management, SA launched a share option scheme on 1 November 2021, awarding each of the 25 senior managers 7,500 options in SA's ordinary shares. The options had a fair value of Rs. 1,175 each on 1 November 2021 and Rs. 1,350 on 30 April 2022. The options vest on 31 October 2024, provided that the managers are still in the employment of SA at that date and the SA share price has increased by at least 12% per year compounded over the vesting period. At 30 April 2022, no senior managers had left SA's employment although it was expected that three senior managers would leave before 31 October 2024. At 30 April 2022, SA management did not believe that the share price increase would be achieved and so no accounting entries had been made in respect of the options.

(iv) On 1 November 2021, SA issued Rs. 1,000 million irredeemable preference shares in order to raise funds ahead of implementing expansion plans. The shares carry mandatory dividends at an annual fixed rate of 8%, which represents a market rate of interest. An initial six-month dividend has been paid in the year and recognised directly in retained earnings.

APPENDIX 4 – EMAIL FROM USMAN AHMED, SA FINANCIAL CONTROLLER

To: Yusuf Abbas
From: Usman Ahmed
Date: 30 May 2022
Subject: Expansion advice

Dear Yusuf, I hope that you are very well?

As you may be aware, one of our major customers, Bukhari Motors (Bukhari), has recently publicly announced its intention to start mass production of an electric compact car, B-EV1 at its manufacturing plant in Karachi. This is a new direction for Bukhari, and some time ago, it requested support from SA in the form of the supply of components specific to the B-EV1.

We now have an agreement in principle with Bukhari for the supply, and this has acted as a catalyst for our own expansion plans which will now take place two years earlier than expected, commencing in the 2022-2023 financial year. As part of these plans, we are almost certain to purchase a new production line from Germany this year at an expected price of €12 million. We anticipate delivery at the end of November 2022 and would pay the supplier on that date.

This is a significant investment on our part and the board is particularly concerned about SA committing to such a big Euro payment, given the volatility of exchange rates. With that in mind, I have suggested that we enter into a forward contract to buy €12 million at a fixed rate in order to hedge the purchase.

Zainab has requested me to share notes with the board to explain the impact of hedging on the SA financial statements for the six months ending 31 October 2022 and for the year ending 30 April 2023. However, I am not up to date on current hedge accounting rules and I would like you to advise me.

For the purposes of illustrative figures, please assume that the forward contract would be entered into today and would be settled on 30 November 2022.

I have already determined the relevant exchange rates for today and have provided the speculative exchange rates for future dates. These rates will suffice for the purposes of explaining the impact of the hedge on the financial statements to the board.

	Spot exchange rate	**Forward exchange rate for delivery on 30 November 2022**
30 May 2022	€1: Rs. 196	€1: Rs. 202
31 October 2022	€1: Rs. 204	€1: Rs. 206
30 November 2022	€1: Rs. 208	

You may assume that all IFRS 9 conditions for hedge accounting to be applied have been met.

Please call me if you have any queries.

Best regards,

Usman Ahmed,
Financial Controller
Sabz Auto Limited

APPENDIX 5 – NOTES FROM PHONE CONVERSATION BETWEEN ZAINAB HASSAN, SA FINANCE DIRECTOR, AND YUSUF ABBAS, AUDIT PARTNER

German production line

Zainab Hassan has asked Gulshan Farooq & Co. to perform an additional engagement to determine the fair value of the new production line from Germany which SA is hoping to purchase in November 2022.

Partner rotation

Gulshan Farooq & Co. has the policy to rotate audit engagement partner at every client after four years. Alina Shah was the previous audit engagement partner at SA for four years. A meeting has been arranged with SA, Alina Shah and the new audit engagement partner, Yusuf Abbas, later this week. Zainab Hassan has requested on phone that Alina Shah acts as audit engagement partner for the coming year. She is concerned that Yusuf Abbas is not as knowledgeable about SA's business and believes the audit will be more efficient and of a higher quality by continuing Alina Shah.

QUESTION 2

You are a member of the finance team of Relay Limited (Relay), the parent company in the Relay Group, and are covering the work of Ahmed Shah, a member of the finance team who has suddenly gone on long sick leave. Relay operates in the agri-business sector and has controlling and non-controlling interests in a number of other companies operating in the same sector.

You have been presented with a draft consolidated statement of financial position (Appendix 1) as well as information about the Relay Group structure (Appendix 2) and outstanding matters in respect of financial statements for the year ended 30 April 2022 (Appendices 3 and 4).

Ismail Latif, the group finance director, has asked for your assistance in understanding the impact of the outstanding matters on the draft consolidated financial statements. Ismail also asks your opinion regarding a conversation he has had with the auditors (Appendix 4).

Requirements

(a) Prepare a briefing note for the group finance director in which you explain, with supporting calculations, the correct accounting treatment to be applied to the outstanding matters detailed in Appendices 3 and 4. **(15 marks)**

(b) Redraft the Relay's consolidated statement of financial position as at 30 April 2022 reflecting any adjustments required as a result of the outstanding matters in (a). **(06 marks)**

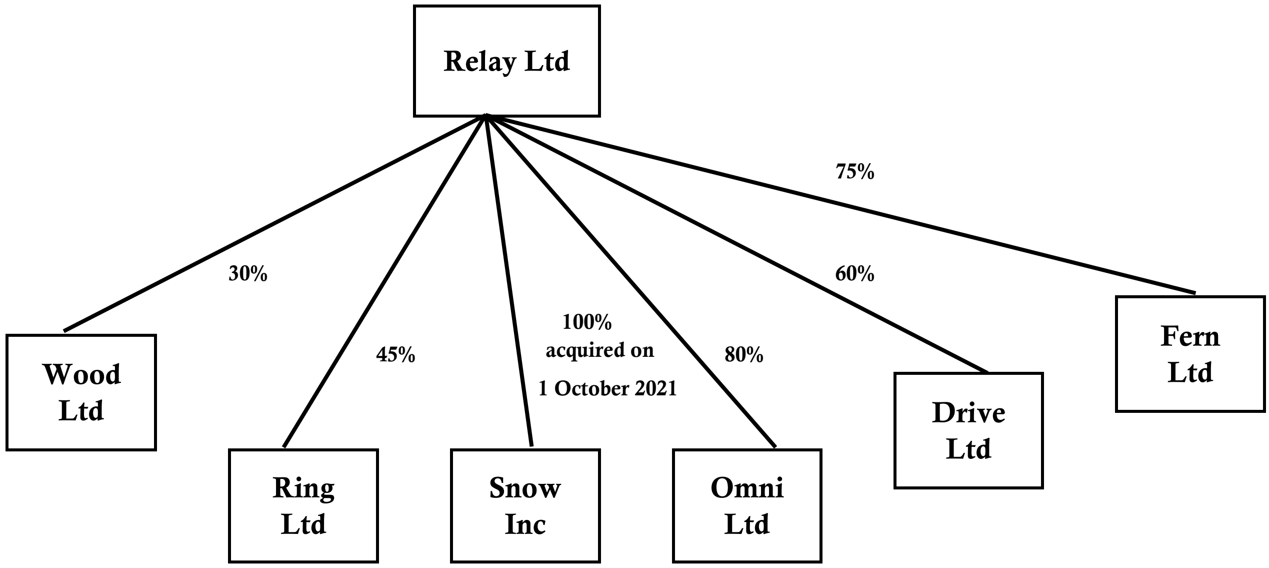
(c) Explain whether the auditor would accept the request made in Appendix 4. You should reflect on any ethical concerns that may arise. **(04 marks)**

Total: 25 marks

APPENDIX 1 – DRAFT CONSOLIDATED STATEMENT OF FINANCIAL POSITION AS AT 30 APRIL 2022

	Rs. in million
Non-current assets	
Property, plant and equipment	26,743
Goodwill	1,078
Investments in associates	3,420
Investment in Drive Limited	(1,893)
Other investments including Snow Inc	1,221
	30,569
Current assets	
Inventories	3,900
Trade receivables	3,210
Other current assets	1,450
Cash and bank balances	167
	8,727
Total assets	**39,296**
Equity and liabilities	
Share capital	2,000
Retained earnings	23,576
	25,576
Non-controlling interests	3,906
Total equity	**29,482**
Non-current liabilities	
Borrowings	2,600
Other liabilities	1,784
	4,384
Current liabilities	
Trade and other payables	3,450
Current tax payable	1,980
	5,430
Total equity and liabilities	**39,296**

APPENDIX 2 – RELAY GROUP STRUCTURE AS AT 30 APRIL 2022



APPENDIX 3 – OUTSTANDING MATTERS

Adjustments have not been made to the draft consolidated financial statements for the following:

(i) On 30 April 2022, Relay sold 30% shareholding in Drive Limited for Rs. 2,250 million, so reducing its shareholding from 90% to 60%. The disposal was reflected correctly in Relay's separate financial statements that were used to prepare the consolidation. The reduction in shareholding has not resulted in a loss of control and the subsidiary has been brought into the draft consolidated financial statements based on 90% shareholding.

The following information relates to Drive Limited:

- 90% shareholding was acquired on 12 December 2015 for Rs. 5,679 million.
- The non-controlling interest (NCI) at acquisition was measured as a percentage of the fair value of identifiable net assets, giving rise to Rs. 144 million goodwill. This is recognised in full in the draft consolidated statement of financial position.
- The net assets of Drive Limited (other than goodwill) were Rs. 6,790 million at 30 April 2022.

(ii) On 30 April 2022, annual impairment tests were conducted on all cash generating units (CGUs) that include goodwill, as required by IAS 36. No impairment losses were identified in respect of any CGUs with the exception of Rs. 520 million loss in Omni Limited (which is a single CGU). This loss was calculated by comparing the recoverable amount of the CGU with its carrying amount, including notional goodwill. Omni Limited has been correctly consolidated. However, no accounting entries have been made in respect of this impairment loss.

The following information relates to Omni Limited:

- 80% shareholding was acquired in August 2017 for Rs. 7,490 million when the carrying amount of the net assets of Omni Limited was Rs. 8,280 million.
- At acquisition, fair value of land was found to be Rs. 235 million in excess of its carrying amount.
- The NCI at acquisition was measured as a proportion of the fair value of identifiable assets acquired and liabilities assumed.
- The goodwill in Omni Limited has not been impaired since acquisition.
- At 30 April 2022, the carrying amount of the net assets of Omni Limited for consolidation purposes included Rs. 8,100 million of property, plant and equipment.

APPENDIX 4 – EMAIL

To: Finance Team
From: Ismail Latif
Date: 26 May 2022
Subject: Consolidation of Snow Inc

As you know, Ahmed Shah is sick and is now on extended leave. It seems that Ahmed Shah will be unable to return to work for three months. The rest of the group finance team have been helping in Ahmed's absence but I think we will need to bring in a temporary member of staff to cover his role.

I had a conversation with the auditors this morning where I suggested that we use a member of the audit team to cover Ahmed's role. I think this is the perfect solution as the auditors are already familiar with our business and the way we operate.

Prior to his sick leave, Ahmed had commenced the translation of our new subsidiary, Snow Inc's financial statements into Rupees for inclusion in the consolidated accounts. He was unable to complete the work before he left and we therefore need to:

(i) Complete the translation of the Snow Inc's statement of financial position.

(ii) Justify the resulting exchange difference on translation and clarify the accounting treatment.

(iii) Calculate goodwill for inclusion in the consolidated financial statements.

I have included two attachments to this email. Firstly, some background information on the acquisition, in case you are not familiar with the details. Secondly, Ahmed's incomplete translation working papers.

Attachment 1: Background information
A 100% shareholding in Snow Inc, a small US-based competitor, was acquired on 1 October 2021 at a cost of $ 3.8 million. At the date of acquisition, the carrying amount of the net assets in Snow Inc's separate financial statements was equal to the fair value as determined in accordance with IFRS 3. The goodwill arising on the acquisition of Snow Inc has not been impaired.

In Relay's separate financial statements, the investment in Snow Inc is carried at cost, translated at the exchange rate on the date of acquisition.

Attachment 2: Translation working papers

Statement of financial position as at 30 April 2022

	$ '000	Exchange rate	Rs. in million*
Property, plant and equipment	5,640	173	976
Inventories	676	173	117
Trade receivables	810	177	143
Other current assets	90	173	16
Cash and bank balances	140	177	25
	7,356		
Share capital	250		
Retained earnings at 1 October 2021	3,381		
Profit 1 October 2021 – 30 April 2022	605		
Long term borrowings	2,020	173	349
Trade and other payables	940	177	166
Current tax	160	177	28
	7,356		

*I have rounded to nearest million since group reports in millions of Rupees

Exchange rates

1 October 2021	$1: Rs. 173
30 April 2022	$1: Rs. 177
Average rate for period	$1: Rs. 175

QUESTION 3

You are an audit manager at Rasool Gul & Co. and are working on the audit of Karachi Fashions Limited (KF), for the year ended 30 April 2022. Revenue and total assets as per draft financial statements are Rs. 500 million and Rs. 126 million respectively. The audit is now at the finalization stage.

KF is a women's retailer offering traditional clothing with a modern twist and has 50 retail outlets across Pakistan.

Ayesha Rasheed, the audit partner, has asked you to review some audit working papers (Appendix 1). She has also forwarded you an email from the finance director of KF, Muhammad Khalid, (Appendix 2) and has asked for your help to prepare a response.

Requirements

(a) Explain the financial reporting issues arising from your review of the audit team's working papers in Appendix 1 and identify any adjustments that are required to the draft financial statements. **(10 marks)**

(b) Explain the impact on the auditor's report if the management of KF refuses to amend the draft financial statements for any adjustments identified in (a). **(05 marks)**

(c) In relation to the warehouse fire detailed in Appendix 2:

(i) Discuss the appropriateness of KF's accounting treatment in response to the fire in respect of the financial statements for the year ended 30 April 2022. **(05 marks)**

(ii) Explain the audit evidence that Rasool Gul & Co. should obtain in relation to the fire. **(05 marks)**

Total: 25 marks

APPENDIX 1 – AUDIT TEAM'S WORKING PAPERS

Properties: *Accounting policies and estimates*

- The cost model is applied to owner-occupied property.
- Depreciation of owner-occupied properties is 2% on cost.
- The fair value model is applied to investment property.

(i) **Falak Square**

The property is an individual retail unit which was bought on 1 October 2021. The property comprises a main showroom, two additional work rooms and a kitchen facility, all accessed via the main showroom. The main showroom is used as a KF retail outlet and one work room is used for KF's administrative function. The second work room is rented to Ms Zimri who runs an independent alterations business. KF is responsible for insuring and maintaining the property and the kitchen facility is shared by KF staff and Ms Zimri's staff.

The property has been accounted for as follows:

	Rs. in '000
Cost	28,200
Gain recognised in P&L	1,300
Carrying amount in SOFP at 30 April 2022	29,500
Rental income in P&L for the year ended 30 April 2022	295

(ii) **Jheel Park**

On 1 November 2021, KF entered into an agreement with the newly built Jheel Park Shopping Centre to rent a specific retail unit for a period of five years. Jheel Park can require KF to move into another retail unit of similar quality and specification during the five-year term. However, it must pay relocation costs and a disruption penalty to KF in such a case.

The terms of the contract require that KF can only trade from this retail unit during the operating hours of the shopping centre. However, KF controls its physical access to the retail unit throughout the rental period and can decide on the mix of goods sold, pricing and quantities of inventory held.

KF is required to pay to Jheel Park a fixed annual rent of Rs. 4.8 million in arrears plus 2% of revenue earned in the year by the KF retail unit located in Jhee Park. The revenue earned in the six months ended 30 April 2022 is Rs. 9.8 million. KF's incremental borrowing rate was determined to be 7% per annum.

KF has concluded that the agreement is not a lease and has recognised a rental expense of Rs. 2,596,000 [(4.8m × 6÷12m) + (2% × 9.8m)] in profit or loss for the year ended 30 April 2022.

APPENDIX 2 – EMAIL FROM FINANCE DIRECTOR

To: Ayesha Rasheed
From: Muhammad Khalid
Date: 05 June 2022
Subject: Warehouse fire

Dear Ayesha,

Last night there was a fire in our main warehouse. Unfortunately, a lot of our clothing inventory was damaged by the fire and the warehouse will also need to be rebuilt. We've contacted our insurance company this morning.

I've done some quick calculations and estimate that approximately Rs. 7 million of clothing has been damaged and the warehouse will cost Rs. 35 million to rebuild. I think we will need to make a provision for Rs. 42 million in the financial statements for the year ended 30 April 2022 to cover for this.

Kindest regards,

Muhammad Khalid
Finance Director
Karachi Fashions Limited

(THE END)