Certified Finance and Accounting Professional Stage Examination

The Institute of Chartered Accountants of Pakistan

9 June 2022
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) You are the audit manager of Maryam & Company, Chartered Accountants, responsible for planning the audit of Turbo Pakistan Limited (TPL) for the year ending 30 June 2022. TPL is engaged in selling branded motorcycles which it imports from China.

After obtaining the preliminary understanding and performing the related procedures, your audit team has presented the following significant matters:

(i) TPL provides one-year warranty on the motorcycles. The warranty covers free of cost repair of any defect and replacement of any faulty part. Up to last year, TPL maintained a warranty provision of 6% of total sales.

The management has informed that the quality of motorcycles has significantly been improved over the period and they are considering the reduction in warranty provision. The audit team reviewed the last year provision and observed that actual claims were slightly higher than the provision.

(ii) During the year, in order to boost sales, TPL has relaxed its credit policy from 30 days to 60 days. This relaxation is expected to increase the sales by at least 10% as compared to last year. Up to last year, TPL maintained provision for bad debts at 5% of the total debtors balance at year-end. The management has informed your audit team that TPL will continue to maintain the same level of provision for current year as well.

(iii) The internal auditors of TPL reported that cash collected from certain small dealers were not recorded and deposited in the bank on timely basis and they have recommended to avoid cash collections from dealers.

Required:
Identify and discuss the audit risks from the above information and explain auditor's response to each risk in planning the audit of TPL. ***(Reporting implications are not required)*** **(12)**

(b) During the planning phase, your audit team has been informed that TPL has been investing heavily in Information Communication Technology (ICT) infrastructure. This has helped them to grow substantially and they have established their presence across 30 cities in Pakistan. For this purpose, TPL has formed a separate department for managing the ICT's operations including identification and management of the possible risks and threats to the ICT infrastructure and processes.

This department is also subject to the oversight of the internal audit department that carries out the risk assessment whenever asked by the audit committee. The latest risk assessment was carried out by the internal audit department in 2021, in which they had identified and established updated mapping of the business functions, roles and supporting processes to identify interdependencies related to ICT and security risk. The next such exercise is planned to be conducted in 2023, in which they intend to classify the identified business functions, supporting processes and information assets in terms of criticality.

Required:
Identify the control weaknesses in the above situation and suggest the improvements that TPL should introduce in order to overcome these weaknesses. **(08)**

Q.2 You are the audit partner of Mansoor Akram and Company, Chartered Accountants. Following significant matters have arisen at different audit clients of your firm where audit field work has been completed:

(a) The management of Popeye Limited (PL), a listed company, has informed you that one of its competitors has initiated a legal action against the company on grounds of infringements of patent rights and is seeking damages of Rs. 200 million. In the draft financial statements, PL has made the following disclosure in this regard:

> Litigation is in the process against the company relating to a dispute with a competitor who alleges that the company has infringed patents and is seeking damages of 200 million. The information usually required by IAS 37 is not disclosed on the grounds that it can be expected to prejudice seriously the outcome of the litigation. The directors are of the opinion that the claim can be successfully resisted by the company.

Being an area of higher assessed risk of material misstatement which involved significant judgement, the audit team has made substantial efforts to review the details of litigation. **(10)**

(b) During the course of audit of Buzz Limited (BL) for the year ended 31 March 2022, your audit team identified that there were three overdue instalments of the long term loans. On enquiry, the management informed your team that they were negotiating a loan restructuring agreement with its banks since February 2022 and had formally signed it with the bank on 7 April 2022. Under the agreement, payment of principal amount has been relaxed in accordance with BL's cash flow forecast and outstanding interest has been converted into a two-year loan. The first repayment of principal is now due in July 2023. All the amounts have been adjusted and disclosures have been made in the financial statements on the basis of the restructuring agreement. **(05)**

(c) During the physical stock count at the audit of Captain Limited (CL), certain expired stock items were identified which were included in the year-end stock balance at their carrying value. The management represented that they have maintained a 10% general provision of Rs. 15 million for slow moving and obsolete stocks in the financial statements and consequently no specific provision is required for expired stock items identified during physical count. On further enquiry, the management informed that this provision has been maintained for last many years but they failed to substantiate the basis of this provision.

The carrying value of stock in trade at year-end was Rs. 55 million net of general provision. **(05)**

(d) During the year, Winnie Limited (WL) has obtained an office building under a three-year lease period for relocating its head office. According to lease contract, WL has the right to cancel the lease anytime by giving one-month notice. Furthermore, after the lease, WL has incurred substantial leasehold improvement costs on the office building.

Considering the lease cancellation option, the management has not recorded right of use assets and related lease obligations as they were of the view that since WL has the right to cancel the lease anytime, it is not a long term lease. Similarly, all leasehold improvement costs were expensed out immediately. **(05)**

Required:
Discuss the auditor's course of action along with implications on the audit report.
(Audit procedures are not required)

Q.3 You are the manager responsible for the audit of Casper Limited (CL), for the year ending 30 June 2022. CL manufactures parts for medical equipment.

CL has been facing issues related to toxic emissions in its manufacturing process. In the last five years, a Government Environmental Agency (GEA) imposed fine between Rs. 3 million to Rs. 5 million each year.

In May 2022, CL has installed a new filter in its manufacturing plant at a cost of Rs. 20 million, to process toxic emissions. The new filter is expected to reduce the toxic emissions by over 95%. It is expected that installation of this new filter will prevent imposition of fines by GEA. Annual inspection by GEA is scheduled to take place in the month of August 2022.

During a meeting with the chief financial officer, she informed you the following:

(i) The filter is a new product of the filter manufacturer and CL is the first buyer of this product. Therefore, the filter manufacturer:

- provided significant discount to CL on purchase of this filter;
- has been providing excellent after sales service to CL; and
- has provided a guarantee to CL that the filter will significantly reduce the toxic emissions.

(ii) The existing provision for fines to GEA has been reversed as the new filter is most likely to prevent imposition of the fine.

(iii) The useful life of CL's manufacturing plant has been increased from 10 years to 15 years. CL had engaged an external independent engineering firm to review the useful life. She also informed that the cost of the new filter has been expensed out as it was not the reason to increase the useful life of the existing manufacturing plant.

Required:
Evaluate the possibility of misstatement which may occur in the above scenario. Also state the audit procedures that should be carried out by your audit team in this regard. **(13)**

Q.4 Ayesha Khalid & Co., Chartered Accountants (the firm) is planning the audits of its clients for the year ending 31 December 2022. For this purpose, the firm is considering to appoint certain partners responsible for some of the listed clients. The name of relevant partners' along with their association with the clients are as follows:

(i) Faizan Rashid has served five years as the engagement partner on the audits of various clients including Dalmatian Limited (DL). The firm has transferred him to taxation department as part of the firm's rotation policy, where he would also be responsible for filing of DL's annual tax return.

(ii) Saad Akbar has recently been promoted as partner from senior manager. He has been in various managerial roles for the audit of Aladin Limited (AL) for the last five years before being promoted to partner. The firm is considering to appoint Saad as the engagement partner of AL.

(iii) Sara Kareem had been the engagement quality control partner of Shifu Limited (SL) from 2012 to 2015 and 2018 to 2020. During 2016 and 2017, Sara was on a service break due to her illness. The firm is now considering to appoint her as SL's engagement partner.

(iv) Raheem Shafique has served as the engagement partner of Panda Limited (PL) for five years. The firm is now considering to appoint him as the engagement partner of Hoper Limited, holding company of PL.

Required:
Discuss whether the partners can be appointed in the roles being considered by the firm. **(10)**

Q.5 You are the manager in Saira Saeed & Company, Chartered Accountants (the firm). Saira has forwarded you the following email received from Fashion Limited (FL), in which they have asked the firm to submit their proposal for the proposed engagement:

> To: Saira
> From: Junaid Sheikh
> Subject: Audit of Prospective Financial Information
> Date: 9 June 2022
>
> Hi Saira,
>
> Our company has witnessed a substantial growth in export sales of our textile products. Owing to this, we have been planning to increase our production capacity by 30% as there are many export orders which we have to turn down. Considering this, we are planning to install an additional manufacturing plant within the existing factory premises. The only major expenditure in this respect is to procure and install the manufacturing plant. Procurement of manufacturing facility is expected to start immediately after sanctioning of loan and the plant would be operational in twelve months' time.
>
> In addition to the above, we are also in a very advanced stage of introducing smart clothing in partnership with a US company. The smart clothing contains modern technology. For example, it will contain the features like meshed wiring woven into fabric which connects via Bluetooth to an iOS or Android smartphone.
>
> The US company has more than 5 years of experience of manufacturing smart clothing. 30% of the capital would be provided by that company whereas the rest would be raised through bank loans. We are expecting that this would be an instant success in the market as no such products are available in the Pakistani market. We are expecting that we would recoup our investment within a five-year period.
>
> For the capacity expansion and the new product, we are preparing Prospective Financial Information (PFI) which needs to be audited, for submission to US company and the banks with whom we are in negotiations.
>
> PFI includes cash flow statement, profit or loss statement and details of assumptions taken. PFI for the capacity expansion is required for a three-year period and for the new product is required for the time until investment is recouped. Since the amount of loan required is substantial, it is highly dependent on good projections.
>
> I would like your firm's services for auditing PFI prepared by our management. It would be great if you could provide us with your quote.
>
> Regards,
>
> ***Junaid Sheikh***
> ***CFO***
> ***Fashion Limited***

Required:
Write an email to Saira in which you identify and evaluate the matters that should be considered before accepting the engagement to report on Prospective Financial Information.
(Ignore the requirements of ICAP's Code of Ethics for Chartered Accountants) **(15)**

Q.6 You are the manager responsible for the audit of Amber Holding Limited (AHL) and its consolidated financial statements for the year ended 31 December 2021. This is your first audit of AHL although AHL has been your firm's audit client since last three years. Your firm is also the auditor of AHL's both subsidiaries namely Dany Limited (DL) and Genie Sugar Mills Limited (GSM).

During the initial meeting with the CFO, following matters have been discussed:

(i) The year-end of AHL and DL is 31 December whereas the year-end of GSM is 30 September.

(ii) DL is a leading producer of savoury snacks which include a wide variety of packaged chips and crackers. Effective from 1 December 2021, DL has expanded its business by commencing production of confectionery snacks. Sugar is one of the major raw materials used in the production of confectionary snacks which is being procured from GSM. It has been agreed between DL and GSM to make payment of the invoices within 45 days.

(iii) DL values its inventory on FIFO basis whereas GSM values its inventory on weighted average cost basis. Value of closing sugar inventory appearing in DL's record amounted to Rs. 30 million.

(iv) At year-end, a payable amount of Rs. 15 million was appearing in the books of DL and a corresponding receivable amount was appearing in the books of GSM.

Required:
Comment on above matters discussed with CFO and state the audit procedures that should be performed in this respect. **(17)**

(THE END)