Certified Finance and Accounting Professional Stage Examination

The Institute of Chartered Accountants of Pakistan

8 June 2023
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 Your firm Asim Ghani & Company, Chartered Accountants has been appointed as the auditor of Sparrow Limited (SL), which is listed on the Pakistan Stock Exchange and engaged in the business of software development and trading. The appointment was made due to the board of directors' dissatisfaction with the previous auditor's performance. The previous auditor was removed after only two years. The board of directors believed that the previous auditor was inefficient in their work and that the changes recommended by them often proved erroneous, as SL's management rarely agreed to them.

During the first meeting with the SL's management, they have shared the following extracts from the draft financial statements for the year ended 31 March 2023 with your team:

	2023	2022
	--------- Rs. in '000 ---------	
Extracts from statement of financial position		
Property and equipment	218,503	73,115
Intangibles	1,000,732	566,870
Contract assets	878,980	444,687
Cash & cash equivalents	357,665	565,880
Share capital	1,000,000	1,000,000
Extracts from profit or loss		
Revenue	5,899,750	3,477,800
Gross margin	773,203	455,790
Operating profit	365,151	215,250

During the meeting, your team has also been informed as follows:

(i) SL's revenue is derived from various sources, primarily through sale of off-the-shelf software, bespoke software projects, regular software updates, and end-to-end solutions in the form of short-term and long-term projects. SL secured two large development projects from a financial institution based in the Middle East, leading to a major increase in contract assets by year-end.

(ii) Until March 2022, 95% of SL's business came from North American clients. However, during the year ended 31 March 2023, SL has witnessed substantial growth in business from the Middle East and Pakistan. Despite this increase, during the year ended 31 March 2023, 50% of income is still generated from North America, 35% from Middle East, and 15% from Pakistan. This rise in sales is mainly attributed to SL's strategic decision to establish a dedicated division catering to clients in Pakistan and Middle East.

(iii) To promote foreign exchange inflow in Pakistan, the government has granted SL a land and building for expanding its operations. The government has set a sales target of USD 100 million to be achieved within five years. The increase in property and equipment is mainly a result of this grant.

(iv) Increase in intangible assets can be attributed to two reasons. Firstly, during the year, SL has revalued its intangible assets, which were previously carried at cost, resulting in a revaluation surplus. These intangibles primarily consist of customer support software acquired by SL in 2018. Secondly, the development of a state-of-the-art website has also contributed to the increase. This website has enabled SL to showcase its projects and collect client's data for bespoke projects.

(v) Due to a high turnover of key development staff, SL has implemented a new scheme of offering interest-free loans for the purchase of vehicle and for housing-related expenses, such as purchasing or constructing a house. These loans are payable over a maximum period of 20 years.

Required:
Discuss the audit risks that exist in the above scenario. **(20)**

Q.2 (a) Raven Limited (RL) has developed an e-commerce platform to sell apparel, daily wear, and footwear. The platform sells RL's products as well as those of other retailers. During the course of audit, the audit team has identified the following matters:

(i) RL maintains stocks of its own products at its warehouses and also at suppliers' facilities located throughout the country. All orders are sent to RL warehouses for quality check and packaging before being dispatched to customers.

(ii) A few years back, RL had launched a reward points program for its customers. For every purchase of Rs. 100, customers are entitled to one reward point equivalent to Rs. 2, which can be redeemed in the form of cash credits against future purchases. Each point expires after six months.

Required:
Evaluate the above matters identified by the audit team and state the audit procedures that should be performed in this respect. **(13)**

(b) Due to the alarming surge in cyberattacks, RL has requested your firm's assistance in suggesting effective controls to mitigate the risk posed by such attacks to its business. **(07)**

Q.3 You are the audit partner of Naseer Jokhio & Company, Chartered Accountants. The following significant matters have arisen at different audit clients of your firm, where the audit field work for the year ended 31 March 2023 has been completed:

(a) Nightingale Limited (NL) had recorded the setup of its production line as capital work in progress in its financial statements for the year ended 31 March 2022, amounting to Rs. 500 million. Your firm expressed a qualified opinion as it believed that the setup of the production line should have been transferred to property, plant and equipment, considering that it was available for use from 1 October 2021.

However, in the financial statements for the year ended 31 March 2023, NL has recorded depreciation for the complete year at a rate of 10% using the straight-line method. As a result, the written-down value of the production line as at the year-end was Rs. 450 million. NL's profit before tax was Rs. 300 million and Rs. 220 million for the years ended 31 March 2022 and 31 March 2023 respectively. **(08)**

(b) Dove Limited (DL) has financing arrangements that are set to expire and outstanding amounts are payable on 19 June 2023. However, DL's management has not made any assessment regarding how the company would manage without these financing arrangements. Further, no disclosures have been made regarding the uncertainty that may arise from this situation. **(08)**

(c) Hawk Automobile Limited (HAL) has experienced significant growth during the year, primarily attributed to the introduction of a highly anticipated vehicle in January 2023. HAL offers a 3-year warranty or 50,000 km, whichever comes earlier, on all its vehicles. As a standard practice, HAL records a warranty provision of 0.2% for all its sales, which has proven to be fairly reliable in previous years.

However, your audit team has noticed significantly high amount of part replacement claims for the newly launched vehicle in the months of April 2023 and May 2023. **(04)**

Required:
Evaluate each of the above matters and advise the course of action. Also suggest the implications, if any, on the audit report.
(Audit procedures are not required)

Q.4 Pelican Limited (PL) is audited by Faraz Naeem Rajput & Company, Chartered Accountants. Faraz Paracha, PL's engagement partner, became ill during the engagement for the year ended 31 March 2023 and was replaced by Raja Jibran, who had recently joined the firm as a partner. Raja Jibran formerly worked as a senior manager audit at Kareem & Company, Chartered Accountants.

The engagement is nearing to the finalization stage, and the audit team has identified that the management has capitalized initial operating losses on a new production plant as a trial run loss. Upon further inquiry with PL's management, they informed that the business feasibility and cash flow projections of the new production plant were undertaken by Kareem & Company. The new production facility started commercial production, and the management identified that an important cost element was missed by Kareem & Company, which resulted in initial operating losses. On the advice of Kareem & Company, PL had capitalized these losses in the cost of the plant.

Furthermore, PL's management expressed surprise that the audit team identified this issue at the finalization stage, as Raja Jibran was part of Kareem & Company team and should have considered this earlier. Raja Jibran was upset and furious with the audit team that why they had not discussed the issue with him before bringing it up with the client. He has strictly instructed the audit team members not to discuss any audit issues with others before discussing it with him.

Required:
In light of ICAP's Code of Ethics, identify and evaluate the threats involved in the above situation and explain the course of action that should be taken to resolve the issue. **(15)**

Q.5 Your firm is the auditor of Swan Energy Limited (SEL) for the year ended 31 March 2023. SEL is engaged in the business of renewable energy. SEL started its business in 1980 by purchasing land of 100 acres on a 50-year lease. SEL kept installing wind turbines in phases and finally reached 2 megawatt electricity production in 1999. Wind turbines have a useful life of 20 years. Upon completion of the lease term, the government requires SEL to remove wind turbines and associated infrastructure, and restore the site.

SEL has commissioned three new wind turbines in October 2022 at a cost of Rs. 300 million, which includes their purchase price and installation cost.

SEL depreciates wind turbines over 20 years.

Required:
Evaluate the implications of the purchase of the new wind turbines and state the audit procedures that should be performed in this respect. **(10)**

Q.6 Kiwi Dairy Farms Limited (KDL) sells milk to corporate tetra packed milk brands (corporates), restaurants and also through its retail outlets.

KDL has recently approached your firm to obtain an independent assurance opinion on a cash flow forecast being prepared for its bankers in support of a loan application. The loan is to be repaid over 4 years.

The cash flow forecast prepared by KDL is as follows:

	Actual	Forecasted cash flow			
	31-Dec-2022	31-Dec-2023	31-Dec-2024	31-Dec-2025	31-Dec-2026
	Rs. in '000				
Receipts					
Sales to corporates	2,200,000	2,134,000	2,240,700	2,352,735	2,470,372
Sales to restaurants	307,500	315,000	330,750	347,288	364,652
Retail sales					
– Milk	704,000	720,000	756,000	793,800	833,490
– Cheese	-	990,000	1,039,500	1,091,475	1,146,049
Long-term loan	-	600,000	-	-	-
Payments					
Operational and administrative expenses	(2,890,351)	(3,837,420)	(4,029,292)	(4,230,756)	(4,442,294)
Capital expenditure for cheese business	-	(857,200)	-	-	-
Finance costs	(10,000)	(49,000)	(70,850)	(51,615)	(32,504)
Repayment of loan	-	(75,000)	(150,000)	(150,000)	(150,000)
Dividends paid	(51,384)	(66,544)	(69,871)	(73,365)	(77,033)
Taxation	(64,230)	(83,180)	(87,339)	(91,706)	(96,291)
Cash flow for the year	195,535	(209,344)	(40,402)	(12,144)	16,441
Opening cash	60,000	255,535	46,191	5,789	(6,355)
Closing cash	255,535	46,191	5,789	(6,355)	10,086

The following information is also available:

(i) Around 70% of KDL's sales was to corporates. However, KDL has been experiencing declining margins within this segment. As a result, KDL has decided to reduce the sale of milk to corporates and instead utilize it for cheese production. KDL plans to produce both fresh and aged cheese. The production process for fresh cheese typically takes around 3 to 4 days, while aged cheese requires a longer maturation period of 6 months to a year. However, the sale price of aged cheese is significantly higher. All the necessary equipment required for cheese production can be obtained locally and will be ready for use starting from July 2023.

(ii) KDL currently has an overdraft facility of Rs. 100 million and has approached the bank with a loan request amounting to Rs. 600 million. The loan is expected to carry an interest rate of 12% per annum. It is intended to be repaid over a period of 4 years, with payments made in 8 equal instalments. KDL expects to receive the loan funds by 30 June 2023.

(iii) All sales through retail outlets are cash sales, whereas sales to restaurants and corporates are made on credit. For credit sales, 15% is paid in the month of the sale, 50% is paid after 30 days, 20% is paid after 60 days, and 10% is paid after 90 days.

(iv) Operational and administrative payments mainly include employee salaries and feed cost of animals.

(v) KDL receives an early payment discount of 8% from its suppliers if payment is made within 21 days of receiving the inventory. It is KDL's policy to avail the early payment discount.

(vi) KDL is subjected to a final tax regime and pays a 2% tax on its sales receipts.

Required:
Specify the key examination procedures that your firm would perform in respect of above information. **(15)**

(THE END)