Certified Finance and Accounting Professional Stage Examination

The Institute of Chartered Accountants of Pakistan

10 June 2021
3 hours – 100 marks
Additional reading time – 15 minutes

Audit, Assurance and Related Services

Instructions to examinees:
(i) Answer all **SIX** questions.
(ii) Answer in **black** pen only.

Q.1 (a) MF Momin, Shams & Company is a firm of chartered accountants (the firm) which was initially registered with two partners namely Momin and Shams, in the year 2011 with offices in Karachi and Islamabad. In 2020, the firm got affiliation with a reputed international firm namely Missouri Fox (MF) which resulted in increase in clientele of the firm especially in the province of Punjab. As a result, the firm has established its new office in Lahore.

You are the quality control partner in the firm. While reviewing the annual revenue earned by the firm for the year ended 31 December 2020, you have extracted the following information from the firm's books of accounts:

Clients	Firm's offices			Firm's partners		
	Karachi	**Islamabad**	**Lahore**	**Momin**	**Shams**	**Others**
	----------------------- Rs. in '000 -----------------------					
Audit and assurance services						
Pervez Limited (PL)	2,730	-	-	-	2,730	-
Amin (Pvt) Ltd (APL)	-	-	1,680	-	-	1,680
Salman Limited (SL)	-	4,000	-	4,000	-	-
Tania Limited (TL)	1,100	-	-	-	1,100	-
Other clients	3,800	3,000	6,000	3,000	1,800	8,000
Consultancy and other services						
Pervez Limited (PL)	500	2,000	500	-	-	3,000
Amin (Pvt) Ltd (APL)	-	-	1,480	-	-	1,480
Salman Limited (SL)	1,500	-	1,300	-	-	2,800
Tania Limited (TL)	200	-	-	-	200	-
Other clients	4,170	6,000	2,040	3,000	3,170	6,040
	14,000	**15,000**	**13,000**	**10,000**	**9,000**	**23,000**

Other information:

(i) PL, SL and TL are listed companies whereas APL is the first multinational client of the firm.
(ii) All the clients have already re-appointed the firm for their subsequent statutory audit.
(iii) Shams is also entitled to 20% additional commission of the total fees earned from PL.

Required:
In the light of ICAP's Code of Ethics for Chartered Accountants, evaluate the implications of revenue earned from PL, APL, SL and TL on the firm and suggest the safeguard(s), if any, available to the firm and partners. **(12)**

(b) Other clients in (a) include Hafiz Limited (HL) and Chand Limited (CL) which have not yet paid the audit fees for the year ended 30 June 2020. The audit report for HL was issued three months ago but HL has still not paid the balance 50% of audit fee, while the audit report for CL has not been issued due to certain pending issues.

Required:
Discuss the course of action available to the firm in the above situation. **(03)**

Q.2 You are the audit manager in a firm of chartered accountants responsible for the statutory audit of Hackney Pharma Limited (HPL) which is principally engaged in the business of manufacturing and sale of pharmaceutical products.

Extracts from HPL's statement of profit or loss for the year ended 31 May 2021 are as follows:

Description	2021	2020
	---------- Rs. in '000 ----------	
Sales	3,343,214	3,213,435
Sales returns	(72,519)	(73,202)
Sales – net	3,270,695	3,140,233
Cost of sales	(1,895,590)	(1,860,579)
Selling & marketing expenses	(94,089)	(93,629)

During the planning meeting for the year ended 31 May 2021, HPL's management informed you about the recall notice issued in respect of HPL's flagship product 'Azteca'. The notice was published in a local newspaper on 1 May 2021. The notice was issued on the advice of the drug regulatory authority following complaints received with regard to development of unexpected side effects in some users of the product.

Azteca is a patent product under the licensing agreement with Global Healthcare Laboratories (GHL), a multinational company, signed in year 2017. Under the agreement, HPL manufactures and sells Azteca for 10 years against payment of upfront license fee of Rs. 300 million. HPL is also subject to penalties in case of use of substandard raw material in the manufacture of Azteca. The raw material is imported from foreign countries. Currently, GHL is investigating the reason for the defect/unexpected side effects.

The management has also informed you that this product recall has not only affected HPL's sales but has also created working capital issues. HPL took immediate steps such as commenced negotiation with the bank for financing working capital and launched aggressive marketing campaign in May 2021 to boost the sale of its other products.

Required:
Discuss the audit risks that exist in the above scenario and suggest the key audit procedures to be performed in respect of identified risks. **(22)**

Q.3 You are the audit manager responsible for the audit of Kamran Limited (KL) for the year ended 31 May 2021. On 1 October 2020, KL raised Rs. 400 million by issuing convertible bonds (having par value of Rs. 100 each). The bonds are convertible to KL's ordinary shares in 5 years' time at the option of bond holders. The convertible bonds carry coupon rate of 5% payable on 30 September each year.

KL's total shareholders equity as at 31 May 2021 was Rs. 3,250 million.

Required:

(a) Specify the matters to be considered by the auditor while planning the audit of convertible bonds. Also suggest the related audit procedures. **(09)**

(b) Discuss the reporting implication(s), assuming that KL believes that at least 30% of the bonds would be converted to equity at the end of year 5 and have therefore recorded Rs. 120 million as equity and the remaining amount as liability. **(03)**

Q.4 (a) You are the audit manager in a firm of chartered accountants responsible for the statutory audit of Fazal Limited (FL) for the year ended 31 March 2021.

During the audit, your audit team was informed that on 1 January 2021, FL entered into a sale and leaseback agreement with Arabian Leasing Company (ALC) for its head office property situated at premier commercial hub. FL sold the property to ALC at fair value with useful life of thirty years as assessed on the date of sale. Subsequently, ALC leased back the property to FL for a period of ten years.

Required:
State the audit procedures which may be performed in respect of the above transaction. **(07)**

(b) Saleem & Company, Chartered Accountants is the statutory auditor of Duo Limited (DL). The management of DL has prepared summary financial statements, which have been derived from DL's statutory financial statements for the year ended 31 December 2020. The management intends to make a statement that the summary financial statements have been derived from the financial statements for which audit report was issued by Saleem & Company on 25 February 2021.

Required:
Discuss whether DL can include such a statement in the summary financial statements and the course of action that the firm should take in this regard. **(06)**

Q.5 Gama Pakistan Limited (GPL) is planning to expand its business by manufacturing telecommunication accessories. For this purpose, GPL intends to obtain financing from a bank for the planned expansion. To meet the bank's requirement, GPL has prepared a five years' cash flow forecast based on management's estimates. GPL has requested your firm to review the forecast and furnish a report thereon.

Following information is available to you in respect of the forecast:

(i) GPL has secured agreement with two mobile phone manufacturers under which it would be able to sell 30% of its production capacity. The mobile phone manufacturers would pay to GPL after selling the accessories to the wholesalers.

(ii) The telecommunication accessories would be sold to mobile phone manufacturers with one-year warranty.

(iii) During the first year, the supplies to the customers would be made through delivery trucks; however, in order to reduce the delivery cost to other cities, cargo train would be used from second year of production. Negotiations with railway authorities are underway.

(iv) Royalty would be paid to a foreign company for acquiring the right to manufacture certain accessories.

(v) A significant reduction in the cash outflows on account of income tax has been forecasted in the years 3, 4 and 5. The management has placed a comment in support of this reduction that the taxation authorities have principally agreed to reduce tax rates for companies manufacturing 'telecommunication equipment and related accessories' and the announcement of the reduction in tax rates will be made in the next budget.

Required:
Discuss the key examination procedures that your firm would perform in respect of the above information. Also discuss the reporting implication(s), if any. **(14)**

Q.6 You are the audit manager at Salman, Pervez and Company, Chartered Accountants. You are responsible for the audit of United Health Limited and its group financial statements for the year ended 31 May 2021. Following information have been provided to you by the audit team:

Name of company	Revenue	Profit before tax	Total assets
	------------ Rs. in million ------------		
United Health Group (Consolidated)	75,000	11,000	69,000
United Health Limited	24,773	2,900	24,484
Quality Labs Limited	54,000	8,100	44,000

United Health Limited (UHL):
Due to COVID-19 pandemic, UHL has witnessed significant decline in sales. In order to meet the sales target, UHL entered into five large contracts with its customers for supply of its products. All these customers carried risks of either non-payments or delayed payments.

In addition to the above, UHL also entered into a contract for supply of lab equipment. UHL had agreed to a pricing model in which 80% of the contract amount will be received as the regular price of the equipment and 20% will be received as performance bonus subject to timely delivery of equipment. UHL has always been able to deliver all its equipment within the agreed time. However, due to COVID-19 lockdown in the country of import, UHL may not be able to receive the lab equipment on time and consequently UHL may not be able to timely supply it to the customer.

Quality Labs Limited (QLL):
Up to last year, the group audit team made local site visit to the component auditor team in Spain to review key audit working papers and attended closing meetings with local management as Spain does not allow the cross border sharing of health data. However, due to COVID-19, Spain has imposed a strict lockdown and has placed travel restrictions which may continue for at least next 30 days.

Required:
(a) Critically evaluate the issues brought to your notice and advise the course of action. **(17)**

(b) Discuss the reporting implications on the group financial statements due to the auditor's inability to obtain sufficient appropriate audit evidence regarding QLL's financial statements. **(07)**

(THE END)