The Institute of
Chartered Accountants
of Pakistan

Multi Subject Assessment Stage

5 December 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 Shafiq Uddin, an audit senior with Dhanial Naqri Co (DNC) and are involved in planning the audit of Sindh Agri Industries (SAI), a new audit client for your firm. SAI operates internationally and produces and supplies agriculture inputs such as fertilisers and pesticides.

Your audit manager is Farid Abbas and the audit partner is Zainab Iqbal. Ahead of the audit of SAI for the year ended 30 September 2022, you have been presented with the following information:

Appendix 1 provides background information on SAI.

Appendix 2 includes extracts from the draft financial statements of SAI for the year ended 30 September 2022.

Appendix 3 is an email received from the audit manager, Farid Abbas, detailing outstanding matters for inclusion in the financial statements.

Appendix 4 contains a memo from the audit partner, Zainab Iqbal, detailing a proposed acquisition of shares by SAI.

Appendix 5 contains information detailing two ethical matters affecting DNC.

Requirements

(a) Identify and explain the key audit risks in respect of the audit of SAI by reference to the background information (Appendix 1), SAI's draft financial statements for the year ended 30 September 2022 (Appendix 2) and the financial reporting issues outlined in the email (Appendix 3). **(17 marks)**

(b) Prepare the briefing notes required by the audit manager in Appendix 3 in which you:

- Explain how IFRSs should be applied to the issues.
- Explain the deferred tax implications of each issue.
- Prepare journal entries for each issue in the financial statements for the year ended 30 September 2022. **(18 marks)**

(c) Prepare notes for the audit partner ahead of his meeting with the finance director of SAI, as requested in the memo (Appendix 4). **(09 marks)**

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

Total: 50 marks

APPENDIX 1 – BACKGROUND INFORMATION

Sindh Agri Industries (SAI), based in Pakistan, is a leading producer and supplier of agricultural inputs, such as fertilisers and pesticides.

Industry regulations
The raw materials and SAI's manufactured products are extremely hazardous. Materials and finished products must be stored and transported in line with strict industry regulations. Inspections take place on a regular basis and SAI can be fined for any non-compliance with regulations or have its operating licence revoked for a serious breach.

Chemical 6502B
Approximately 35% of the pesticides manufactured by SAI contain Chemical 6502B. Recent research revealed Chemical 6502B causes harm to wildlife when washed away by rainfall into lakes and rivers. Consequently, products containing Chemical 6502B are banned from sale in Pakistan from January 2023. SAI's key export markets have also established a ban on these products. On 30 September 2022, SAI had Rs. 658 million of pesticides containing Chemical 6502B in inventory.

The chemical process for the production of pesticides using Chemical 6502B is complex and uses machinery designed specifically for the synthesisation of Chemical 6502B. This machinery cannot be used in other areas of production and has a carrying amount of Rs. 3,955 million in SAI's draft statement of financial position.

Hamal Lake
The Pakistan Environmental Protection Agency (Pak-EPA) has concluded that SAI's pesticides containing Chemical 6502B were responsible for the environmental damage to Hamal Lake. Contamination of the lake has resulted in a major loss of fish and birds which once flocked to the area, but now no longer visit.

The Pak-EPA has charged SAI a penalty of Rs. 600 million to cover the cost of restoring Hamal Lake to its unpolluted state. In July 2022, a legal case against the Pak-EPA was commenced by SAI in order to waive the penalty. SAI is confident that it can win the case since it was using Chemical 6502B legally. However, the Pak-EPA claim that SAI acted negligently and should have halted use of Chemical 6502B earlier as other pesticide producers did. The case has not been settled at year-end.

Bank loan
SAI obtained a loan from a Malaysian bank in May 2022. The loan has strict covenants attached and the bank has the right to recall the loan if the covenants are breached.

APPENDIX 2 – EXTRACTS FROM DRAFT FINANCIAL STATEMENTS

Statement of profit or loss for the years ended 30 September

	2022	2021
	------- Rs. in million -------	
Revenue	37,908	42,100
Cost of sales	(20,753)	(21,892)
Gross profit	**17,155**	**20,208**
Distribution and marketing costs	(6,329)	(5,900)
Administrative expenses	(9,350)	(9,950)
Operating profit	**1,476**	**4,358**
Finance costs	(650)	(586)
Profit before tax	**826**	**3,772**
Taxation	(235)	(450)
Profit for the year	**591**	**3,322**

Statement of financial position as at 30 September

	2022	2021
	------- Rs. in million -------	
Non-current assets		
Property, plant and equipment	27,520	23,960
Right-of-use assets	4,865	3,242
Intangible assets	3,775	2,812
	36,160	30,014
Current assets		
Inventories	2,318	2,919
Trade receivables	6,892	6,915
Other receivables	2,965	2,890
Cash	1,748	3,924
	13,923	16,648
Total assets	**50,083**	**46,662**
Equity		
Ordinary share capital	690	690
Retained earnings	30,634	30,443
	31,324	31,133
Non-current liabilities		
Borrowings	7,350	5,900
Lease liabilities	4,110	2,945
Deferred tax	1,860	1,860
	13,320	10,705
Current liabilities		
Trade payables	3,658	2,699
Lease liabilities	215	210
Other payables	1,566	1,915
	5,439	4,824
Total equity and liabilities	**50,083**	**46,662**

Statement of changes in equity for the year ended 30 September 2022

	Share capital	Retained earnings	Total
	--------------- Rs. in million ---------------		
At 1 October 2021	690	30,443	31,133
Profit for the year	-	591	591
Dividends paid	-	(400)	(400)
At 30 September 2022	**690**	**30,634**	**31,324**

APPENDIX 3 – EMAIL FROM AUDIT MANAGER

To: Shafiq Uddin
From: Farid Abbas
Date: 25 November 2022
Subject: SAI audit – outstanding matters

Hi Shafiq,

We have received the draft financial statements from SAI ahead of the audit but an accompanying email (see below) identified that there are few outstanding issues that have not yet been reflected in them. SAI will resolve these before the audit starts but I think it would be a good idea for us to think about what we should expect to see in terms of their effect on the financial statements. Could you prepare briefing notes for the audit team that explain the financial reporting impact and any deferred tax impact of the issues below? As you can see from the accompanying email, deferred tax has not been accounted for at all so we need to understand how that will affect the financial statements.

I saw that one of the issues relates to a loan in Malaysian Ringgit (RM) so I have noted down exchange rates that may be useful to you:

1 May 2022	RM 1 : Rs. 44
30 September 2022	RM 1 : Rs. 46

I will be in the office all week so drop by and see me if you have any further questions.

Regards,

Farid Abbas
Audit Manager
Dhanial Naqri Co

To: Farid Abbas
From: Mirha Abidi
Date: 22 November 2022
Subject: Draft F/S and outstanding matters

Dear Farid,
Please find attached a copy of the draft financial statements of SAI (Appendix 2) for the upcoming audit. We still have a few matters that are outstanding, but we will have dealt with these by the time you arrive on site for the audit. The outstanding matters are as follows:

(i) On 1 May 2022, SAI obtained a loan from a Malaysian bank, denominated in Malaysian Ringgit (RM). The loan of RM 40 million was used to finance the setting up of a new plant for exports to Malaysian markets. It has a 10-year term and carries interest at an annual rate of 6%. Interest is payable every six months in arrears. No entries have been made other than to record loan proceeds translated at the spot rate on 1 May 2022.

(ii) On 1 June 2022, SAI issued a total of 2 million share options to its directors. These vest after two years dependent on the directors remaining in SAI's employment. The fair value of each option at the grant date was Rs. 96 and their exercise price is Rs. 134. At 30 September 2022, all directors remained in SAI's employment and this was not expected to change. The price of each share of SAI at 30 September 2022 was Rs. 257, giving intrinsic value of Rs. 123 per share.

(iii) At 30 September 2022, the SAI board decided to change the accounting policy for owner occupied property and apply the revaluation model. We have determined that the fair value of all properties other than the head office is Rs. 5,160 million above the year-end carrying amount. The head office has a carrying amount of Rs. 3,860 million but we have not yet confirmed its fair value. It is located in an area of Karachi that is undergoing redevelopment and we are aware of several nearby sites being developed as high-rise residential blocks. Property valuation experts have indicated that on 30 September 2022 we could have achieved Rs. 5,200 million if we had sold the head office for continued commercial use and that price would have been 25% higher if it were sold for future residential use. If we sold to a property developer, they would have to invest approximately Rs. 2,100 million in order to convert the property to apartments, but could sell those apartments for a total of Rs. 10,000 million. When SAI bought the property, the legal purchase documents specified that it must not be used for "housing or permanent shelter". The legal department has concluded that this restriction would not be transferred on a sale.

(iv) We are also a bit behind on the deferred tax calculations and the draft financial statements still include last year's liability. We have calculated that there are net taxable temporary differences this year of Rs. 6,700 million, excluding the matters above. We will be calculating deferred tax on the basis that:

- Exchange gains and losses are taxable when realized
- Finance costs are admissible in tax when paid
- A property revaluation is taxed when the property is sold
- Tax relief on share options is provided when the options are exercised, based on intrinsic value at that date
- The corporate tax rate is 29% this year
- All deferred tax amounts are permitted to be offset

We are all looking forward to welcoming you and your team on site but, in the meantime, if you have any questions please do not hesitate to give me a call.

Regards,

Mirha Abidi
Finance Manager
Sindh Agri Industries

APPENDIX 4 – MEMO FROM THE AUDIT PARTNER

Memo

Re: SAI proposed acquisition of shares
To: Shafiq Uddin
From: Zainab Iqbal
Date: 1 December 2022

I have a meeting set up with the SAI finance director, Waqas Bashir, the week after next to discuss a proposed acquisition of shares in Muker Industries Co (MIC) by SAI. Waqas has provided outline information on the acquisition (see below), however I have a full diary and do not have time to digest the relevance of this information before the meeting. SAI is a key client to DNC and it is important that I am well-prepared for the meeting. Therefore, please prepare briefing notes for me in which you:

- Explain whether SAI will be required to prepare consolidated financial statements after the share acquisition.
- Explain whether SAI can recognise MIC's know-how and customer database if it does prepare consolidated financial statements. Also, explain whether there would be any deferred tax consequence of recognising these as assets.
- Explain whether the different assumption regarding the measurement of inventories causes an issue in terms of preparing consolidated financial statements.

Outline information on the acquisition provided by Waqas Bashir, SAI.

SAI intends to acquire 45% of the equity shares in MIC during the first half of the year ending 30 September 2023. MIC is a competitor of SAI and has been hugely successful in developing new pesticide products and manufacturing processes. It also has a very effective marketing team that has built up an extensive customer database. The main reason for us acquiring interest in MIC is to access the product and processes know-how as well as the customer database, neither of which is represented in MIC's statement of financial position. In terms of operations, I have been told that MIC measures its inventories using a first-in-first-out formula, whilst we use average cost, but other than this policy, the two companies are very similar and I imagine that we will be able to achieve some synergies over time.

In terms of the deal, SAI will purchase the 45% shareholding from the two brothers who originally set up MIC. Over the years, the remainder of the equity shares have become widely dispersed such that they are held by thousands of shareholders, who each exercise their voting rights independently and none of whom owns more than 1%. In addition to the 45% equity shareholding, SAI will have the right to appoint the production and operations director of MIC due to its experience in this industry.

APPENDIX 5 – INFORMATION DETAILING TWO ETHICAL MATTERS

Kharoti Agricultural Group
Zainab Iqbal was introduced to Abdullah, finance director of Kharoti Agricultural Group (KAG) at a recent charity event. KAG is an international group specialising in the production of fertilisers and pesticides for agricultural use and is a direct competitor of SAI. Abdullah explained that KAG is changing auditor this year and would like DNC to act as the new auditor. He went on to explain that KAG is particularly interested in DNC due to its experience in auditing companies in KAG's industry.

Luxury resort
Waqas Bashir, SAI’s finance director, explained to Zainab Iqbal that he takes the finance team for a weekend at a luxury resort in Murree every year to thank them for their hard work. This year, he would like to invite the entire audit team to join them in Murree. The trip would be funded in full by SAI.

QUESTION 2

You are Noor Baqri, a financial accountant at Kalmati Transport Co (KTC) and are responsible for preparing the consolidated financial statements for the year ended 30 September 2022.

KTC has held a controlling 90% shareholding in City Hopper Co (CHC) for several years and acquired a 30% interest in Ideal Bus Co (IBC) on 1 October 2021, giving it significant influence over IBC. On 1 July 2022, KTC increased its shareholding in IBC to 65%, which gave it control of IBC from that date.

You have been presented with the following information to help prepare the consolidated financial statements:

Appendix 1: Draft statements of profit or loss and other comprehensive income for KTC, CHC and IBC.

Appendix 2: Additional information related to the consolidation.

Appendix 3: An email from Ayaan Abidi, the KTC financial controller regarding a potential investment in Lahore Urban Transport Co (LUTC).

Appendix 4: An email from Ali Bux, finance director at KTC, discussing the recent offer of an engagement to Ahmed Nabi & Co (AN & Co) to examine prospective financial information.

Requirements

(a) Explain, with supporting calculations, how the goodwill arising on the acquisition of IBC would be determined. **(06 marks)**

(b) Prepare the KTC's consolidated statement of profit or loss and other comprehensive income for the year ended 30 September 2022. **(11 marks)**

(c) Discuss the nature of the potential investment in LUTC (Appendix 3). **(04 marks)**

(d) Explain the matters which AN & Co would be considering prior to accepting the engagement to examine prospective information in response to the email from Ali Bux (Appendix 4). **(04 marks)**

Total: 25 marks

APPENDIX 1 – DRAFT FINANCIAL STATEMENTS

Statement of profit or loss and other comprehensive income
For the year ended 30 September 2022

	KTC	CHC	IBC
	------------------ Rs. in million	------------------	
Revenue	9,560	7,250	6,890
Operating costs	(8,700)	(6,452)	(6,324)
Operating profit	**860**	**798**	**566**
Finance costs	(191)	(57)	(44)
Profit before tax	**669**	**741**	**522**
Tax	(165)	(190)	(186)
Profit for the year	**504**	**551**	**336**
Other comprehensive income that may be reclassified to profit or loss			
Net fair value gains on cash flow hedges	38	26	24
Total comprehensive income	**542**	**577**	**360**

APPENDIX 2 – ADDITIONAL INFORMATION RELATING TO THE CONSOLIDATION

Ideal Bus Co (IBC)

The 30% shareholding in IBC was originally bought on 1 October 2021 for Rs. 4,080 million, on which date the net assets of IBC had a carrying amount, equal to their fair value, of Rs. 13,375 million. The shareholding provided KTC with significant influence over IBC. KTC subsequently acquired a further 35% of the 10 million shares in IBC on 1 July 2022. KTC had control over IBC from that date.

Consideration for the additional shares was provided in the form of Rs. 2,554 million cash plus a share for share exchange in which 2 KTC shares were issued for every 5 IBC shares acquired. The KTC share price on 1 July 2022 was Rs. 2,140 and the IBC share price was Rs. 1,580. At the acquisition date, IBC owned property which had a fair value of Rs. 232 million in excess of its carrying amount and spare parts which had a fair value of Rs. 65 million less than their carrying amount. The spare parts had not been used by 30 September 2022 and remained in inventory. IBC's property had a remaining useful life of 40 years at 1 July 2022. IBC's profits and other comprehensive income accrued evenly across the year ended 30 September 2022.

City Hopper Co (CHC)

Goodwill of Rs. 960 million arose on the acquisition of CHC. In the year ended 30 September 2022, trading difficulties meant that the goodwill of CHC was impaired by 15% of its carrying amount. There had been no previous impairments of goodwill.

During the year, CHC provided excess spare parts to KTC for onward sale to other unrelated bus companies. CHC transferred these for Rs. 20 million, charging a 20% margin. By the reporting date, KTC had sold three-fourth of these spare parts outside the group; the remaining spare parts remained in its inventory.

Other information

KTC has elected to measure the non-controlling interests (NCI) in IBC as a proportion of net assets, although it measured the NCI on the acquisition of CHC at fair value.

APPENDIX 3 – EMAIL FROM FINANCIAL CONTROLLER

To: Noor Baqri
From: Ayaan Abidi
Date: 25 November 2022
Subject: Potential investment in LUTC

Hi Noor,

I have just had a meeting with the directors and they are interested in acquiring a 30% equity shareholding in the Lahore Urban Transport Co (LUTC) that operates inner city bus routes in locations throughout Pakistan. The directors have given me the following information and would like to understand how the investment would be classified for financial reporting purposes in consolidated financial statements:

(i) The other investors are unrelated to KTC with one holding 50% equity shares and the other 20%.

(ii) A contractual arrangement between the investors indicates that decisions about LUTC's routes, pricing, funding and capital expenditure require a 75% majority of votes.

(iii) The contractual arrangement establishes that:

- Assets held by LUTC are LUTC's assets and the three investors have no rights, title or ownership in those assets.
- LUTC is liable for its debts and obligations and LUTC creditors have no right of recourse against investors in LUTC.

I am busy with completing year-end, so please could you prepare notes on this for me to pass to the directors?

Thanks,
Ayaan

APPENDIX 4 – EMAIL FROM FINANCE DIRECTOR

To: Noor Baqri
From: Ali Bux
Date: 16 November 2022
Subject: Examination of prospective financial information

Dear Noor,

As you are aware, KTC is applying for a bank loan to fund its planned investment in LUTC.

We would like to engage Ahmed Nabi & Co (AN & Co) to provide assurance over the profit and cash flow forecasts required by the bank to support the loan application. Our auditors have explained that they are unable to perform this engagement and so we are looking to employ the services of an accountancy firm that is not our auditor.

The engagement partner at AN & Co told me there are various matters to consider before they accept the work. I am finding this quite frustrating as I would like the work to be completed as soon as possible so we can provide the bank with what they need. I remember you used to work in an accountancy firm. Are you able to help me understand what AN & Co might be considering and why this is taking so long? I don't understand why they could not accept the work straight away.

Regards,

Ali Bux
Finance Director
Kalmati Transport Co

QUESTION 3

You are an audit manager at Asif Bilal & Co (AB & Co) and are working on the audit of Jokio Shopping Malls Ltd (JSM) for the year ended 30 September 2022. JSM owns 23 shopping malls located across Pakistan and leases floor space to retailers. The company was founded by Zahid Jokio in 2008 and has grown rapidly by acquisition.

JSM's draft financial statements for the year ended 30 September 2022 show net profit of Rs. 22,130 million and total assets of Rs. 145,345 million. The audit is currently at the execution stage.

Umer Jawad, the audit partner, has asked you to review some audit working papers (Appendix 1). He has also provided you information extracted from an email of the JSM’s finance director regarding property valuation (Appendix 2) and has asked you to help prepare a response.

Requirements

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

(b) Explain the impact on the auditor's report if JSM management refuse to adjust the financial statements for the two items detailed in Appendix 1. **(05 marks)**

(c) In relation to the information provided in Appendix 2:

(i) Discuss whether AB & Co can rely on the work of Faisal Akbar in valuing the properties of JSM. **(05 marks)**

(ii) Explain whether JSM's decision not to disclose the transaction with Faisal Akbar as a related party transaction is correct, and any further action(s) that AB & Co need to take. **(05 marks)**

Total: 25 marks

APPENDIX 1 – NOTES FROM AUDIT WORKING PAPERS

(i) In order to raise immediate funds to take advantage of an opportunity to buy a shopping mall from a struggling competitor, JSM entered into a sale and leaseback transaction for one of its malls on 1 April 2022. The sale raised proceeds of Rs. 8,000 million, which JSM has recognised as income. At the date of sale, the carrying amount of the mall was its fair value of Rs. 9,720 million. JSM has continued to recognise the carrying amount of the mall in its statement of financial position. Legal title to the mall passed to the purchaser, Lahore Bank, however under the terms of the arrangement, JSM would continue to operate, maintain and insure the mall throughout the 10-year lease term and would continue to sublet units to retail tenants. Those tenants' occupancy would not be interrupted as a result of the sale and leaseback transaction. The terms of the arrangement require JSM to pay annual rental charges of Rs. 900 million to Lahore Bank and it has an option to repurchase the mall after 10 years for Rs. 2,460 million. Discount rate of 6% per annum may be used.

(ii) JSM has recently employed consultants to streamline its business and has decided to eliminate a layer of middle management from the company. It has made a provision of Rs. 500 million for all expected costs, including redundancy settlements, retraining of lower level managers that will be required to take on new responsibilities and amounts owed to the consultants in respect of their advice relating to the restructuring. JSM has not disclosed this detail in the financial statements as it does not wish to alert affected staff about the reorganisation until an official announcement is made in January 2023.

APPENDIX 2 – INFORMATION ON PROPERTY VALUATION

The statement of financial position of JSM contains Rs. 87,000 million of investment properties which are measured using the fair value model. In August 2022, JSM engaged the services of Faisal Akbar to remeasure the fair value of all investment properties. A gain of Rs. 3,500 million was subsequently included in JSM's net profit for the period ended 30 September 2022.

Faisal Akbar is the son of Mansab Khan, the CEO of JSM. AB & Co has not worked with Faisal Akbar previously. However, preliminary research by the audit team shows he has been a member of the Pakistan Valuers Association for the past ten years.

Services rendered by Faisal Akbar cost Rs. 20 million and payment was made into an off-shore bank account. The directors have not included this amount as a related party transaction in the draft financial statements.

AB & Co does not have expertise in the valuation of shopping malls.

(THE END)