Certified Finance and Accounting Professional Stage Examination

The Institute of
Chartered Accountants
of Pakistan

7 December 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 You have been working as an audit manager in a firm of chartered accountants. Your firm was appointed as the auditor of Info Tech Limited (ITL) for the year ending 31 December 2023. Previously, it was audited by another audit firm. ITL has been in the business of augmented reality since 2018 and has been behind various successful products in this business.

While reviewing the intangible assets under development, your team has identified two projects that require your attention:

Project 1: Advertech

This project started in February 2023. Advertech is a project that augments advertisements within games to connect brands with uniquely engaged audiences, and enabling new revenue streams for game developers. Advertech initially focused on four different type of advertisements to be integrated into games; static ads, dynamic ads, native ads, and rewarded ads. However, during its development, ITL decided to shelve the rewarded ads feature, as they could not figure out a way to disburse the rewards from viewed ads within the country's legal framework.

Currently, this project is recorded in the financial statements as development cost at Rs. 200 million, which includes Rs. 10 million spent on the development of rewarded ads. Management strongly believes that the rest of project is on track, and the project would be officially launched in June 2024.

Project 2: 3D-Canvas

This project, which entered the development phase in October 2022, was designed to transform files, images, and text into rich interactive presentations for selling, marketing, and supporting various products. The success of this project was heavily dependent on its compatibility with average specification systems and mobiles. However, during development, ITL found that it could only run on systems with enormous computing powers. In June 2023, ITL decided to drop this project, and all costs incurred to date, amounting to Rs. 120 million, were expensed out. Of this amount, Rs. 70 million was incurred in the current year.

Management also informed you that an internal investigation uncovered a critical issue, which was identified during the research phase but not addressed in the demonstration of criteria for the development phase in October 2022. This lapse was the main reason for dropping out of the project.

Based on the management accounts for November 2023, the profit before tax for the year ending 31 December 2023 is expected to be Rs. 650 million (2022: Rs. 600 million).

Required:
(a) Evaluate the impact of the above-mentioned two projects on the audit of ITL. Also, state the audit procedures to be performed in this regard. **(13)**
(b) Discuss the reporting implications, related to the above situation. **(12)**

Q.2 You are the ethics partner in a firm of chartered accountants. You have received the following email from Farhan Akhtar, the audit partner, seeking advice on accepting a prospective client:

From: Farhan Akhtar
To: Ethics Partner
Subject: Advice for accepting STL

Hi,

I hope you are doing well. I have been in negotiation with the CEO of Sweet Tooth (Private) Limited (STL) about providing multiple services for the year ending 31 December 2024. STL, a family managed enterprise, has been in the confectionary business since 1995. Currently, it is being audited by Karim Ayesha and Company, Chartered Accountants

STL has faced financial difficulties since the onset of COVID-19, witnessing a significant decline in revenue and has been in losses for the last four years. Due to this challenging financial situation, STL has been unable to fulfil its obligations to financial institutions and is currently in the process of restructuring its long-term liabilities.

STL's owners' highly value the impactful management consultancy services our firm provides. They are eager to engage our consultancy expertise to revitalize their marketing and sales department. They believe that there has been a lack of evolution in their marketing strategies and sales promotion over the years. They hope that our consultancy services can guide them out of this financial challenge. Since our firm also offers audit services, they are interested in hiring us for both services. However, their primary interest lies in leveraging our management consultancy to drive transformative changes.

STL's CEO has offered a total fee of Rs. 1,500,000 for the management consultancy and the audit for the year ending 31 December 2024.

I would appreciate your thoughts on any professional and ethical issues related to accepting this offer.

Best regards

Farhan

Required:
Advise Farhan Akhtar regarding the acceptance of STL's offer. **(15)**

Q.3 Your firm is the auditor of Valley Hotels Limited (VHL) for the year ended 30 November 2023. VHL operates three hotel chains namely, Prestige Palace, Luxe Heaven and Eco Stay, with details provided in **Annexure A**. The following are the extracts from the financial statements of VHL:

Statement of financial position

	2023	**2022**
	------- Rs. in million -------	
Non-current assets:		
Property, plant and equipment	8,803	3,778
Intangible assets	426	335

Statement of profit or loss

	2023	**2022**
	------- Rs. in million -------	
Revenue:		
Room rent	1,523	898
Food and beverages	137	96
Others	607	82
Total revenue	2,267	1,076

Additional information:

Revenue:
Luxe Heaven operates on an 'all-inclusive' basis, allowing guests unrestricted access to food and beverages, various activities, and all hotel amenities included in the price of their stay. On the other hand, VHL's other hotels generates revenue through room rent, food and beverages, and other revenue such as hall rent, car hire, laundry services and health club services.

VHL collaborates with travel agencies, online hotel booking platforms, and utilizes its own website for hotel reservations. Room rent from booking made through travel agencies and hotel booking platforms is transferred to VHL after the guest's stay, with the agreed commission deducted. For booking via VHL's website, 30% of the room rent is charged in advance, and the balance amount is payable at check-out. If a booking is cancelled more than a week before the guest's arrival, a full refund is issued. However, cancellations made within the week prior to the guest's stay are non-refundable.

To further attract foreign customers, VHL has recently registered its properties on Troval.com, a platform that allows hotel bookings through debit cards, credit cards, bank transfers, and cryptocurrency payments. Troval.com has experienced a significant increase in hotel bookings compared to other websites. It offers hotels the option to receive payments via bank transfers, which is subject to higher fees, or in cryptocurrency.

Operational matters:
To expand its consumer base, VHL has actively engaged with various social media platforms. It provides complimentary stays to travel bloggers, journalists, or social media influencers in exchange for publicity on their platforms. In a similar manner, VHL often provides its empty halls for media events without any cost, in exchange for VHL's promotion during the event.

VHL completed the construction of a new hotel in Karachi in February 2023. However, it faced challenges in commencing operations due to the complaints from the local community about increased commercial activity in the area. These complaints led to a legal issue, which was resolved in favour of the community. Consequently, VHL has repurposed the building as a warehouse for inventory storage, addressing the community's concerns.

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

Annexure A: Details of VHL's hotel chains

Prestige Palace:
It is the oldest brand, established by VHL itself. This brand has a history of sustained development in terms of both sales and profits. Properties belonging to the Prestige Palace brand are located in all the major cities in Pakistan.

Luxe Heaven:
In February 2023, VHL acquired Luxe Heaven hotel brand, marking strategic expansion into the Northern areas of Pakistan. This acquisition included three hotels, all part of the Luxe Heaven brand, which are upscale resorts with high-end designs. VHL spent a total of Rs. 5,000 million on this transaction. This amount has been recorded in the company's fixed assets and allocated across various assets, including land, buildings, and equipment.

Eco Stay:
In April 2023, VHL introduced the Eco Stay brand, designed to appeal to cost-conscious travellers. Operating on a franchise-based model, Eco Stay has successfully established five hotels this year. Notably, VHL does not own these Eco Stay hotels; instead, it grants franchise licenses to investors in exchange for an initial payment of Rs. 100 million. This allows the investor the authority to manage a hotel. This initial payment also includes VHL's support in establishing the hotel, and providing training for its personnel. Additionally, VHL is entitled to receive 3% of the hotel's annual revenue at each year end throughout the duration of the agreement.

Q.4 Your firm is the auditor of Saga Industries Limited (SIL) for the year ended 30 September 2023. In addition to conducting the statutory audit, your firm also reports on SIL's summary financial statements. The audit field work has been completed, and during the statutory audit, your team identified an uncorrected material misstatement in the other information, which has been communicated in the draft statutory audit report of SIL.

SIL's management has requested your firm to sign the audit report for the summary financial statements so these can be shared with the shareholders. Meanwhile, they have indicated that the firm may take additional time before signing the audit report for the statutory audit.

Required:
Evaluate the above situation and discuss the implications for the audit report of the summary financial statements. **(05)**

Q.5 Your firm is the auditor of Shifa Equipment Limited (SEL), a listed company, for the year ended 30 September 2023. SEL supplies testing equipment and produces testing kits which are used by clinical laboratories for diagnostics procedures. SEL imports the testing equipment, but manufactures the testing kits in-house. The testing equipment sold by SEL is only compatible with the testing kits produced by SEL. Testing kits are consumable items for a laboratory, whereas testing equipment is an asset with a useful life of 6 years.

In order to expand SEL's business, a new sales scheme was introduced in October 2022. SEL's management identified that setting up a new laboratory requires significant initial investment, especially for testing equipment. To facilitate setting up of new laboratories, SEL offered testing equipment without any payment, contingent upon a guaranteed purchase of testing kits over a 5-year period. SEL believes that this initiative will also help in generating stable and regular cash flows for its business. Other key features of this scheme are as follows:

- The price of the testing kits sold under this arrangement is higher compared to regular standalone sale price.
- The agreement is non-cancellable, and a penalty is imposed if the committed quantity of testing kits is not purchased over the period of 5 years.
- SEL retains the right to recover the testing equipment in case of default. However, after successful completion of the 5-year agreement, customers can purchase the testing kits at regular standalone price.

SEL's management has provided you with the following schedule related to revenue recorded in the financial statements:

Particulars	Price (Rs.)	Quantity	Amount (Rs.)
Sale of testing equipment	9,000,000	40	360,000,000
Testing kit - old scheme	1,000	73,000	73,000,000
Testing kit - new scheme	1,500	292,000	438,000,000
			871,000,000
Discount for testing equipment	9,000,000	40	(360,000,000)
Total revenue recognized			**511,000,000**

This has resulted in exponential increase in business; in the previous year, only 20 testing equipment and 146,000 testing kits were sold.

The profit before tax for the year ended 30 September 2023 in the draft financial statements is Rs. 200 million. Furthermore, excess funds invested by SEL earn an annual return of 18.5%.

Required:
(a) Evaluate the impact of the new scheme on the audit of SEL. Also, state the audit procedures that should be performed for the above mentioned transactions. **(17)**
(b) Discuss the reporting implications if SEL does not agree with your findings. **(08)**

Q.6 Cloud Services Limited (CSL) has been your firm's client since 2022. Your firm assists the management in preparing monthly financial statements. CSL shares these statements with its holding company, along with a report signed by the firm's engagement partner.

During the assignment for preparing the monthly financial statements for November, your team noticed some revenue transactions that CSL had recorded in the wrong accounting period. Your team is of the view that these transactions actually pertain to the month of December.

Required:

(a) Discuss how you would resolve the disagreement along with the implication, if any, for the report. **(05)**

(b) Assuming that the matter has been adequately resolved, CSL's management has asked whether these monthly financial statements, along with the firm's report, could be shared with the holding company's regulators. **(05)**

(THE END)