The Professionals' Academy of Commerce
Pakistan's Leading Accountancy Institute

Certified Finance and Accounting Professional Stage Mock Examinations
22nd May, 2023
3 hours – 100 marks
Additional reading time - 15 minutes

Advanced Accounting & Financial Reporting

Q.1 The following consolidated financial statements relate to Mehanti Limited **(ML)** Group for the year to 31 May 2022.

Consolidated Statement of Profit or loss for the year ended 31 May 2022

	Rs'000
Revenue	2 360
Cost of sales	(884)
Gross profit	1, 476
Other income	40
Distribution cost	(666)
Administrative cost	(530)
Finance cost	(90)
share of associate loss	(120)
Profit before tax	110
Taxation	(44)
Profit for the period	66
Other comprehensive income	
Net actuarial gain	8
Total comprehensive Income	74
Profit for the period attributable to:	
Equity holders of parent	52.8
Non-controlling interest	13.2
	66.00
Total comprehensive income attributable to:	
Equity holders of parent	60.80
Non-controlling interest	13.20
	74

Consolidated Statement of Financial Position as at 31 May

	2022	**2021**
	Rs'000	**Rs'000**
Assets		
Non-current		
Property, plant and equipment	1,600	1,400
Goodwill	176	180
Investment in associate	284	300
Deferred tax	-	20
	2,060	1,900

Current		
Inventory	200	172
Trade Receivables	280	292
Cash & cash equivalents	-	26
	480	490
Total Assets	**2,540**	**2,390**
Equity and liabilities		
Equity		
Equity shares of Rs 0.50 each	660	440
Share premium	132	32
Retained earnings	(18)	(48)
	774	424
Non- controlling interests	254	232
Total Equity	**1,028**	**656**
Liabilities Non-current		
Employee benefits	448	596
Deferred Tax	34	
20% Loan Notes	464	680
	946	1,276
Current		
Trade payables	260	268
Taxation	58	94
Finance cost payable	160	96
Bank overdraft	88	
	566	458
Total Liabilities	**1,512**	**1, 734**
Total equity and liabilities	**2, 540**	**2, 390**

The following information is relevant:

(1) Depreciation charge for the year amounted to Rs. 136,000. It is ML's group policy to value non – controlling interests using proportion of net assets method.

(2) Consolidated goodwill and investment in associate were both impaired during the year to 31 May 2022, with the exception of goodwill in Chase Limited in.

(3) On 31 May 2022, ML acquired 80% of the equity shares of Manzil Limited for a cash consideration of Rs. 252,000. The fair value of net assets of Manzil Limited at acquisition was Rs.28,000. This is summarised below:

	Rs.'000
Property, plant and equipment	27.20
Trade receivables	3.40

Bank	2.40
Trade payables	(4.00)
Taxation	(1.00)
	28.00

There was no disposal of subsidiary during the year to 31 May 2022.

(4) ML acquired 10% additional equity shares in Chase Limited for a cash consideration of Rs 28,000 on 31 May 2022. This increased its shareholding to 80%. ML acquired 70% of the equity shares in Chase Limited on 1 June 2019 for a consideration of Rs 178,000. The fair value of the net assets of Chase Limited was Rs. 260,000 and Rs.220,000 on 31 May 2022 and 1 June 2019 respectively. Goodwill in Chase Limited had not been impaired since its acquisition. The movement on equity arising from this transaction was taken to share premium.

(5) ML acquired 25% of equity shares in Koshish Limited on 1 November 2021 for a cash consideration of Rs.144,000. ML has significant influence in Koshish Limited.
ML received total dividends of Rs.16,000 from all of its associated companies for the year to 31 May 2022. No investments in associated companies were disposed off during the year.

(6) On 30 March 2022, ML disposed of equipment with a carrying value of Rs.76,000 for Rs. 116,000 cash. On 1 April 2022, ML disposed off a piece of plant for Rs.12,000 cash. This had a carrying value of Rs. 14,000.

(7) ML introduced a defined benefit plan on 1 June 2019. During the year to 31 May 2022, it paid pension contributions of Rs. 200,000 . No pension benefits were paid out during the year. Net pension expenses were charged to administrative costs. Net actuarial gains were taken to share premium.

(8) The 20% loan note was issued on 1 June 2020. It was correctly classified as 'financial liability through profit or loss'. All changes in fair value are taken to administrative expenses.

(9) ML issued equity shares for cash on 31 December 2021. Further, ML, its subsidiaries and associated companies paid dividends on 1 December 2021.

Required:

Prepare a consolidated statement of cash flows of Mehanti Limited Group using the indirect method, for the year ending 31 May 2022 in accordance with the requirements of IAS 7 'Statement of cash flows'.

(25)

Q.2 (a) Zaheen Limited (ZL), a manufacturer of ships, has entered into the following contracts during the year ended 31 December 2022:

(i) On 1 January 2022, ZL entered into a contract with Aye Limited (AL) to construct a cruise ship for Rs. 400 million to be delivered on 31 December 2023 i.e. the date on which control of the ship would be transferred to AL. As per the contract, 90% of agreed amount was paid immediately by AL and the balance will be paid on delivery.

Till 31 December 2022, only 40% of the construction of the ship was completed at a cost of Rs. 150 million.

(ii) On 1 April 2022, ZL entered into a contract with Bee Limited (BL) to sell three fishing boats for Rs. 50 million per boat. The amount was received on 1 April 2022 but the boats were delivered on 1 May 2022. As per the contract, if BL purchases more than six boats before 31 December 2022, ZL will retrospectively reduce the price to Rs. 48 million per boat. At the inception of the contract, ZL expected that BL would meet the threshold for the discount.

On 1 November 2022, BL purchased two additional boats on the same price of Rs. 50 million per boat for which the payment was made in January 2023.

Despite ZL's expectation, no further order was placed by BL till 31 December 2022.

(iii) On 1 November 2022, ZL sold a luxury yacht to Gee Limited (GL) for Rs. 100 million on cash. ZL also provided GL with a Rs. 5 million discount voucher for any interior design work on yacht within six months. There is 80% likelihood that GL will award the work of interior design within six months and will avail the discount. However, no interior design work was awarded till 31 December 2022. ZL normally sells such luxury yachts for Rs. 100 million without any discount voucher for interior design work.

Discount rate of 15% per annum may be used wherever required.

Required:

Prepare journal entries in ZL's books to record the above information for the year ended 31 December 2022 in accordance with IFRSs. ***(No marks will be awarded on entries without dates)*** **(09)**

(b) The following information is relevant to financial statements of Himmat Limited (HL) for the year ended 31st December 2022;

(i) On 1st January 2022,HL acquired 20 million debentures in Jazba Limited (JL) for Rs. 220 million at its fair value (Par value is Rs.200 million). The investment was classified at FV-OCI and Transaction cost of Rs. 1.5 million was also incurred on purchase of debentures . Coupon rate on debentures is 10% per annum payable annually on 31 December while effective rate of interest is 12% per annum.

On 31 December 2022, HL received the interest however, due to deteriorating credit rating of the debentures, HL determined that there had been a significant increase in credit risk since the acquisition of the debentures.

Following information regarding the 20 million debentures at various dates is also available:

Date	**Expected credit losses**		**Fair value**
	Life time	**12 months**	
	--------------- Rs. in million ---------------		
1 January 2022	7.5	2.4	220
31 December 2022	18.4	7.1	196

Under tax laws, impairment and fair value adjustments do not affect taxable profits while interest income is taxable at coupon rate. Further, transaction cost is allowed as deductible expenditure in the year in which it is incurred.

(ii) On 1st January 2022, HL granted 3,000 share options each to 20 senior executives, conditional upon the executives remaining in HL's employment until 31st December 2024. The exercise price is Rs. 30 per share. On grant date, HL estimated the fair value of the share options at Rs. 100 per option.

As on 31st December 2022 it was estimated that 5 employees would leave HL before 31st December 2024. Fair value of each share as on 31st December 2022 was Rs. 108.

(iii) The tax rate for 2022 and onward is 25% while it was 30% in 2021 and prior years.

(iv) Adjustable minimum tax as on 31st December 2021 was Rs. 65 million and on which deferred tax of Rs.50 million was recognized. Carrying value of PPE exceeded Tax base of PPE by Rs.640 million as on 31st December 2021

(v) Accounting depreciation for the year exceeds tax depreciation by Rs. 92 million On 1st January 2022Equipments were revalued for the first time resulting in revaluation gain of Rs. 400 million. Revaluation does not affect taxable profits.

(vi) On 1st January 2022 HL had issued 2 million 10% convertible bonds of Rs. 100 each. Interest is payable annually on 31st December whereas the principal is to be paid after four years. Two bonds are convertible into one ordinary share at any time prior to maturity. On the date of issue, the prevailing interest rate for similar debt without conversion option was 14% per annum. The tax authorities do not allow any deduction for the imputed discount on the liability component of the convertible bonds.

(vii) Profit before tax for the year was Rs.3,100 million and revenue for the year is Rs. 7,400 million. HL is subject to minimum tax of 1% of revenue which is adjustable in full from the future tax liability (if any) in subsequent 3 years.

Required:

Prepare notes on taxation expense for inclusion in HL's financial statements for the year ended 31st December 2022, in accordance with the IFRSs. **(15)**

Q.3 **The following information is related to** Awami Agri Limited (AAL), based in Pakistan, is a leading producer and supplier of agricultural products for the year ended September 30th 2022.

(i) On 1 May 2022, AAL 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.

Relevant exchange rates are as follows:

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

Required:

Discuss how the above arrangements should be dealt with in AAL's financial statements for the year ending 30th September 2022 and also record adjusting accounting entry.**(Narrations are not required)** **(05)**

(ii) On 30th June 2022, AAL signed an agreement to purchase machinery from China at price of USD 5 million and will be delivered at the end of December 2022 and would pay the supplier on that date.

On 30th June 2022, AAL hedged the foreign exchange risk by entering into a forward contract with a bank to buy USD 5 million on 31st December 2022. It may be assumed that all IFRS 9 conditions for hedge accounting to be applied have been met. Machinery was received on 31st December 2022 and payment made on that date. Useful Life of machinery is estimated at 10 years.

The spot and forward rates per USD were as follows:

	Spot exchange rate	**Forward exchange rate for delivery on 31st December 2022**
30th June 2022	USD1: Rs. 200	USD1: Rs. 206
30th September 2022	USD1: Rs. 208	USD1: Rs. 211
31st December 2022	USD1: Rs. 220	

Required:

Record Accounting entries for the year ended 30th September 2022 and 2023 in the books of AAL.
(Narrations are not required) **(08)**

(iii) On 1 August 2022, AAL sold one of its investments in bonds for Rs. 115 million to Beta Bank and simultaneously entered into a contract to buy the same bonds back on 1 May 2023 at Rs. 125 million. AAL purchased these bonds on 1 August 2021 for Rs. 106 million (par value Rs. 110 million). Debentures carry annual coupon at the rate of 10% per annum payable on 31 July each year and have effective yield of 11% per annum. AAL carries this investment at amortised cost.

Required:

Record Accounting entries for the year ended 30th September 2022 in the books of AAL. **(Narrations are not required)** **(05)**

(iv) On 1 September 2022, AAL transferred its receivables of amounting to Rs. 60 million to IK Bank for an immediate cash payment of 95% of its value against 6% factoring fee. Remaining 5% amount will be paid by IK Bank in 20 days. Under the arrangement, AAL is not liable to compensate IK Bank for any default by AAL's customers. 40% of receivables have not yet been recovered by IK Bank till 30th September 2022.

Required:

Record Accounting entries for the year ended 30th September 2022 in the books of AAL. **(Narrations are not required)** **(05)**

Q.4 The following information is presented in draft financial statements of Problem Limited (PL) for the year ended 30th April, 2023.

	Rs. (million)
Total Assets	1,970
Total Liabilities	710
Share Capital	800
Retained Earnings	400
Other Reserves	60
Profit Before Tax for the year	150

While reviewing the financial statements, the following issues were noted by IFRS consultant.

(i) PL has accounted for investment in shares of Kitkat Limited (KL) as a financial asset subsequently measured at fair value through other comprehensive income instead of applying its policy of equity method for investment in associates.

On 1 July 2022, PL purchased 500,000 shares (par value at Rs. 10 each) of KL representing 20% shareholdings at Rs. 60 per share. On 30 January 2023, KL paid interim cash dividend of Rs. 3 per share. KL reported net profit of Rs. 15 million for the year ended 30 April 2023. The fair value of each share of KL was Rs. 67 on 30 April 2023

(ii) On 1st May 2022, PL sells an item of machinery to Solution limited for Rs.9.5 million. Its fair value was Rs. 9 million. The machinery had a carrying amount of Rs. 4.5 million prior to the sale and remaining life of ten years. This sale represents the satisfaction of performance obligation, in accordance with IFRS 15 Revenue from Contracts with Customers. PL enters into a contract with Solution limited for the right to use the asset for the next five years. Annual payments of Rs. 1.2 million are due at the end of each year. PL's incremental borrowing rate is 10% p.a. PL only recorded sales proceeds as liability and annual payment of Rs. 1.2 million is recorded as interest expense.

(iii) On 1 May 2021, PL granted 0.5 million share appreciation rights(SARs) to each of its 20 executives. The rights are redeemable in cash on 30 April 2025 provided the executives remain employed by PL until at least 30 April 2025. On 1 May 2021, PL estimated that two (2) of the 20 executives would leave in the period from 1 May 2021 to 30 April 2025 and this estimate remained unchanged at 30 April 2022 and no employee left in the year ended 30 April 2022.

During the year ended 30 April 2023, one executive left and on that date PL estimated that other 19 executives would remain in employment until 30 April 2025 and so be entitled to SARs.On 1 May 2021, the fair value of a SAR was estimated to be Rs.6. The fair value of a SAR had increased to Rs.6.20 by 30 April 2022 and to Rs. 6.40 by 30 April 2023. PL has correctly accounted for this transaction in its financial statements for the year ended 30 April 2022 but No entry is recorded for the year ended April 30,2023

Required:

Determine the revised amounts of profit before tax, total assets, total liabilities & total equity (All equity components separately) for the year ended April 30th 2023 after incorporating the impact of above adjustments. **(15)**

Q.5 (a) You have recently joined as Finance Manager of Mercury Limited (ML) and have been asked by the CFO to prepare a power point presentation on ML's financial statements for the half-year ended 31 December 2022 for the board of directors' meeting. These financial statements were finalised by the CFO who is a chartered accountant.

While preparing the presentation, you have noted that a five storey building purchased in July 2022 by ML was entirely classified as an investment property. ML uses the ground and first floors for its administrative purposes while remaining three floors were rented out to different tenants and will be sold in future. Further, on 31 December 2022, the fair value increase of Rs. 150 million for the entire building has been taken to the statement of profit or loss which has ensured that the required interest cover as per bank loan covenants has been met.

The CFO is of the view that IFRSs allow such application as ML only uses less than 50% of the building for its own use. He further explained that non-compliance of loan covenants should be avoided at any cost as the bank loan would become immediately payable upon non-compliance. This would create significant financial difficulties for ML which may even result in closure of business.

Required:
Briefly explain how CFO may be in breach of the fundamental principles of ICAP's Code of Ethics for Chartered Accountants. Also state the potential threats that you may face in the above circumstances and how you should respond. **(06)**

(b) Following balances have been extracted from the trial balance of Markhor Bank Limited (MBL) for the year ended 31 December 2022.

	Rs. in million
Current account with Habib Bank Limited	137
Current account with State Bank of Pakistan	4,833
Cash in hand	3,033
Bills discounted and purchased	226
Call money lending	217
Current account with National Bank of Pakistan	767
Deposit account with Central Bank of Afghanistan	233
Loans, cash credits and running finances	38,067
Market treasury bills	8,167
National Prize Bonds	23
Deposit account with National Bank of Pakistan	467
Deposit account with United Bank Limited	104
Deposits and prepayments	1,063
Interest accrued	7,150
Provision for diminution in value of investment	(74)
Repurchase agreement lending	2,033
Sukuk Bonds	400
Pakistan Investment Bonds (20% given as collateral)	600
Provision against non-performing advances	(2,226)
Net investment in finance lease	1,633
Operating fixed assets	8,233

Required:
Prepare the asset side of the statement of financial position as at 31 December 2022 of MBL, based on the above balances. (Notes to the financial statements are not required). **(07)**

(THE END)

Answer:01

ML Group

Consolidated Statement of Cashflow for the year ended 31 May 2022

Cash flow from operating activities	**Rs '000**
Profit before tax **Add back:**	110.00
Share of associate loss	120.00
Finance cost expense	90.00
Depreciation	136.00
Net pension expense **W9**	60.00
Loss on disposal of plant (12 -14)	2.00
Profit on disposal of equipment (116 -76)	(40.00)
Decrease in fair value of loan note (680 - 464)	(216.00)
Goodwill impairment **W2**	233.60
Increase in inventory (200 - 172)	(28.00)
Decrease in trade receivables (280 -292 - 3.4)	15.40
Decrease in trade payables (260 - 268 - 4)	(12.00)
Cash generated from operations	471
Pension contribution paid	(200.00)
Taxation paid **W4**	(27.00)
Interest paid **W10**	(26.00)
Net cash inflow from operating activities Cash flow from investing activities	**218.00**
Purchase of Manzil Limited (252 - 2.4)	(249.60)
Purchase of shares in Chase Limited	(28.00)
Purchase of shares in Koshish Limited	(144.00)
Purchase of PPE **W1**	(398.80)
Proceeds from disposal of PPE (116+12)	128.00
Dividends received from associates	40.00
Net cash outflow from investing activities Cashflow from financing activities	**(652.40)**
Proceeds from issue of shares **W6**	314.00
Cash received from NCI **W8**	29.20
Other dividends paid **W7**	(22.80)

Net cash inflow from financing activities	**320.40**
Decrease in cash & cash equivalents	**(114.00)**
Opening cash & cash equivalents	26.00
Closing cash & cash equivalents	**(88.00)**

W1	Property, plant & equipment	
		Rs.'000
	Opening balance	1,400.00
	Depreciation charge	(136.00)
	New subsidiary	27.20
	Disposals (76+14)	(90.00)
	Acquisition (bal. fig.)	**398.80**
	Closing balance	1,600.00

W2	Goodwill	
		Rs.'000
	Opening balance	180.00
	New subsidiary 252 – (80% x 28)	229.60
	Impairment (bal fig.)	**(233.60)**
	Closing balance	176.00

W3	Investment in associate	
		Rs.'000
	Opening balance	300.00
	Acquisition	144.00
	Share of loss	(120.00)
	Disposal	-
	Dividends received	(40.00)
	Closing balance	284.00

W4	Taxation	
		Rs.'000
	Opening balance (94 - 20)	74.00
	Profit or loss	44.00
	New subsidiary	1
	Cash paid (bal. fig)	**(27.00)**
	Closing balance (58+34)	92.00

W5	Movement on Equity - 10% shareholding	
		Rs.'000
	NCI at 31 May 2022 before disposal (30% x 2600)	78
	Decrease in NCI 10/30 x 78	26
	Consideration paid	28
	Negative movement on equity	**(2)**

W6	Issue of shares	
		Rs.'000
	Opening balance (440 + 32)	472.00
	Net actuarial gain	8.00
	Shares issued for cash (bal. fig)	**314.00**
	Movement on equity **W5**	**(2.00)**
	Closing balance (660 + 132)	792.00

W7	Retained Earnings	
		Rs.'000
	Opening balance	(48.00)
	Profit or loss	52.80
	Dividends paid (Bal. fig)	**(22.80)**
	Closing balance	(18.00)

W8	Non - Controlling Interest	
		Rs.'000
	Opening balance	232.00
	New subsidiary 20% x 28	5.60
	Profit or loss	13.20
	Decrease in NCI **W5**	(26.00)
	Cash received (Bal. fig)	**29.20**
	Closing balance	254.00

W9	Employee Benefits	
		Rs.'000
	Opening balance	596.00
	Net actuarial gain	(8.00)
	Net pension expense (Bal. fig)	**60.00**
	Contribution paid	(200.00)
	Closing balance	448.00

W10	Interest Payable	
		Rs.'000
	Opening balance	96.00
	Profit or loss	90.00
	Cash paid (Bal.fig)	**(26.00)**
	Closing balance	160.00

Answer:02

S.No.	Date	Description		Debit	Credit
				----- Rs. in million -----	
(i)	1 Jan 22	Cash	400×90%	360.0	
		Contract liability - AL			360.0
	31 Dec 22	Interest expense	360×15%	54.0	
		Contract liability - AL			54.0
		Inventory		150.0	
		Cash			150.0
(ii)	1 Apr 22	Cash	50×3	150.0	
		Contract / Refund liability - BL			150.0
	1 May 22	Contract / Refund liability - BL	48×3	144.0	
		Revenue			144.0
	1 Nov 22	Receivable - BL	50×2	100.0	
		Revenue	48×2		96.0
		Contract / Refund liability - BL			4.0
	31 Dec 22	Contract / Refund liability - BL	6(150–144)+4	10.0	
		Revenue			10.0
(iii)	1 Nov 22	Cash		100.0	
		Contract / Refund liability - GL	**(W-1)**		3.8
		Revenue	**(W-1)**		96.2

W-1:

Price allocation

	Standalone price	Price
	------- Rs. in million -------	
Luxury yacht	100.0	96.2 (100×100÷104)
Discount	4.0 (5×80%)	3.8 (4×100÷104)
	104.0	100.0

Answer : 2(b)

Himmat Limited
Notes to Financial Statement
For the year ended December31,2022

<u>Taxation</u>		**Rs. million**	
Income Tax			
Current Year		736.46	**[M-5]**
Deferred tax (W-2)			
-Relating to temporary difference		23.62	**[M-6]**
-Relating to Rate Change		(32.00)	**[M-1]**
		728.08	

<u>1 - Relationship between tax expense and accounting profit</u>

		Rs	
Accounting profit		3,100.00	
Tax [3100 x 25%]		775.00	
Tax effect due to rate change		(32.00)	
Adjustment due to Share based payment (1.5-1.17)*.25		0.08	
Unrecognized minimum tax claimed		(15.00)	
Tax expense for the year / effective rate of tax		**728.08**	**[M-3]**

		Rs. million
W-1 Current tax		
PBT		3,100.00
Interest income @ coupon rate		20.00
Interest income @ effective rate		(26.58)
Transaction cost on purchase of debentures		(1.50)
Expected credit loss		18.40
SBP expense		1.50
Excess accounting depreciation		92.00
Accounting expense on CFI		26.04
Tax expense on CFI		(24.00)
Taxable profit		**3,205.86**
Taxable profit-adjusted		**3,205.86**
Current tax-Normal	25%	**801.46**
Tax Credit		
Normal Tax		**801.46**
Minimum Tax (7400x1%)		**74.00**
Higher of normal tax & minimum tax		801.46
Adjustment of minimum tax		**(65.00)**
Normal Tax -after adjsutment		**736.46**
Current tax for the year		**736.46**

(W 2) **Opening Deferred Tax Liability /Asset 31-12-21**

	CA	TB	Diff	DTL / (DTA)	
		---------------- Rs. million ----------------			
PPE			640.00	30%	192.00
Unused minimum tax					(50.00)
					142.00

(W 2.1) **Closing Deferred Tax Liability /Asset 31-12-22**

	CA	TB	Diff	DTL / (DTA)	
		---------------- Rs. million ----------------			
PPE			948.00	25%	237.00
Investment in debentures	196.00	220.00	(24.00)	25%	(6.00)
SBP	-	1.17	(1.17)	25%	(0.29)
Convertible Debt	188.01	200.00	11.99	25%	3.00
					233.70

W-2.2 PPE difference	**Rs. million**
Opening balance	640.00
Depreciation	(92.00)
Disposal	
Revaluation	400.00
Closing balance	**948.00**

W-2.3		**Rs. In million**
SBP expense	3000*15*100*1/3	1.5
Intrinsic Value	3000*15*(108-30)x1/3	1.17

W-2.4 **Convertible TFC**

Initial value of debt(2.4.1)	185.98
Initial value of Equity(bal.)	14.02
Total value of CFI	**200.00**

W-2.4.1

Year	Cash flow	PVF @ 14%	PV
2,022.00	24.00	0.88	21.05
2,022.00	24.00	0.77	18.47
2,023.00	24.00	0.67	16.20
2,024.00	220.00	0.59	130.26
			185.98

W-2.4.2

year	B/F	Interest exp@14%	Payment	C/F
2,022.00	185.98	26.04	24.00	188.01
2,022.00	188.01	26.32	24.00	190.34
2,023.00	190.34	26.65	24.00	192.98
2,024.00	192.98	27.02	220.00	-

(w-2.5) **Deferred Tax**

		B/F	142.00
OCI FV Loss (13.68x25%)	3.42	Eq reserve (14.02x.25)	3.51
P&L(rate change)	32.00		
		OCI -Revaluation (400x.25)	100.00
		P&L temprary diff.(bal.)	23.62
C/F	233.70		
	269.12		**269.12**

Year	Opening Bal.	Interest income	receipt	Closing Bal.
2022	221.5	26.58	20	228.08

Fair Value Loss	
Gross	(32.08)
ECL (Adjsutment)	18.4
Net FV Loss	(13.68)

Regards: Saboor Ahmad (0302-9114479)

Answer: 03

(i)

AAI received a loan of RM 40 million on 1 May 2022 and recognised it based on the exchange rate at that date. It is therefore initially measured at Rs. 1,760 million (40m × 44). A loan is a monetary item and IAS 21, therefore, requires that it is retranslated at each period end using the closing exchange rate. The loan should be measured at Rs. 1,840 million (40m × 46) at 30 September 2022.

This gives rise to an exchange loss of Rs. 80 million (1,840–1,760), which is recognised in profit or loss as an element of finance cost.

It is therefore recognised by (Rs. in million):

Interest on the loan is charged at 6% per annum and is payable every six months in arrears. By the year end, the loan has been outstanding for 5 months and interest of RM 1 million (40m × 6% × 5/12m) arises. This forms an accrual at the year end, which is a monetary item. It should, therefore, be translated using the closing rate, giving Rs. 46 million (1m × 46). The interest should be recognised by (Rs. in million):

		Debit	Credit
		------- Rs. in million -------	
30-09-2022	Exchange Loss	80	
	Loan		80
30-09-2022	Finance costs	46	
	Interest Payable		46

(ii)

		Debit	Credit	Marks
30-09-2022	Forward Financial Asset	25.00		
	Cash Flow Hedge Reserve[OCI]		25.00	
				(M-1.5)
31-12-2022	Forward Financial Asset	45.00		
	Cash Flow Hedge Reserve[OCI]		45.00	
				(M-1.5)
31-12-2022	Bank	70.00		
	Forward Financial Asset		70.00	
				(M-1)
31-12-2022	Property.plant & equipment	1,100.00		
	Bank		1,100.00	
				(M-1)
31-12-2022	Cash Flow Hedge Reserve	70.00		
	Property.plant & equipment		70.00	
				(M-2)
30-09-2023	Depreciation	154.50		
	Accumulated Depreciation		154.50	
				(M-1)

Working #1 **Hedged item** **Hedged instrument**

30-09-2022 (208-200) x 5 = 40 million Loss (211-206) x 5 = 25 million gain

31-12-2022 (220-208) x 5 = 60 million Loss (220-211) x 5 = 45 million gain

(iii)

		Debit	Credit	
		------- Rs. in million -------		
01-08-2022	Bank	115.00		
	Financial Liability		115.00	
				(M-2)
30-09-2022	Financial Asset	1.96		
	Interest income		1.96	
	(106.66x11%x2/12)			**(M-1.5)**
20-09-2022	Finance cost	2.22		
	Financial Liability		2.22	
	(10/9*2)			**(M-1.5)**

(iv)

Year	**Opening Bal.**	**Interest income**
2022	106	11.66

		Debit	Credit	
		------- Rs. in million -------		
01-09-2022	Bank	57.00		
	Receivables from IK bank			
	Receivables		60.00	
				(M-2)
01-09-2022	Factor Fee	3.60		
	Bank		3.60	
		3.00		(M-1)
20-09-2022	Bank			
	Receivables from IK bank		3.00	
				(M-1)

Answer: 4

		PBT	Total Assets	Total Liabilities	Retained Earnings (Total Equity)	Other Reserves	Share Capital
	As Given	150.00	1,970.00	710.00	400.00	60.00	800.00
(i)	Reversal of Fv gain		(3.50)			(3.50)	
	Record share of Profit	1.00	1.00		1.00		
(ii)	in ROUA /Machinery (4.5-1.62)		(2.43)				
	in Lease Liability /Loan Liability (9.5-3.81)			(5.69)			
	depreciation expense (0.45-0.41)	0.04			0.04		
	Finance cost (1.2-0.46)	0.74			0.74		
	gain on Sales & lease back	2.48			2.48		
(iii)	Expense for the year	(16.45)		16.45	(16.45)		
	increase in iability						
		137.81	**1,965.07**	**720.76**	**387.81**	**56.50**	**800.00**

Working Rs in million

(w-1)

Errror

FV OCI — **Rs in million**

Dividend income P&L (0.5x3)	1.5
FV Gain (OCI) (7x0.5)	3.5
Financial Asset at year end(67x0.5)	33.5

Correct Treatment

Equity Method

Share of Profit(15*10/12)x20% -1.5	1.00
Financial Asset at year end(60x0.5)+2.5	31

Adjustment needed

Deduct 3.5 from other reserve and investment
Add in P&L 1 and add in investment

W-2

Correct Treatment

ROUA as at year end (2.03/5*4)	1.62
Lease Liability at year end(4.55+0.46-1.2)	3.81
Depreciation on ROUA (2.03/5)	0.41
Finance Cost on lease liability(4.55*10%)	0.46
Derecognition of machinery	4.50
gain on Sales & lease Back (9.5+2.03-4.55-4.5)	2.48

Errror

Machinery as at year end (4.5/10*9)	4.05
Depreciation on machinery (4.5/10)	0.45
Interest expense	1.20
Loan Liability at year end	9.50

Adjustment needed

Deduct	in ROUA /Machinery (4.05-1.62)	2.43
Deduct	in Lease Liability /Loan Liability (9.5-3.81)	5.69
Deduct	depreciation expense (0.45-0.41)	0.04
Deduct	Finance cost (1.2-0.46)	0.74
Add	gain on Sales & lease back	2.48

w2.1 Pv of Lease Liability 1.2x ((1-(1.10^-5))/0.10
4.55

Initial Value of ROUA (4.55 -0.5) x4.5/9 2.03

(w-3) **Balance of Liability as at 30th April 2022**
18 x0.5x6.2x1/4 13.95

Balance of Liability as at 30th April 2023 30.40
19 x0.5x6.4x2/4

Expense for th year 16.45

Answer: 5(a)

In the given situation, CFO might be in breach of the following fundamental principles of the Code of Ethics for Chartered Accountants:

(i) Professional competence and due care:
A chartered accountant (CA) should act diligently and in accordance with the applicable technical and professional standards. Applying incorrect application of standard raises questions on his professional competence and due care. Under IAS 40, each portion that can be sold separately should be accounted for separately. Therefore, ground and first floors should be recorded as 'Property, plant and equipment' and remaining floors should be recorded as 'Investment property'. **(M-1)**

(ii) Objectivity:
CA should not compromise professional or business judgements because of bias, conflict of interest or undue influence of others. Incorrect application of IFRSs by CFO to avoid the non-compliance of loan covenant is affecting the objectivity of CFO. (M-1)

(iii) Professional behavior:
CA should comply with the relevant laws and regulations and avoid any conduct that might discredit the profession. Pressurizing or threatening subordinates with an intention to influence them is the non-compliance of ICAP's code of ethics and is reflective of non-professional behavior of CFO. **(M-1)**

In the given situation, following threats to compliance with the fundamental principles arises for me:

(i) Intimidation threat:
CA will be deterred from acting objectively because of pressures or exercise of undue influence over him. I may feel intimidation threat due to perceived pressure exerted by the CFO on raising objection over his finalized financial statements. **(M-0.5)**

(ii) Self-interest threat:
CA's judgement or behavior may be inappropriately influenced by financial or other interest. I may feel self-interest threat due to fear of losing job in case of financial difficulties of ML. **(M-0.5)**

In order to reduce the threat to an acceptable level, one or more of the following safeguards should be applied:

1. Discuss and persuade CFO to follow the correct application of standard and adjust the financial statements.
2. If CFO refuses to adjust the financial statements, consider informing appropriate authorities such as CEO or the audit committee.
3. Consult the policies or procedures (i.e. ethics or whistleblowing policies) of ML.
4. Refuse to present or disassociate with the presentation of misleading financial statements.
5. Resign from the job. **(M-2)**

Answer: 5(b)

MARKHOR BANK LIMITED
STATEMENT OF FINANCIAL POSITION
AS ON 31 DECEMBER 2022

Assets:	**Rs. in million**
Cash and balances with treasury banks (3,033+4,833+233+767+23)	8,889
Balances with other banks (137+104+467)	708
Lending to financial institutions (217+2,033)	2,250
Investments – net (8,167+400+600–74)	9,093
Advances – net (38,067+1,633+226-2,226)	37,700
Operating fixed assets	8,233
Other assets (7150+1063)	8,213
	75,086

Advanced Corporate Laws & Practices

Q.1 Gulistan Limited (GL) is managing a provident fund for the benefits of its employees since 2015 through a Trust. The trustees of the provident fund have invested funds of the trust in different avenues. The following information is available in this regard:

Description	Rs. in Million
Investment in Government Securities	225
Investment in Mutual Funds (Note-1)	350
Money Market Collective Investment Scheme	207
Investment in listed shares of different Sugar companies (Note-2)	47
Investment in SW Sugar Limited - A listed Company*	10
Funds in saving accounts in scheduled banks	193
Total Size of the fund	1,000

Note-1: The trustees have made investments in those schemes which invest only in debt securities. Out of the total investment in Mutual Funds, an amount of PKR 255 million is invested in three different mutual funds being managed by "Casio Asset Management Company."

Note-2: Investment in listed securities include following companies:

Company	Amount of Investment (Mn)	Remarks
ASML	32	ASML is a profit-making company.
RSML	5	Company is in loss since last 2 years.
ZSML	10	Company did not pay any dividend despite of the profits.

*The investment in SW was made by subscribing to shares offered through IPO on 22nd August 2022.
Orega Cement Limited (OCL) and K2 Limited (KL) have recently published their prospectus for IPO on 25 November 2022 and 30 November 2022 respectively. The trustees of the Fund are considering to subscribe for shares in both these IPOs. OCL is a company having a profitable operational record whereas KL is a greenfield project.

Required:
Under the Employees Contributory Funds (Investment in Listed Securities) Regulations, 2018:

(a) Identify discrepancy(ies) if any, in investments made by Fund. **(07)**

(b) Advise the trustees regarding investment in IPO of OCL and KL and maximum amount which the Trustees can invest in IPO. **(06)**

Q.2 Following are the extracts from financial statements of Ahmad Limited (AL), a deposit taking listed NBFC, having license for Investment Finance Services.

Description	Rs. in million
Ordinary Share Capital	500
Accumulated Profits	425
Redeemable Preference Shares	110
Revaluation Reserve	150
Subordinated Loans	250

Details of investment in listed shares are as follows:

Description	Total no. of shares	No. of shares acquired	Cost of investment (Rs in million)
Gilgit Limited	160	5	200
Kashmir Limited	200	8	205
Skardu Limited	150	3	215
Multan Limited	100	4	90

- Investment in Skardu Limited was impaired and provision against permanent diminution was created amounting to Rs. 25 million.
- Ahmad Limited (AL) intends to acquire further shares of Multan Limited (ML). Current market price of share of Multan Limited is Rs.12/Share.

Required:

(a) Under the provisions of Non-Banking Finance Companies Regulations determine the maximum number of shares of ML which AL can purchase. **(09)**

(b) After acquisition of shares of ML in (a) above, how much further investment AL can make in other listed securities. **(03)**

Q.3 Pasha Limited, PL is planning to conduct election of directors in the upcoming Annual General Meeting. The directors have decided that the number of directors for the next term shall be 9 and the existing chief executive, Mr. Waheed, who is expert in sales and marketing shall be considered for re-appointment.

Mr. Tarik and Mr. Fahad have given their consent to act as independent directors in the company. Independent directors are not financially literate.

NIT is a major shareholder in the company and they have shown their willingness to continue Mr. Adnan and Mr. Mansoor (having sales and marketing background) as their nominee on the Board of the company. Mr. Mansoor is available at the company office for 3 days a week to look after the marketing department of the company. He is not paid, however, he is entitled to an incentive on sales made through his links.

Pasha family is a sponsor family and the shareholding and past trends suggest that they shall be able to elect remaining directors on the BOD, the details of the family members on BOD are as follows:

Name	Particulars
Mr. Saud Pasha- MSC Electrical Engineering	Already on BOD and heads the production department of the company.
Mr. Mubeen Pasha – BS Pharma	Already on BOD however he does not attend the office regularly, he gets the remuneration as a technical consultant from the company.
Mr. Faisal Pasha –BS IT	Already on BOD and he heads the IT department of the company.
Mr Shahrukh Pasha – MBA	Already on the BOD and he acts as agent of the company for procurement of raw materials.
Moazzam Pasha- Student	He is already a director and after attending the university, he joins office and sits with CEO to learn the business. He is not paid.

Required:

The BOD has requested you to provide an insight as to whether or not this BOD appropriate as per the requirements of the Companies Act 2017 and the Listed Companies Corporate Governance Regulations 2019. **(12)**

Q.4 Bashir Zaman and his two brothers Nadeem and Faheem are the only shareholders of Nakin Tyre Limited (NTL) holding 20 million, 35 million and 45 million shares respectively.

Bashir Zaman also holds 2 million shares in Axis Rubber (Pvt) Limited (ARL). The other shareholders of ARL are Tahir, his daughter Nasira and his minor son Rauf, who respectively holds 8 million, 37 million and 3 million shares in ARL. In the lastest election of directors held during the last year, Tahir and Nasira were re-elected as directors of ARL.

On 26 February 2023, Bashir Zaman got married to Nasira.

On 22 may 2023, the following proposals are under consideration of the boards of NTL and ARL:

i) The grant of a loan of Rs. 50 million by NTL to ARL. The loan will be repayable over a period of five years.

ii) The sale of products by ARL to NTL on special credit term of six months.

Under the provisions of the Companies Act, 2017, and relevant regulations advise the boards of NTL and ARL the conditions that must be complied with before implementing the above proposals.
(Ignore the requirements relating to notice of the meeting). **(11)**

Q.5 Bhatti Bottlers, a manufacturer of Bottles, having paid up capital of Rs. 1,000M, is running a successful business in Pakistan since last 15 years. In November 2022 BL decided to install a new plant for efficient production. For this purpose company issued further shares through right issue amounting to Rs. 500M. Process was completed within allowed timelines and company collected required funds successfully.

In May 2022, plan of installation of new plant was changed due to imposition of certain restrictions by Govt and management of company decided to start a new segment of Beverages. Management is planning to complete the process before closing of financial year on 30 June 2023 and following options are under consideration to finance the project:

1) To make right issue of further shares amounting to Rs. 270 Million.
2) Mr. Olufsen, one of the existing shareholders, offered a plot in industrial zone against issue of shares amounting to Rs. 100 Million.

Further, some of the shareholders who exercised the right option in November 22 raised concerns over the change of plan to start a new business segment.

Required:

(a) Assuming that general conditions are fulfilled, you are required to elaborate any specific conditions in both of the above options of issuance of shares, if any. **(06)**

(b) Keeping in view the above scenario, whether company can change the purpose of issue and process to be followed for this purpose. **(05)**

Q.6 (a) Pakistan Stock Exchange is a growing market and is attracting investors from all over the world. Mr. Jack, a British Investor, wants to invest in securities listed on Pakistan Stock Exchange. With reference to relevant provisions of Foreign Exchange Manual, you are required to advise Mr. Jack on the following:

i) The procedure to be followed in order to trade in listed shares in Pakistan.

ii) Whether Mr. Jack would be entitled to receive dividends on such securities and are there any restrictions on repatriation of funds outside Pakistan. **(06)**

(b) Mr. Ateeq, Branch manager of Sarmaya Bank Limited, received application for account opening from a client. For the purpose of Customer Due Diligence Mr. Ateeq asked for some details from client. Instead of giving full information client suggested to give a deposit of Rs. 20 million to his branch which will improve deposit position of branch.

Under the provisions of Anti Money Laundering Act, 2010 you are required to guide Mr. Ateeq if due diligence is not completed and if Mr. Ateeq is suspicious about client and carrying due diligence will alert the client. **(04)**

Q.7 (a) Wood Limited (WL) is engaged in production and supply of home furnishings and supply of allied products for the last 10 years. Management is now planning to expand the business and to start export to more countries. Mr. Usman, a newly appointed CFO, suggests to establish a subsidiary company in UAE to promote export business in that region. WL has applied for establishing a subsidiary company and Khazana Bank Limited (KBL) being an authorized dealer has received required documents from WL.

Explain the terms and conditions to be complied with for this purpose matters to be considered by KBL before allowing the transaction. **(10)**

(b) Bunty Limited (BL), a listed company, has 300M voting shares of Rs. 10 each. Mr. Muneer, One of the shareholders of (BL), who owns 48 million shares of BL, has entered into an agreement with Asif Ali, another shareholder of BL, to acquire further 75 million shares at an agreed price of Rs. 24 per share. After agreement, Mr. Munir made a public offer to acquire 80 million shares of BL against consideration of 8% shares of SWL, a listed company, owned by Mr. Munir.

For this purpose Manager to the offer required security from Mr. Munir. He has following assets to be given as security.

i) Govt Securities
ii) Cash
iii) Listed securities – MTS Eligible
iv) Shares of Bawani (Pvt) Limited
v) Shares of Jawani Limited, Public Unlisted Co
vi) Shares of SWL

Required:
You are required to elaborate which of the above assets can be given as security by Mr. Munir and conditions to be fulfilled in each case. **(06)**

Q.8 (a) Mr. Ali Raza is an experienced corporate consultant and doing his practice since last ten years. He wants to start a new line of practice for restructuring of companies. For this purpose he also hired an experienced team of restructuring experts. For this purpose one of his associates proposed to establish a Corporate Restructuring Company. You are required to elaborate the conditions to be fulfilled for carrying on a business as an corporate restructuring company. **(06)**

(b) Shakkar Limited, incorporated in 2010 with paid up capital of Rs. 1000M (Rs. 10 each), is involved in production and distribution of sugar and allied products.

During the year management of SL decided to acquire Meetha Limited, another sugar company operating in the region of sindh and having paid up capital of Rs. 1200M (Rs. 10 each). As per agreement all shares of ML had to be acquired by SL. All shareholders of ML has sold their shares to SL except Mr. Yasir and Mr. Amir holding 4.8M and 8.7M shares respectively.

In order to acquire 100% shares SL asked Mr. Yasir and Mr. Amir to sell their shares to SL. As a result Mr. Yasir sold his shares to SL while Mr. Amir refused to sell his shares to SL.

Required:
(a) You are required to explain whether SL is entitled to buy shares from Mr. Amir against his consent. **(05)**
(b) What course of action is available to SL in the above scenario. **(04)**
(Ignore the provisions of Competition Act, 2010)

(THE END)

Answer: 1 (a)

(i) Investment in mutual funds managed by a single asset management company can be up to 25% of the size of fund. In above scenario, the investment in mutual funds management is single Asset Management Company is 25.5% (255/1000*100). Hence the Fund is non-compliant with the requirement of law and should consider disinvestment from any of the mutual funds managed by Casio Asset Management to bring the aggregate investment to PKR 250 M. **(02 Marks)**

(ii) Total investment in any single money market collective investment scheme shall not exceed twenty percent of the size of the Fund or Trust. In above scenario, the investment in money market collective investment scheme is 20.7% (207/1000*100). Hence the Fund is non-compliant with the requirement of law and should consider disinvestment from Money Market CIS to bring the aggregate investment to PKR 200 M. **(02 Marks)**

(iii) Investment in listed securities have following discrepancies:

- Investment in ASML, being a single listed company, can be made up to 3% of size of fund. i.e 30M (3% * 1000). Existing investment is in excess of limit allowed.
- RSML is a loss-making company so investment can not be made in RSML.
- Investment can be made in equity securities of listed companies only where such company average dividend of not less than fifteen percent to the shareholders during two out of three preceding consecutive years. In case of ZSML no dividend was paid by company so investment is in contravention of relevant regulation. **(03 Marks)**

Answer: 1 (b)

(i) KL is a greenfield project so trustees can not invest in IPO of KL. Investment can be made in IPO of OCL and maximum limit for this investment is lowest of the following:

(1 Mark for each calculation)

Nomenclature	Total Limit	Already Used	Balance Limit
Amount which can be invested in listed equity securities = 30% of 1,000	300	50	250
Amount which can be invested in single listed securities i.e. OCL = 10% of 300	30	0	30
Amount which can be invested in IPO in 6 months = 5% of 300 =	15	10	5
Amount which can be invested in a single sector = 20% of 300=	60	50	10
Limit for investment in a single IPO 2% of 300 =	6	N/A	6
Based on above the lowest available limit is Rs. 5 million which can be invested in IPO of Omega Cement Limited (OCL) **(01 Marks)**			

Answer: 2 (a)

		In million
	Equity	
	Share Capital	800
	Accumulated Profits	425
	Subordinated Loans	250
	Total Equity	1475
A	Investment allowed upto 50% of AL's equity.	737.5
	Already held investment*	685
	Limit available for further investment	52.5
	Current Market Price	12
	No of shares which can be purchased	4.38
	*(200+205+215+90)-25	
B	**Limit of 10% of AL's equity**	
	Investment permitted in single company upto 10% of AL's equity	147.5
	Amount already invested in ML	90
	Limit available for further investment	57.5
	Current Market Price	12
	No of shares which can be purchased	4.79
C	Total number of shares of ML which AL can hold (10% of 100 million)	10
	Shares already held	4
	Additional shares which can be purchased	6

Based on above working AL can purchase 4.38 million shares of ML which is lower of A, B and C.

Answer: 2 (b)

	Rs. in million
Investment allowed upto 50% of AL's equity.	737.5
Already held investment*	685
Further Investment in ML (4.38*12)	52.5
Limit available for further investment in listed securities	zero

Answer: 3

A board of listed company shall comprise of members having appropriate mix of core competencies, diversity, requisite skills, knowledge, experience and fulfills any other criteria as deem relevant in the context of the company's operations. It shall comprise of the following types of the Directors.

- Independent Directors.
- Executive Directors.
- Non-Executive Directors.

CEO of the company, by virtue of his being chief executive officer shall be deemed to be a tenth director of the company.

As per Companies Act, 2017, a listed company must have 7 directors. Pasha Limited has 10 making them compliant with this provision of the Act.

As per Code of Corporate Governance, a listed company should have at least two or one-third members of the Board, whichever is higher, as independent directors. In this case the requirement for the independent directors is Three point three (3.3) as the company has ten directors on board. The company is not compliant with this provision as the company has only two Independent Directors i.e., Mr. Tarik and Mr. Fahad. Since Mr. Adnan and Mr. Mansoor are the Nominees of NIT, therefore, same cannot be considered as independent Directors for this purpose. Moreover, as per Code of Corporate Governance Regulations 2019, a company is required to explain the reasons, in the compliance report, if any fraction contained in such one-third number which is not rounded up as one.

As per Code of Corporate Governance, a listed company should have at least one Female Director on Board. Pasha Limited does not have any female director contravening the provision of COCG.

As per Code of Corporate Governance, executive directors of the company, including the CEO, should not be more than one-third of the members of the Board. In our case the company has four Executive Directors excluding the CEO, i.e., Mr. Saud Pasha, Mr. Faisal Pasha, Mr. Shahrukh Pasha & Mr. Moazzam Pasha. The company needs to lessen the number of Executive Directors to comply with the relevant provisions of the Listed Companies (Code of Corporate Governance) Regulations, 2019.

Further, the chairman and the CEO should not be the same person and the Chairman of the Board shall be from Non-Executive Director.

As per Code of Corporate Governance, it is mandatory that the Audit committee shall be constituted by the Board which shall have at least three members comprising of non-executive directors and at least one independent Director and the Chairman of the committee shall be an independent director. Furthermore, the Board shall satisfy that at least one member of the Audit committee shall be "financial literate" whereas in our case, the Board does not have any such Director.

As per Code of Corporate Governance, the Board shall have in place a formal policy and transparent procedure for fixing the remuneration packages of individual directors which shall commensurate with the level of responsibility and expertise of the Directors whereas the company is paying Mr. Mubeen Pasha solely because of him being a technical consultant of the company.

Answer: 4

Since Bashir Zaman directly holds 20% shares [20 ÷ (20+35+45) × 100] of NTL and indirectly controls 78% shares of ARL (W-1), NTL and ARL are associated companies under the provisions of the Companies Act, 2017.

Shareholders	**ARL**	
Bashir Zaman	2 ÷ (2+8+37+3)	**4%**
Bashir Zaman's spouse	37 ÷ (2+8+37+3)	**74%**
		78%

Consequently, following conditions must be complied with by NTL and ARL before implementing the proposal:

i) **By NTL:**

- NTL may grant loan to ARL only under the authority of a special resolution passed by the members in the general meeting.
- The said special resolution shall indicate the nature, period, amount of investment and terms and conditions attached thereto.
- NTL shall enter into an agreement in writing with ARL.
- The said agreement shall include the terms and conditions specifying the nature, purpose, period of loan, rate of return, fees or commission, repayment schedule for principal and return, penalty clause in case of default or late repayments and security, if any, for the loan in accordance with the approval of the members in the general meeting.
- The rate of return on loan shall not be less than NTL's borrowing cost or the rate as may be specified by the Commission whichever is higher.
- NTL's directors shall have to certify that:
  - they have conducted the due diligence and
  - that ARL's financial health is such that it has the ability to repay the loan as per the agreement

ii) By ARL:

Since ARL and NTL are associated companies, it will also falls under the ambit of related party.

Accordingly, the sale of products by ARL to NTL on special credit term of six months cannot be classified as an arm's length transaction.

Therefore, the following conditions must be complied with by ARL before implementing the said proposal:

- ARL's board must have approved the policy for entering into any contract or arrangement with a related party, subject to such conditions as may be specified by the Commission through regulations.
- Such transactions should be carried out in accordance with the board's policy.
- Since one out of two directors of ARL are interested in the said transaction, the matter may be placed before ARL's general meeting for members' approval through special resolution.

Answer: 5 (a)

Right issue of Rs. 270M:

Company made a right issue in November 2022 amounting to Rs. 500M. Now along with this new issue of Rs. 270M total size of right issue will cross the limit of Rs. 750M during a financial year if company issue shares before 30 June 2023 as decided by management.

In this case company have to follow certain additional/specific requirements:

i) BL shall not issue right exceeding the above referred threshold if BL, its sponsor, promoter, substantial shareholder and directors have overdues or defaults irrespective of the amount appearing in the report obtained from Credit Information Bureau;

ii) BL shall prepare and its board shall approve the draft offer document in easily understandable English and Urdu language;

iii) the Offer document shall contain all disclosures and such disclosure should be true and adequate and enable the applicants to take an informed investment decision;

iv) the draft offer document shall be submitted to PSX and the Commission within 45 days of the date of announcement and it shall simultaneously be placed by the BL on the PSX and company's website. It shall be the discretion of BL and its board to seek public comments on the offering document and in such case, the public can submit its comments within 7 days of placement;

v) PSX and the Commission shall, within 15 days of the filing of draft offer document, share their observations and changes with the company, if any;

vi) the board shall ensure that draft offer document is updated in light of the public comments, (if opted for), PSX and the Commission comments/observations, and shall submit final offer letter to PSX within 20 days from the date of comments/observations, whichever is later. Simultaneously, the Board shall also disclose in tabular form on PSX and company website, all the comments received along with the explanations as to how they are addressed;

vii) the final offer document shall be placed on PSX website along with book closure dates, and relevant right issuance timelines in accordance with Section 83 of the Act;

viii) the sponsors shall retain their entire shareholding for one year or project completion whichever is later;

ix) the statutory auditor shall monitor the proceed utilization till 95% of the proceeds are utilized in the manner referred to in the final offer letter, and shall submit half yearly report to the BL. BL will include the report, along with its comments, if any, in its half yearly and annual financial statements.

Issue of Shares to Mr. Olufsen:

Issue of shares to Mr. Olufsen shall be considered other than right issue and keeping in view the consideration against shares will be other than cash, following specific conditions are required to be fulfilled.

i) the value of non-cash assets or services or intangible assets shall be determined by a valuer: Provided that the valuation shall not be older than six months from the date of submission of the application to the Commission and the value of non-cash assets or services or intangible assets shall be determined by a valuer:

ii) the company shall invite claims, if any, on the non-cash assets through advertisement in the widely circulated newspaper both English and Urdu language clearly mentioning the fact that-
- after issuance of shares the title of the assets will be transferred in the name of the issuer; and
- claims must be submitted to the statutory auditors (insert name) within seven (7) days of the date of advertisement.

iii) the company shall intimate the Commission, at the time of seeking approval, confirming details of claims received and settled, verified through its statutory auditor along with an affidavit that the information is correct to the best of their knowledge;

iv) non-cash assets shall be transferred in the name of issuer within sixty (60) days of the date of approval by the Commission or within such extended time not exceeding 30 days with the approval of the Commission;

Answer: 5 (b)

BL can change the purpose of right issue made in November 22 in exceptional circumstances. For this purpose BL have to pass a special resolution and offering an exit opportunity to dissenting shareholders who have not agreed to the change in purpose of proceeds utilization.

The mechanism for an exit offer opportunity shall be as under-
- EOGM notice in respect of any change in the purpose of proceeds utilization of the issue as disclosed in the offer document shall be given along with draft special resolution as required under the provisions of the Act;
- subject to approval of special resolution as defined in the Act, the shareholders who have dissented against the special resolution and conveyed their dissent to the company secretary under intimation to PSX, shall be provided an opportunity to exit;
- during the exit opportunity, shares shall be purchased by sponsors of the issuer;
- purchase price per share shall be average market price of the period between last date of payment against right issuance and the date of passing of special resolution;
- the exit offer shall be executed by the sponsors with in a period of thirty (30) days from the date of passing of special resolution.

Answer: 6 (a)

i) Mr. Jack will be required to open a "Special Convertible Rupee Account" with any authorized dealer.

- Such account can be fed by:
  - Remittances from abroad
  - Transfer from a foreign currency account maintained in Pakistan by Mr. Jack
- Mr. Jack shall be allowed to trade freely in any shares quoted on Pakistan Stock Exchange from this account.
- Payment from such purchases may be debited to the account on production of stock broker's memo.

- Disinvestment proceeds may be credited to the account on provision of stock broker's memo.
- Transfer from one such account to another may also be made in case of transfer of shares.

ii) Yes, Mr. jack is entitled to receive dividends which shall also be credited into special convertible rupee account.

There are no restrictions on repatriation of funds outside Pakistan and the funds available in such special accounts can be transferred outside Pakistan or credited to a Foreign Currency Account maintained in Pakistan at any time without prior approval of SBP.

Answer: 6 (b)

According to Section 7D of Anti Money Laundering Act,2010 If Mr. Ateeq is unable to complete CDD requirements:

i) He shall not open the account, commence business relations or perform the transaction and
ii) shall promptly consider filing a Suspicious Transaction Report in relation to the customer.

Where a reporting entity forms a suspicion of money laundering or terrorist financing, and reasonably believes that performing the CDD process will tip-off the customer, the reporting entity shall not pursue the CDD process and shall file a STR. So, Mr. Ateeq should not perform CDD and promptly file a STR.

Answer: 7 (a)

WL can establish subsidiary abroad subject to following terms and conditions:

- Total amount of remittance during a calendar year, should not exceed the 10% of average annual export earnings of last three calendar years of the applicant, or USD 100,000 whichever is higher. Authorized Dealer can also open standby letter of credit to facilitate the offshore entity of the applicant for raising funds from offshore jurisdiction, within this limit.

- At any point of time, investment abroad of the applicant should not exceed 80% of its equity (after adjusting for investments in subsidiaries/ associates, goodwill, Deferred Tax Assets, receivables from related entities etc.).

- Transactions shall be carried out by the exporter by utilizing foreign currency funds available to the credit of special foreign currency accounts maintained in terms of applicable Foreign Exchange Regulations. However, if the balance available in its special foreign currency accounts is not sufficient, remittance of balance amount can be allowed from interbank market.

- The export overdue of intending investor shall not be more than 1% of the previous year's exports.

- One entity per jurisdiction shall be allowed for establishment/ acquisition of subsidiary.

  KBL being the Authorized Dealer shall ensure the following through assessment of relevant information/documents submitted by the WL, before allowing the transaction:

- In case WL's export earnings during last three calendar years is less than USD 300,000 or equivalent in other currencies, the KBL shall obtain details of products to be exported by the WL and an undertaking that proposed investment has the potential to increase the exports of Pakistan.
- The business activity of the company, firm in which investment is desired to be made should ordinarily be of the same nature as that in which the applicant is already engaged in Pakistan. Proposal for investment abroad in the extended line of business or vertical business integration shall also be considered as similar line of business.
- The WL should be financially sound as shown by its audited accounts for the last three years.
- The bonafides of the applicant and the genuineness of the transaction by verifying the necessary documents.
- Due weightage shall be given to the performance of previous investments abroad, if any, in terms of profit repatriation, increase in exports etc.

Answer: 7 (b)

Following securities can be given by Mr. Munir.

Asset	Eligible as Security	Conditions
Govt Securities	Yes	With minimum ten percent margin
Cash	Yes	in an escrow account with a commercial bank with a minimum rating of "A" and to be operated by the manager to the offer.
Listed securities – MTS Eligible	Yes	margin trading system eligible shares with thirty percent haircut based on their current market value.
Shares of Bawani (Pvt) Limited	No	-
Shares of Jawani Limited, Public Unlisted Co	No	-
Shares of SWL	Yes	the shares of a SWL that are proposed to be offered as non-cash consideration in the takeover transaction shall be subject to following requirements:- i) such company is listed for at least two years before the date of announcement of offer; and ii) shares of such listed company are presently being traded at normal counter of securities exchange:

Answer: 8 (a)

Corporate Restructuring company will be established as a public limited company.

A licence is required from Commission to carry business as a corporate restructuring company after fulfilling following conditions:

a) the promotors and directors are, in opinion of the Commission, the persons of means and integrity and have special knowledge and experience of matters regarding restructuring of companies in distress, financial engineering techniques and skills and capacity to deal with the out of court work out;

b) the promoters have given an undertaking that they shall not enter into any agreement or utilize the assets of the financial institutions or companies for personal gain;

c) a company shall be incorporated with such paid up capital as may be specified by Commission in consultation with the State Bank of Pakistan and with approval of Ministry of Finance;

d) proposed director, officer or employee of such company shall not be such a person who has been convicted of any offence involving fraud or breach of trust and adjudged as insolvent or who has suspended payment or has compounded with his creditors;

e) (e) there is no instance of overdue or past due payment to a financial institution, irrespective of amount, appearing in the latest consumer credit information report (CCIR) of the person and of the companies, Limited Liability Partnerships, firms, or sole proprietorships where promoter is chief executive, director (other than nominee director), partner or owner; and

f) any other requirement as the Commission may deem fit.

Answer: 8 (b)

i) As per section 285 of Companies Act, 2017, where a scheme or contract involving the transfer of shares in any company (ML) to another company (SL) has been approved by the holders of not less than nine-tenths in value of the shares whose transfer is involved (other than shares already held at the date of the offer by, or by a nominee for, the transferee company or its subsidiary),within one hundred and twenty (120) days after the making of the offer-by the transferee/buying company, Then SL may give notice in the specified manner to any dissenting shareholder that it desires to acquire his shares, at any time within sixty (60) days after the expiry of the said one hundred and twenty (120) days.

When such a notice is given, SL shall be entitled and bound to acquire those shares on the terms on which the shares of the approving shareholders are to be transferred to the SL, unless the Commission order otherwise on an application made by the dissenting shareholder within thirty (30) days from the date on which the notice was given.

As Mr. AMir holds only 7.2% of the shareholding of ML which is less than 1/10th in value of the shares whose transfer is involved therefore SL is entitled to buy shares from Mr. Amir by giving notice to him.

ii) As per section 285, where a notice has been given by the transferee company under and the Commission has not, on an application made by the dissenting shareholder, made an order to the contrary, SL shall, on the expiration of thirty (30) days transmit a copy of the notice to the ML together with an instrument of transfer and pay or transfer to the ML the amount representing the price payable by SL for the shares which that company is entitled to acquire i.e shares of Mr. Amir.
ML shall

- thereupon register the SL as the holders of those shares; and
- within thirty days of the date of such registration, inform Mr. Amir of the fact of such registration and of the receipt of the amount or other consideration representing the price payable to him by SL.

(THE END)

Certified Finance and Accounting Professional Stage Mock Examinations

26th May, 2023
3 hours – 100 marks
Additional reading time - 15 minutes

Strategy and Performance Measurement

Q.1 Unique Business Institute (UBI), a renowned world-class education provider, is offering a range of degree courses in business, accounting, finance, human resource, hospitality management, marketing, and supply chain management. The school boasts a strong faculty, high-quality research, state-of-the-art infrastructure, and a zero-tolerance policy for quality education.

UBI has been receiving grants from the government to support its futuristic educational activities. However, due to political instability and a deteriorating economic situation in the country, the educational sector has experienced a decline in grants over the past year. Further, it has been under consideration that the grant shall be given to a university only on the recommendation of the Higher Education Commission and its related bill has recently been placed before the National Assembly.

In order to remain competitive, UBI has invested heavily in the latest software and technology for its education program, to ensure smooth delivery of lectures both online and in-person. It is also reserving seats and offering scholarships for international students and is working on student and faculty exchange programs with world-class universities. UBI's long-term plans include launching various online programs for international students and opening facilitation offices in countries with a high potential for collaborations and international students.

Required:

a. Conduct PESTEL analysis on the information provided for UBI. **(10)**

b. How can UBI make use of future basing as a tool for strategic management. Briefly explain. **(04)**

Q.2 For each of the following independent scenarios, identify the force that has shaped the competition. Provide valid arguments for your reasoning while clearly highlighting the strength of each force.

i. Textile industry in Pakistan is dominated by four major players such as Nishat, Gul Ahmed, Sapphire, and Khadi. It has taken some time for these brands to establish themselves in the market and to become the first choice of the customer. Collectively, these brands share over 90% of the market in Pakistan for value added apparels.

ii. E-commerce sector in Pakistan has witnessed significant growth since Covid-19 pandemic. The companies operating in E-commerce related businesses are thriving in their profits. It is not difficult to establish an online store due to a number of reasons.

iii. Firms operating in the automobile sector in Europe are striving to capture a fair share of the market. There are over eighty automobile firms in the European region that have assembly plants all over the country. The firms are trying to supersede their competitors by offering high quality and unique features in their cars.

iv. Airline business was gravely affected during Covid-19 pandemic and many companies filed bankruptcy due to operational inefficiencies and declining shareholders' value. **(08)**

Q.3 Refer to the following scenarios:

i. Imagine a company that has been in the market for decades and has a well-established product line of household cleaning products. These products have a large market share and consistent demand. The company has built strong brand loyalty and has successfully captured a significant portion of the market. As a result, the products generate stable and substantial profits for the company, which can be reinvested in other product lines or business ventures.

ii. Consider a technology startup that recently launched a new innovative product in the wearable fitness tracker industry. While the product has generated initial buzz and garnered attention, it is still in the early stages of market penetration. The company faces intense competition from well-established players in the market. It's uncertain whether the product will gain widespread acceptance and achieve sustainable growth. The company needs to carefully analyze market trends, invest in marketing and product development, and closely monitor consumer feedback to determine the viability and potential of the product.

iii. Picture an automobile manufacturer that has recently introduced a new line of electric vehicles (EVs) to the market. EVs have gained significant traction and have witnessed a rapid increase in sales. The company has successfully positioned itself as a leader in the electric vehicle industry and has a competitive advantage over traditional combustion engine vehicles. The market for electric vehicles is growing, and the company's EVs are well-received by consumers due to their performance, eco-friendliness, and government incentives. The company needs to continue investing in research and development, expand production capacity, and capitalize on the market's growth potential.

iv. Suppose a company operates a line of compact disc (CD) players in the current era of digital streaming and online music platforms. The demand for CDs has significantly declined as consumers have shifted to more convenient and portable music formats. The company's CD players are facing obsolescence, and sales are rapidly declining. The market for CD players is highly saturated and offers limited growth opportunities. The company needs to make strategic decisions about whether to discontinue the product line, explore alternative markets, or invest in a transition to digital music platforms.

Required:

a. Identify and explain the relevant quadrant in which each of the product(s) discussed in above scenarios belong. **(06)**

b. Also recommend suitable strategies for each quadrant mentioned in (a). **(04)**

c. Highlight one risk that is associated with each of the strategies mentioned in (b). **(03)**

Q.4 (a) You are an IT auditor working for an ecommerce-based business that operates a popular online marketplace. The company relies heavily on its IT systems to handle a large volume of transactions and customer data. Your task is to assess the effectiveness of the organization's general IT controls.

Required:

a. Identify and explain three key system IT controls that are crucial for ensuring the security and integrity of the company's IT systems and customer data. **(06)**

b. For each control, provide a scenario-based example of its implementation and the potential risks it helps mitigate. **(03)**

(b) You are a IT governance consultant working with a financial services organization that aims to enhance its IT processes and controls using the COBIT (Control Objectives for Information and Related Technologies) framework. Your role is to assist in the implementation of COBIT and ensure alignment with the organization's goals and regulatory requirements.

Discuss the application of COBIT to the business processes. What benefits can be accrued by successful implementation of COBIT. **(06)**

Q.5 Presented below are the three independent situations:

i. Abbas, ACA, is the in-charge of approving tender applications on behalf of his company. Recently, he awarded a large tender to Bulk Limited because its CEO had been his mentor during his struggling years.

ii. Adnan, an audit senior, is auditing a client where his friend, Aliya, works. In a casual conversation, Adnan told Aliya that she gets paid the lowest salary among all the officers of her grade.

iii. Salman, an audit supervisor, intentionally missed many trainings that were deemed necessary to conduct the audit of the firm's clients.

Required:

In the light of ICAP's Code of Ethics, identify and explain the fundamental principles, other than professional behaviour, that may be violated in each of the above cases. **(06)**

Q.6 Imran Waseem (Imran) works for a pharmaceutical company that is conducting clinical trials for a new drug. The company has strict protocols and regulations in place to ensure the safety and efficacy of the drug being tested. However, Imran started noticing some irregularities in the way data is being collected and documented during the trials.

Upon further investigation, Imran discovered that one of the senior researchers involved in the trials has manipulating the data to make the drug appear more effective and safer than it actually is. This unethical behavior puts the health and safety of the trial participants at risk and compromises the integrity of the study's findings.

As an employee of the pharmaceutical company, Imran finds himself faced with a difficult decision. Blowing the whistle on this misconduct could have significant consequences, but remaining silent would perpetuate unethical behavior and potentially harm patients who may rely on the drug in the future.

Required:

a. What are the key considerations that must be evaluated before blowing the whistle? **(06)**

b. Give one benefit and one drawback for Imran if he decides to blow the whistle. **(02)**

Q.7 (a) Employee A

Alex has a natural dislike for work and must be closely supervised and controlled to ensure productivity. Alex is a junior employee in the customer service department of a telecommunications company. He consistently shows a lack of motivation, frequently arrives late to work, and often requires constant monitoring to complete his tasks. He tends to resist change and displays little initiative in seeking opportunities for professional growth.

Employee B

Beth is self-motivated, responsible, and enjoys work. Beth is a senior employee in the same customer service department as Alex. She consistently demonstrates a high level of enthusiasm and commitment towards her work. Beth is proactive, consistently seeks opportunities to improve her skills, and readily takes on additional responsibilities. She actively engages with customers, shows a desire to satisfy their needs, and frequently suggests innovative ideas to enhance customer service processes.

Required:

Apply suitable management theory to ensure motivation of both employees. **(06)**

(b) Refer to the following employees in Mark and Co.

i. Sarah is an employee who thrives on hands-on experiences and enjoys being actively involved in learning activities. She prefers trying new things and experimenting with different approaches. Sarah is enthusiastic and often seeks opportunities to collaborate with others.

ii. Mark is an employee who prefers to observe and gather information before taking action. Mark is thoughtful, introspective, and takes time to analyze situations. He appreciates opportunities for self-reflection and enjoys discussing and sharing insights with others.

iii. Lisa values logical reasoning, conceptual frameworks, and theoretical models. Lisa enjoys analyzing and organizing information to form a comprehensive understanding of a topic. She appreciates structured learning activities that involve exploring concepts and theories.

iv. John likes practical applications and focuses on how learning can be applied in real-life situations. John learns best through trial and error, seeking feedback, and applying his knowledge in practical scenarios. He prefers tasks that have direct relevance to his job or daily life.

Required

a. For each of the mentioned employees, identify and explain the best learning style that suits to each of them. **(06)**

b. Give two ways to train each of the employees based on their learning styles. **(04)**

Q.8 Ali works for a consumer electronics company that specializes in manufacturing smartphones. The company is planning to release a new flagship smartphone model in the market. As the product manager, Ali needs to analyze the product's lifecycle and propose strategies to maximize its profitability throughout the different stages.

Required:

Identify and explain two key challenges or opportunities that the smartphone may encounter at different stages of its lifecycle (introduction, growth, maturity, and decline). For each stage, describe a specific strategy that can help the company address the challenges or capitalize on the opportunities. **(08)**

Q.9 (a) For a bank, deploy balanced scorecard model highlighting 2 performance indicators under each of the elements of the scorecard model. **(04)**

(b) The management team at 7Eleven, a call centre, notices that their call handling times, one of their critical success factors (CSFs), have been consistently underperforming. The management determines that the lack of proper training and inadequate staffing are the main reasons for the declining performance. The data shows that the desired call handling time to achieve the competitive advantage is 30 seconds, but the actual call handling time recorded is 45 seconds.

Given the importance of the issue, the management has hired 3 additional staff and emphasized on setting ambitious training targets to resolve the matter within the next three months. The management is closely following the progress of implementing the plan and has recorded a decrease in call handling time to 35 seconds for the first month. For the second month the target is to reduce call handling time to 30 seconds, which will outcast the competition, and 28 seconds in the third month to solidify their position as a market leader in call handling times.

Required:

Identify, explain and relate Johnson and Scholes six-step approach to using CSFs from the scenario above. **(08)**

(THE END)

Strategy and Performance Measurement

Suggested Answers

Certified Finance and Accounting Professional Stage – Mock Summer 2023

Answer: 1 (a)
PESTEL Analysis for UBI:

Political Factors:

Political instability and deteriorating economic situation in the country: This can impact UBI's financial stability and the availability of government grants.

Government's decision to grant funds based on the recommendation of the Higher Education Commission: UBI needs to ensure strong relationships and positive engagement with the commission to secure future grants.

Economic Factors:

Decline in grants for the educational sector: UBI needs to adapt its financial strategy to cope with reduced funding and explore alternative sources of revenue.

Deteriorating economic situation: This can affect the affordability of education for students, requiring UBI to consider pricing strategies and financial assistance programs.

Sociocultural Factors:

Demand for a range of degree courses: UBI's existing course offerings align with the market demand, catering to various fields of study.

International student recruitment: UBI's focus on attracting international students highlights the growing demand for global education and cultural diversity.

Technological Factors:

Investment in latest software and technology: UBI's commitment to technological advancements ensures effective delivery of lectures and enhances the learning experience.

Launching online programs: UBI's plan to offer online programs demonstrates its adaptation to changing educational preferences and the increasing demand for remote learning options.

Environmental Factors:

No specific environmental factors mentioned in the scenario.

Legal Factors:

Bill placement before the National Assembly: UBI needs to monitor the progress of the bill and understand its potential implications on the grant allocation process.

Answer: 1 (b)

Future Basing as a Tool for Strategic Management:

Future basing is a strategic management tool that involves planning and preparing for future scenarios and uncertainties. UBI can utilize future basing in the following ways:

Scenario Planning: UBI can develop multiple scenarios, considering different grant funding outcomes, economic conditions, and political stability. This allows UBI to be prepared for various eventualities and develop contingency plans accordingly.

Diversification of Revenue Streams: Given the decline in grants, UBI can proactively explore and invest in alternative revenue sources such as industry collaborations, executive education programs, partnerships with businesses, and consulting services.

Long-Term Planning: UBI's long-term plans, including online programs and facilitation offices in high-potential countries, demonstrate future basing. By identifying emerging trends, demand for online education, and potential collaborations, UBI can strategically position itself for growth and sustainability.

Risk Management: Future basing enables UBI to identify and mitigate potential risks and challenges associated with political instability, economic fluctuations, and changes in the grant allocation process. It allows UBI to be proactive in managing uncertainties and minimizing their impact on operations.

Overall, future basing empowers UBI to navigate the dynamic educational landscape and make informed decisions to sustain its competitiveness and adapt to changing circumstances effectively.

Answer: 2

i. Competitive rivalry

The dominance of four major players in the textile industry in Pakistan has strong rivalry. The established brands, namely Nishat, Gul Ahmed, Sapphire, and Khadi, have taken time to establish themselves and become the preferred choice of customers. The strength of this force can be explained as follows:

<u>Strength of the Force:</u>

Brand Recognition: The dominant players have built strong brand recognition over time, making it difficult for new entrants to compete.

Slow growth in market demand: Established brands benefit from economies of scale and have captured 90% of the market share whereby the demand is slow in its growth.

Distribution Networks: The dominant players have well-established distribution networks, making it challenging for new entrants to reach customers effectively.

Customer Loyalty: These brands have developed a loyal customer base, which creates a barrier for new entrants trying to capture market share.

ii. Threat of new entrants

The significant growth of the e-commerce sector in Pakistan and the ease of establishing an online store indicate a moderate threat of new entrants. The strength of this force can be explained as follows:

<u>Strength of the Force:</u>

Low Barrier to Entry: Establishing an online store has become relatively easier due to factors such as accessible technology, availability of e-commerce platforms, and digital payment systems.

Market Growth: The significant growth of the e-commerce sector indicates a lucrative market, attracting new entrants.

Competitive Pricing: The presence of numerous competitors in the e-commerce sector may drive prices down, increasing the threat for existing players.

iii. Product differentiation/suppliers' bargaining power

The firms operating in the automobile sector in Europe striving to capture market share indicate a strong force of product differentiation. That would also increase the suppliers' bargaining power. The strength of this force can be explained as follows:

Strength of the Force:

High Competition: The presence of over eighty automobile firms in Europe with assembly plants indicates a highly competitive market.

High-Quality and Unique Features: Firms are competing by offering high-quality products with unique features to differentiate themselves from competitors.

Brand Reputation: Established automobile brands have built strong brand reputations over time, giving them a competitive advantage in terms of customer trust and loyalty.

iv. Competitive rivalry

The airline industry's decline during the COVID-19 pandemic and the bankruptcy filings of many companies highlight a strong force of competitive rivalry. The strength of this force can be explained as follows:

Strength of the Force:

High Number of Competitors: The airline industry is highly competitive, with numerous companies vying for market share.

Operational Inefficiencies: Companies that filed for bankruptcy indicate the presence of operational inefficiencies, leading to intensified competition.

Declining Shareholders' Value: The decline in shareholders' value suggests a fierce competitive environment where companies struggle to maintain profitability and market position.

Answer: 3 (a)

BCG Quadrant Analysis:

i. Well-Established Household Cleaning Products:

This product line falls into the "Cash Cow" quadrant of the BCG matrix. The products have a large market share and consistent demand, generating stable and substantial profits for the company.

ii. New Wearable Fitness Tracker:

The new wearable fitness tracker product falls into the "Question Mark" quadrant of the BCG matrix. It is in the early stages of market penetration and faces intense competition from established players

iii. New Line of Electric Vehicles (EVs):

The new line of electric vehicles falls into the "Star" quadrant of the BCG matrix. EVs have gained significant traction, and the company has positioned itself as a leader in the industry, experiencing rapid sales growth.

iv. Compact Disc (CD) Players:

The CD players fall into the "Dog" quadrant of the BCG matrix. The market for CD players is declining, sales are rapidly decreasing, and the product is facing obsolescence.

Answer: 3 (b)

Recommended Strategies:

i. Cash Cow:

Strategy: Maintain and Harvest

Explanation: The company should focus on maintaining its dominant market position and generating profits from the well-established household cleaning products. It can invest the profits in other product lines or business ventures.

ii. Question Mark:

Strategy: Invest or Divest

Explanation: The technology startup should carefully analyze market trends, consumer feedback, and the product's potential. It can invest in marketing and product development to increase market share and achieve sustainable growth. Alternatively, if the product's viability is uncertain, the company may consider divesting or exiting the market.

iii. Star:

Strategy: Invest for Growth

Explanation: The automobile manufacturer should continue investing in research and development, expand production capacity, and capitalize on the growing market for electric vehicles. It should aim to further strengthen its competitive advantage and gain a larger market share.

iv. Dog:

Strategy: Harvest or Divest

Explanation: The company operating the CD player line should make strategic decisions regarding the product's future. It can choose to harvest the remaining profits while minimizing investment or consider divesting the product line. Exploring alternative markets or investing in a transition to digital music platforms may also be options.

Answer: 3 (c)

Risks Associated with the Strategies:

i. Maintain and Harvest:

Risk: The risk of becoming complacent and missing out on potential opportunities for growth. By solely focusing on maintaining the existing product line, the company may neglect emerging trends or fail to adapt to changing customer preferences.

ii. Invest or Divest:

Risk: The risk of investing significant resources in a product that may not gain widespread acceptance or achieve sustainable growth. The uncertainty surrounding market acceptance and competition requires careful analysis and assessment of the product's potential.

iii. Invest for Growth:

Risk: The risk of market saturation or increased competition. As more players enter the electric vehicle market, the company needs to continuously innovate and differentiate its offerings to maintain its competitive advantage and avoid being surpassed by competitors.

iv. Harvest or Divest:

Risk: The risk of losing out on potential revenue or missing opportunities for diversification. If the company decides to harvest or divest the CD player line without exploring alternative markets or transitioning to digital platforms, it may miss out on potential revenue streams or fail to adapt to changing market dynamics.

It is important to note that the risks mentioned above are not exhaustive and may vary based on specific market conditions and company dynamics. Companies should conduct thorough analysis and consider additional factors when formulating strategies and assessing associated risks.

Answer: 4 (a)

a. Following are the key IT system controls that can be deployed for enhanced system security.

Passwords
A computer password is defined as 'a sequence of characters that must be presented to a computer system before it will allow access to the systems or parts of a system'

Typically, a computer user is given a prompt on the computer screen to enter his password. Access to the computer system is only permitted if the user enters the correct password.

Passwords can also be placed on individual computer files, as well as systems and programs.

To gain access to a system, it may be necessary to input both a user name and a password for the user name. For example, a manager wanting to access his e- mails from a remote location may need to input both a user name and the password for the user name.

Problems of password system include:

- giving their passwords to other individuals who are not authorised to access the system.
- Choosing predictable passwords
- Writing down passwords that can be stolen
- Not regularly changing the password

Effective password control system includes:

- Passwords must be changed regularly
- Passwords must not be easy to guess
- Developing security culture in the organization

Encryption
Encryption involves the coding of data into a form that is not understandable to the casual reader. Data can be encrypted (converted into a coded language) using an encryption key in the software.

A widely-used example of encryption is for sending an individual's bank details via the Internet. An individual buying goods or services from a supplier's web site may be required to submit credit card details. The on-line shopping system should provide for the encryption of the sender's details (using a '**public key**' in the software for the encryption of the message) and the decryption of the message at the seller's end (using a '**private key**' for the decryption).

Preventing and detecting hackers
Various measures might help to prevent hacking into a system, or to detect when a hacker has gained unauthorised access. However, the fight against hacking is never-ending, and computer users must be alert at all times.
Controls to prevent or detect hacking include:

- Physical security measures to prevent unauthorised access to computer terminals
- The use of passwords
- The encryption of data
- Audit trails, so that transactions can be traced through the system when hacking is suspected
- **Network logs**, whereby network servers record attempts to gain access to the system
- Firewalls.

Firewalls
Firewalls are either software or a hardware device between the user's computer and modem. Computer users might have both.

A firewall:

- Will block suspicious messages from the Internet, and prevent them from entering the user's computer, and
- May provide an on-screen report to the user whenever it has blocked a message, so that the user is aware of the existence of the messages.

b. Scenario based examples for each of the control:

i. Passwords: By developing a culture of strong passwords and secrecy of passwords, there would be lesser risk of unauthorized access to the system.

ii. Encryption: By encrypting the data, the risk of hacking will be avoided especially when sensitive data is shared over the network.

Firewalls: Firewalls help in securing the data and avoid unauthorized access to the systems. By installing firewalls, the firm can ensure that the data is secured against any hacking or unauthorized access.

Answer: 4 (b)

COBIT (Control Objectives for Information and Related Technologies) is a widely recognized framework for IT governance and management. When applied to business processes, COBIT provides a structured approach for ensuring effective controls, risk management, and alignment with business objectives. Here are the key aspects of COBIT's application to business processes and the benefits of successful implementation:

Process Orientation:
COBIT emphasizes a process-oriented approach, where each business process is defined, documented, and aligned with organizational objectives. It provides a comprehensive framework for identifying and documenting process inputs, outputs, controls, and performance metrics.

Control Objectives:
COBIT defines control objectives that help ensure the effectiveness, efficiency, and reliability of business processes. These control objectives provide a basis for establishing appropriate controls, monitoring compliance, and managing risks associated with the processes.

Risk Management:
COBIT incorporates a robust risk management framework that helps identify, assess, and mitigate risks associated with business processes. It enables organizations to proactively address vulnerabilities and prioritize resources based on risk exposure, ensuring that critical processes are adequately protected.

Performance Measurement:
COBIT facilitates the measurement and monitoring of process performance through the use of key performance indicators (KPIs) and metrics. It enables organizations to track and report on process performance, identify areas for improvement, and make data-driven decisions to optimize processes.

Compliance and Regulatory Alignment:
COBIT helps organizations align their business processes with relevant regulatory requirements and industry best practices. By implementing COBIT, organizations can establish a control framework that assists in compliance with various regulations, standards, and legal obligations.

Benefits of Successful COBIT Implementation:

a. Improved Process Efficiency: COBIT enables organizations to streamline and optimize business processes, leading to increased efficiency, reduced costs, and improved resource utilization.

b. Enhanced Risk Management: COBIT's risk management framework helps organizations identify and mitigate risks, reducing the likelihood of incidents, disruptions, and compliance breaches.

c. Increased Control and Compliance: By implementing COBIT's control objectives and aligning with regulatory requirements, organizations can strengthen their control environment and demonstrate compliance to internal and external stakeholders.

d. Effective Decision-Making: COBIT provides reliable and relevant information through its performance measurement and reporting capabilities, enabling informed decision-making and resource allocation based on process performance data.

e. Enhanced Stakeholder Confidence: Successful implementation of COBIT demonstrates a commitment to strong IT governance, risk management, and compliance, thereby instilling confidence in stakeholders such as customers, partners, regulators, and investors.

f. Continuous Improvement: COBIT's emphasis on measurement, monitoring, and feedback loops enables organizations to continuously assess and improve their business processes, ensuring ongoing alignment with strategic objectives.

Overall, the successful implementation of COBIT brings several benefits, including improved operational efficiency, effective risk management, regulatory compliance, informed decision-making, and stakeholder confidence. It helps organizations achieve their IT governance goals and maximize the value derived from their IT investments.

Answer: 5
In accordance with the ICAP's (Institute of Chartered Accountants of Pakistan) Code of Ethics, the following fundamental principles, other than professional behavior, may be violated in each of the given cases:

i. Case of Abbas, ACA:

Fundamental Principle: Integrity

Explanation: Abbas's decision to award a large tender to Bulk Limited based on a personal relationship with its CEO violates the principle of integrity. Integrity requires professionals to be straightforward and honest in all professional and business relationships. By favoring Bulk Limited due to a personal connection, Abbas compromises his objectivity and impartiality in the tender approval process, undermining the integrity of the decision-making process.

ii. Case of Adnan, the audit senior:

Fundamental Principle: Confidentiality

Explanation: Adnan's disclosure of salary information to his friend Aliya violates the principle of confidentiality. Confidentiality requires professionals to refrain from disclosing confidential information acquired during the course of their work, unless there is a legal or professional duty to disclose. Sharing salary information without proper authorization breaches the trust and confidentiality expectations between auditors and their clients, potentially damaging the reputation and trustworthiness of the profession.

iii. Case of Salman, the audit supervisor:

Fundamental Principle: Professional Competence and Due Care

Explanation: Salman's intentional avoidance of necessary trainings for conducting audits violates the principle of professional competence and due care. Professional competence requires professionals to maintain and develop their knowledge and skills to perform their duties competently. By deliberately missing essential trainings, Salman fails to meet the expected professional competence standards and compromises the quality of audits. This behavior undermines the credibility and professionalism of the audit process.

It is important to note that these are brief explanations based on the information provided. A comprehensive analysis of each case would require a detailed review of the specific circumstances and applicable professional codes of ethics.

Answer: 6 (a)
Key considerations that must be evaluated before blowing the whistle:

Ethical Responsibility: Imran must consider his ethical duty to uphold honesty, integrity, and the well-being of the trial participants and the public. He should assess the severity of the misconduct and the potential harm caused by the manipulation of data.

Legal Protections: Imran should familiarize himself with the legal protections available to whistleblowers in his jurisdiction. This includes understanding any whistleblower protection laws, policies, or procedures that may safeguard him from retaliation.

Internal Reporting Mechanisms: Imran should explore the internal reporting channels within the company, such as a designated whistleblower hotline or an established code of conduct, to determine if there are appropriate channels for reporting misconduct. He should assess the effectiveness and integrity of these mechanisms and consider whether they will lead to a fair investigation.

Organizational Culture: Imran should evaluate the organizational culture and management's commitment to ethical behavior. If the culture supports open communication, transparency, and accountability, it may be more conducive to addressing the issue internally. Conversely, if there is a culture of silence or resistance to addressing misconduct, external reporting may be necessary.

Potential Consequences: Imran must carefully consider the potential consequences of blowing the whistle. This includes the risk of retaliation, such as job loss, damaged professional reputation, or personal repercussions. He should also evaluate the impact on his future career prospects and the potential for legal or regulatory investigations.

Impact Assessment: Imran should assess the potential impact of the misconduct on the public, patients, and the reputation of the pharmaceutical company. This evaluation should weigh the potential harm caused by withholding the information against the potential negative consequences of reporting the misconduct.

Answer: 6 (b)
Benefit and drawback for Imran if he decides to blow the whistle:

Benefit: By blowing the whistle, Imran can uphold his professional integrity and moral values. He can contribute to safeguarding the safety and well-being of the trial participants, ensuring the accuracy of research findings, and protecting public health. Whistleblowing can bring attention to the misconduct, leading to corrective actions, increased transparency, and improved ethical practices within the pharmaceutical company.

Drawback: One potential drawback for Imran is the risk of facing retaliation. Whistleblowers often face challenges such as job loss, harassment, damaged professional reputation, or strained relationships with colleagues. The decision to blow the whistle can have personal and professional consequences, potentially impacting career opportunities and future employability.

It is important for Imran to carefully consider these factors and seek advice from legal professionals or whistleblower support organizations before making a decision.

Answer: 7 (a)
Theory X and Theory Y are management theories developed by Douglas McGregor to understand and address different employee motivational needs and behaviors. Let's apply these theories to ensure motivation for both employees:

Employee A (Alex) - Theory X Approach:

Theory X assumes that employees have an inherent dislike for work and need to be closely controlled and supervised. To motivate Alex, the following strategies can be applied:

Clear Expectations and Consequences: Clearly communicate the expectations for Alex's performance, including attendance, timeliness, and task completion. Clearly outline the consequences of not meeting these expectations, such as reprimands or potential disciplinary actions.

Structured Supervision: Provide close supervision and monitoring of Alex's work to ensure productivity. Assign a supervisor or mentor who can provide guidance, support, and feedback on a regular basis.
Performance Incentives: Establish performance-based incentives to reward Alex for meeting targets or improving performance. This can include recognition, bonuses, or other rewards that motivate him to increase productivity.

Training and Development: Provide specific training and development opportunities that target areas where Alex needs improvement. Offer guidance on time management, task prioritization, and ways to enhance his skills and knowledge.

Employee B (Beth) - Theory Y Approach:

Theory Y assumes that employees are self-motivated, responsible, and enjoy work. To motivate Beth, the following strategies can be applied:

Empowerment and Autonomy: Provide Beth with the freedom to make decisions and take ownership of her work. Encourage her to explore innovative ideas and solutions, allowing her to contribute her insights and expertise.

Opportunities for Growth: Offer Beth opportunities for professional growth and development, such as attending training programs, conferences, or seminars related to her field. Provide challenging assignments or projects that allow her to expand her skills and take on additional responsibilities.

Recognition and Rewards: Acknowledge and appreciate Beth's contributions publicly and privately. Provide recognition for her high level of enthusiasm, commitment, and proactive approach to customer service. Consider offering rewards such as promotions, salary increases, or other benefits that reflect her dedication and performance.

Collaborative Environment: Foster a collaborative and inclusive work environment that encourages open communication and idea-sharing. Involve Beth in decision-making processes and actively seek her input to make her feel valued and engaged.

Answer: 7 (b)
a. Learning Styles:

i. Sarah: Experiential Learning Style

Sarah thrives on hands-on experiences and actively engaging in learning activities. The best learning style for Sarah is experiential learning. This involves learning through direct experiences, reflection, and applying knowledge in real-world situations. Sarah enjoys trying new things, experimenting, and collaborating with others, which aligns well with the experiential learning approach.

ii. Mark: Reflective Learning Style

Mark prefers to observe and gather information before taking action. He is thoughtful, introspective, and enjoys analyzing situations. The best learning style for Mark is reflective learning. This style involves taking time to think, analyze, and reflect on experiences, observations, and insights. Mark benefits from opportunities for self-reflection and discussing and sharing his insights with others.

iii. Lisa: Theoretical Learning Style

Lisa values logical reasoning, conceptual frameworks, and theoretical models. She enjoys analyzing and organizing information to gain a comprehensive understanding of a topic. The best learning style for Lisa is theoretical learning. This style involves engaging with theories, models, and concepts to grasp the underlying principles and frameworks. Lisa benefits from structured learning activities that involve exploring concepts and theories.

iv. John: Pragmatic Learning Style

John likes practical applications and focuses on how learning can be applied in real-life situations. He learns best through trial and error, seeking feedback, and applying his knowledge in practical scenarios. The best learning style for John is pragmatic learning. This style involves learning by doing and applying knowledge directly in practical contexts. John benefits from hands-on exercises, simulations, case studies, and tasks that have direct relevance to his job or daily life.

b. Training Approaches:

i. Sarah:

Hands-on Workshops: Provide hands-on workshops or training sessions where Sarah can actively participate, try new things, and experiment with different approaches. These workshops can involve simulations, role-plays, and interactive activities that allow Sarah to engage and collaborate with others.
Collaborative Projects: Assign collaborative projects or group activities where Sarah can work with colleagues to solve real-world problems. This encourages active involvement, teamwork, and the application of knowledge in practical scenarios.

ii. Mark:

Case Studies and Discussions: Use case studies and group discussions to engage Mark in analyzing situations, sharing insights, and gathering different perspectives. This allows Mark to reflect on experiences, exchange ideas, and gain a deeper understanding of complex situations.
Self-Reflection Exercises: Provide opportunities for Mark to engage in self-reflection exercises, such as journaling or personal assessments. This allows him to introspect, analyze his own experiences, and derive insights from his observations.

iii. Lisa:

Theoretical Frameworks and Conceptual Models: Provide structured learning materials, such as theoretical frameworks, models, and conceptual diagrams, to help Lisa analyze and organize information. This allows her to grasp complex concepts and form a comprehensive understanding of the subject matter.
Structured Learning Activities: Offer structured learning activities, such as reading assignments, research projects, or presentations, that require Lisa to delve into theories, analyze data, and apply logical reasoning to solve problems.

iv. John:

Practical Training and On-the-Job Learning: Provide practical training sessions that allow John to apply his knowledge in real-life situations. This can involve on-the-job training, shadowing experienced colleagues, or participating in real-world projects that align with his job responsibilities.

Feedback and Continuous Improvement: Encourage regular feedback and coaching sessions to help John learn from his experiences, identify areas for improvement, and refine his practical skills. This feedback-driven approach supports his trial-and-error learning style.

Answer: 8
Introduction Stage:

<u>Challenge: Limited market awareness and customer acceptance</u>
During the introduction stage, the key challenge for the smartphone is to create awareness among potential customers and gain their acceptance. There may be skepticism or resistance towards a new product in the market.

<u>Opportunity: Early adopters and technological innovation</u>

The introduction stage also presents an opportunity to target early adopters who are eager to try new technologies. These customers are more likely to embrace innovative features and be the first to purchase the new smartphone.

<u>Strategy: Focus on marketing and differentiation</u>

To address the challenge, the company should invest in effective marketing campaigns to create awareness and generate interest in the new smartphone. Emphasize the unique features and benefits that set it apart from competitors. Offer promotional incentives to encourage early adoption.

Growth Stage:

<u>Challenge: Increased competition and market saturation</u>

In the growth stage, the smartphone faces increased competition from rival manufacturers who introduce their own flagship models. Market saturation becomes a concern as more competitors enter the market.

Opportunity: Expanding customer base and market share.

The growth stage presents an opportunity to expand the customer base and increase market share. As the smartphone gains popularity and acceptance, there is a larger market segment to target.
Strategy: Continuous product improvement and market expansion.

To address the challenge, the company should focus on continuous product improvement and innovation to stay ahead of the competition. Regularly release updates, new features, and improvements to maintain customer interest. Explore new markets and distribution channels to expand the customer base and increase market penetration.

Maturity Stage:

Challenge: Market saturation and declining sales

In the maturity stage, the market becomes saturated, and sales growth slows down. The smartphone may face declining sales as customers have various options to choose from.

Opportunity: Brand loyalty and market segmentation

In the maturity stage, there is an opportunity to build strong brand loyalty among customers. Establishing a loyal customer base can help sustain sales and maintain market share. Market segmentation allows the company to target specific customer segments with tailored marketing strategies.
Strategy: Customer retention and diversification

To address the challenge, the company should focus on customer retention by providing excellent customer service, after-sales support, and loyalty programs. Offer incentives for existing customers to upgrade to newer models. Explore diversification by introducing variants of the smartphone that cater to different customer preferences or target niche markets.

Decline Stage:

Challenge: Obsolescence and declining demand

In the decline stage, the smartphone faces the challenge of declining demand as newer technologies emerge, and customer preferences shift towards other products. The smartphone may become obsolete and lose relevance in the market.

Opportunity: Product differentiation and exit strategies

Although the decline stage is challenging, there are still opportunities to maximize profitability. Differentiate the smartphone by focusing on unique features or niche markets that still have demand. Evaluate exit strategies such as discontinuing the product or repurposing it for a different market.

Strategy: Harvesting and diversification.

To address the challenge, the company can implement a harvesting strategy by reducing marketing and R&D expenses while maximizing profitability from the remaining customer base. Explore diversification into other product lines or technological innovations to transition from the declining smartphone market.

Answer: 9 (a)

The Balanced Scorecard is a strategic performance management framework that helps organizations align their activities with their strategic objectives. Here are two performance indicators under each element of the Balanced Scorecard model for a bank:

Financial Perspective:

Return on Assets (ROA): Measures the bank's ability to generate profits from its assets.

Cost-to-Income Ratio: Evaluates the bank's efficiency in managing operating costs in relation to its income.

Customer Perspective:

Customer Satisfaction Index: Tracks customer satisfaction levels through surveys and feedback.
Net Promoter Score (NPS): Measures customer loyalty and the likelihood of customers recommending the bank to others.

Internal Process Perspective:

Average Loan Processing Time: Measures the time taken to process and approve loans, indicating the efficiency of internal processes.
Compliance and Risk Management Effectiveness: Evaluates the bank's ability to identify and manage risks and comply with regulatory requirements.

Learning and Growth Perspective:

Employee Training and Development Hours: Tracks the number of hours invested in training and development programs for employees.

Employee Satisfaction Index: Measures employee satisfaction levels to assess the bank's ability to attract and retain talented staff.

Answer: 9 (b)

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Step 1 - Identify the critical success factors that are essential for profitability.
Short/minimal call handling time is one of their critical success factors (CSF).

Step 2 - Identify what is necessary (the 'critical competence') in order to achieve a superior performance in the critical success factors.
The critical competence in this case is adequate number of staff and their proper training.

Step 3 - The entity should develop the level of critical competence so that it acquires the ability to gain a competitive advantage in the CSF.
The staff, new and existing, should be trained to reduce the call handling time.

Step 4 - Identify appropriate key performance indicators for each critical competence.
The target KPI is to reduce the call handling time from 45 seconds to the desired level of 30 seconds or less.

Step 5 - Give emphasis to developing critical competencies for each aspect of performance, so that competitors will find it difficult to achieve a matching level of competence.
Given the importance of the issue, the management has hired 3 additional staff and emphasized on setting an ambitious training target to resolve the matter within the next three months.

Step 6 - Monitor the firm's achievement of its target KPIs and also monitor the competitors' comparative performance.
The management closely followed the progress in implementing the plan and has recorded a decrease in call handling time to 35 seconds for the first month. Getting the call handling time reduced to 28 seconds as planned shall solidify their position as a leader in the market for call handling times.

(THE END)

The Professionals' Academy of Commerce
Pakistan's Leading Accountancy Institute

Certified Finance and Accounting Professional Stage Mock Examinations

23rd May, 2023
3 hours – 100 marks
Additional reading time - 15 minutes

Business Finance Decisions

Q.1 Omaan Co, a large listed company located in Pakistan whose currency is the RS, manufactures engines and engine parts. It is considering whether or not to invest in new four-year project: Project Alpha. Previously, Omaan Co has used relevant risk-adjusted discount rates to calculate the net present value (NPV) of projects. However, the finance director believes that calculating adjusted present values (APV) of projects would be more appropriate. Omaan Co wants to base its decision on which project to invest in, on the returns generated by the projects, the projects' risk as measured by their project durations, and important non-financial aspects. Project is due to commence in six months' time.

Funding for projects Alpha

Project Alpha will each require the same amount of initial funding of Rs 40,000,000.

Proceeds from the sale of a factory based in Europe in six months' time, for Euro (€)100,000, will provide part of the funding and the balance will be financed by debt borrowing.

Omaan Co expects to hedge the €100,000 using either forward markets or money markets. The following information is available on these markets:

Foreign exchange rates RS/€1

Spot	310.20-312.40
Six months forward	318.20–318.40

Bank interest rates

	Investing	Borrowing
Pakistan	12·40%	15·00%
Eurozone	2·05%	3·20%

The balance of funding raised by domestic debt borrowing will be through a four-year subsidized loan on which interest is payable at 10 %, although Omaan Co's normal borrowing rate is 15%.

Issue costs related to raising this finance will be 3% of the gross proceeds.

Project Alpha details

Project Alpha's base case NPV and APV should be estimated using the following information in six months' time when the project will commence.

The sales revenues and production costs related to Project Alpha in six months' time, before any annual price or cost increases, are estimated as follows:

Year	1	2	3	4
Sales revenue (RS 000s)	15,750	28,350	47,250	23,100
Production cost (RS	6,120	10,710	21,420	8,160

It is expected that the sales price will increase at an annual inflation rate of 12%. Domestic production costs are likely to increase at Pakistan's annual inflation rate.

In addition to the above, components will be imported from the UK (currency £), at the following current cost:

Year	1	2	3	4
Component costs £	6,000	9,000	18,500	7000

The costs of components from the UK are fixed and not subject to inflation.

The funds of Rs. 40,000,000 for Project Alpha will be used to purchase plant and equipment needed for manufacturing purposes. Tax allowable depreciation is available on the value of the plant and equipment at 25% per year on a reducing balance basis. The plant and equipment are expected to be sold for RS10,000,000 (post-inflation) at the end of the project.

At the start of every year, Project Alpha will require working capital. In the first year this will be 10% of the estimated year 1 sales revenue. In subsequent years, the project will require an increase or a reduction in working capital of 15% for every 1 Rs increase or decrease in sales revenue respectively. The working capital is expected to be fully released when project alpha ceases.

The expected spot exchange rate between the RS and the £, in six months' time, is expected to be RS 350 per £1. The annual inflation rates are currently 8% in the UK and 16% in Pakistan. It can be assumed that these inflation rates will not change for the foreseeable future.

The cost of capital for appraising the base case net present value of Project Alpha is 15%. Omaan Co pays tax at an annual rate of 29%. Tax is payable in the same year as the profits it is based on. Omaan Co makes sufficient profits from its other activities to take advantage of any tax loss relief. Risk free rate is 10%

Economic risk and risk categories

One of Omaan Co's subsidiary companies in Pakistan, which produces and sells all its products domestically, has still found that it is exposed to economic risk (economic exposure). The directors of the subsidiary believe that this is because Pakistan's government has maintained comparatively higher interest rates, even though the inflation in Pakistan is now under control.

Required:

(a) Discuss why a company may prefer to use the adjusted present value (APV) method, rather than the net present value (NPV) method. **(04)**

(b) Estimates the minimum amount of debt borrowing Omaan Co would require; **(04)**

(c) Estimates Project Alpha's base case NPV, in six months' time, before considering the financing side effects, **(12)**

(d) Discuss why Omaan Co's subsidiary company may be exposed to economic risk (economic exposure) and how it may be managed. **(04)**

Q.2 Lahore Co is a listed electronics company. Lahore Co has recently appointed a new chief executive, who has several plans to expand the company. The chief executive also plans to look carefully at the costs of all departments in Lahore Co's head office, including the centralized treasury department.

The first major investment which the chief executive will oversee is an investment in facilities to produce applications-specific components. To finance the planned investment, it is likely that Lahore Co will have to borrow money. It is now 1 May. At present, it seems that Lahore Co will need to borrow Rs 84 million on 1 September, for a period of six months, though both the amount and the period of borrowing are subject to some uncertainty. The treasurer plans to borrow the funds at a variable rate of KIBOR plus 50 basis points. KIBOR is currently 14% but is expected to rise by up to 5% between now and 1 September.

So far, the possibility of hedging a rise in KIBOR of 6% using a forward rate agreement or September Rs futures has been investigated. The results of the calculations for these instruments were as follows:

4-10 Forward rate agreement from United Bank: 18 ·38%

Three-month traded September Rs futures: 18.36%

Lahore Co's treasurer also wants to consider using options on futures to hedge loans.

Although Lahore Co has not previously used swaps for hedging purposes, the treasurer has asked United Bank to find a counterparty for a potential swap arrangement.

Relevant information about options and swaps is as follows:

Options

The current price for three-month Rs September futures, Rs 2 million contract size is 82·50. The price is quoted in basis points at 100 - annual % yield.

Options on three-month September Rs futures, Rs 2 million contract size, option premiums are in annual %

September Call	Strike Price	September Put
0.22%	82.05	0.44%

It can be assumed that futures and options contracts are settled at the end of each month. Basis can be assumed to diminish to zero at contract maturity at a constant rate, based on monthly time intervals. It can also be assumed that there is no basis risk and there are no margin requirements.

Swap

United Bank has found a possible counterparty to enter into a swap with Lahore Co. The counterparty can borrow at an annual floating rate of KIBOR + 2·5% or a fixed rate of 19.11%. United Bank has quoted Lahore Co a notional fixed rate of 18·6% for it to borrow. United Bank would charge a fee of 10 basis points to each party individually to act as the intermediary of the swap. Both parties would share equally the potential gains from the swap contract.'

Required:

(a) Compare the results of hedging the Rs 84 million, using the options and the swap, with the results already obtained using the forward rate agreement and futures, and comment on the results. Show all relevant calculations, including how the interest rate swap would work. **(12)**

(b) Discuss the advantages and disadvantages of using swaps as a means of hedging interest rate risk for Lahore Co. **(05)**

(c) Explain how Lahore company reduce its cost by having a central treasury department instead of having a decentralized treasury department for subsidiaries **(05)**

Q.3 Line Co is a private company, based in Pakistan, which owns a chain of restaurants and hotels across the country. Line Co's strategy of acquiring companies in different business sectors across the globe has so far diversified its risk until a recent board of directors (BoD) meeting, which revealed that a recent acquisition of Asian Co, an event management company in Asia, has brought major losses and has resulted in higher gearing levels in Asia. The credit rating of Asian Co has downgraded from A to BBB according to credit agency rating. The directors are very concerned about this decision by the agency as this would directly impact the valuation of Asian Co's bonds and the future cost of debt.

Despite incurring losses, Asian Co has explored opportunities arising in Asia in the upcoming years

Investment Project by Asian Co

Asian Co, however, has tried to convince the Line Co's BoD that Asia is currently investing massively in leisure industry, which will create recreations and expand the tourism industry, resulting in rapid growth soon. Asian Co is considering entering the tourism market through a four-year project. Asian Co suggests that the investment must be done on a now or never basis or the market will saturate and due to increased competition, it will no more be feasible to remain in the industry.

Year	**0**	**1**	**2**
	Rs. 000	Rs. 000	Rs. 000
Planned Capital Expenditure	20000	15000	10000

In addition, total working capital required at the start of each year will be as follows:

Year	**1**	**2**	**3**	**4**
	Rs. 000	Rs. 000	Rs. 000	Rs. 000
Working Capital Required	3000	3450	4000	3800

Working capital is expected to be fully released at the end of year 4.

Forecast pre-tax profits for the investment are stated below. They are stated AFTER the deduction of tax allowable depreciation, which is equal to accounting depreciation.

Year	**1**	**2**	**3**	**4**
	Rs. 000	Rs. 000	Rs. 000	Rs. 000
Tax-allowable depreciation	2,600	5,200	6,700	6,700
Pre-tax Profit	8,700	11,600	15,200	15,500

Currently, BoD being skeptical about further investing in Asian Co, has asked to delay and granted an option to invest in the project after two years as immediate investment would be risky due to the project volatility of 25% attached to its net present value.

Other Information

Asian Co market value of equity is estimated to be Rs22 million. Asian Co non-current liabilities of Rs20 million consists solely of 8% redeemable bond which has a nominal value of Rs100 and a redemption premium of 4% in four years' time. The government of Asia has issued four bonds. Since the bonds are all government bonds, it is assumed that the bonds are of the same risk class. Taxation can be ignored on government bond. The coupon is payable on annual basis. The annual spot interest rate of one-year redeemable bond is 88 basis points above the risk-free rate.

The detail of bonds and credit spreads for a bond of the same risk class is as follows:

Bond	**A**	**B**	**C**	**D**
Redeemable Years	**1**	**2**	**3**	**4**
Coupon	7%	6%	5%	4%
Current Market Value (Rs)	103	102	98	92
Credit Spreads Rating (shown in basis points)				
Year	**1**	**2**	**3**	**4**
A	21	30	42	56
BBB	55	71	87	100

Tulip Co, a listed company, provided hotel & tourism services for several years in Asia. Its business proportion of about 20% relates to tourism services and equity beta is 1.5. The asset beta of hotel services is estimated to be 0.75. Tulip Co has issued 5 million shares currently trading at Rs5 per share and its debt is currently trading at Rs108 per Rs100 at a book value of Rs 24 million. The debt beta is estimated to be zero.
Corporation tax applicable to all companies is 20%. The risk-free rate is estimated to be 3% and the market risk premium is estimated to be 6%.

Required

1. Estimates the value of the bond, YTM under both ratings. **(08)**
2. Evaluate the project decide whether Company should accept the project or not **(12)**

Q.4 There are two publicly listed publishing firms, Pakiza Co and ALeeza Co, that primarily focus on producing magazines but also release a few books related to their publications. Pakiza Co specializes in lifestyle and property magazines, while ALeeza Co's niche is showbiz. Both firms offer a mix of new and long-established magazines.

Pakiza Co employs a group of young staff writers and editors to create content in-house, but turnover is high. ALeeza Co, on the other hand, has in-house teams for each of its magazines made up of seasoned writers and editors who specialize in the relevant sports. Some popular showbiz figures also contribute to ALeeza Co's magazines. The company gives a lot of independence to the most successful magazine teams to determine content and direction.

Both firms have online platforms in addition to print copies of their magazines. Digital subscribers have access to exclusive online content. Pakiza Co has been recognized for its digital presence and e-marketing, while ALeeza Co's website has received criticism for looking outdated. However, its online content is highly regarded for its writing quality.

Pakiza Co is interested in acquiring ALeeza Co and has reached out to its board. Pakiza Co's management sees the acquisition as an opportunity to create synergies in online presence, marketing, and cross-selling, as well as to achieve cost savings by reducing staff, administration, and paper expenses.

Pakiza Co is valued at Rs620m in the market, and ALeeza Co's equity is worth Rs340m. ALeeza Co's board expects a 20% premium on its current equity value. Pakiza Co's management also anticipates a gain of at least 20% of their current equity value from the acquisition.

Pakiza Co plans to estimate the equity values of the acquisition using the free cash flow to firm method. The firms' combined sales revenue in the first year is expected to reach Rs820m (the sum of their most recent financial year's sales revenue). Sales are projected to grow by 10% in each of the following three years.

Post-tax operating cash flows are forecast to be 15% of sales revenue in each of the first four years. In the first year, Rs25m of additional investment in non-current assets is required, with Rs0.30 investment for every Rs1 increase in sales revenue in the following three years. After year 4, the company's free cash flow to firm is expected to grow by 5% annually.

Asset beta of the combined company is the individual companies asset betas weighted in proportion of individual companies market value of equity.Asset beta of Pakiza co is 0.95 and asset beta of Aleeza co is 0.67.

The estimate of the risk free rate is 6% and market risk premium is 8%, the target Gearing ratio for the combined company is 25%.Tax rate is 30% and combine company can borrow at 50 basis above RF rate.

Estimate:

1. The equity value of the combination of Pakiza Co and ALeeza Co; and the benefits which would be gained by Pakiza Co's shareholders from the **acquisition.** **(11)**
2. Discuss the assumptions made in the calculations in (a), including whether the expected synergies are likely to be achieved. **(04)**
3. Explain the actions which Pakiza Co's board can take to ensure that the companies are integrated successfully and synergies are realised. **(05)**

Q.5 Tyga Co has been engaged in the Food sector for the past decade and has amassed a wealth of experience in the industry. In recent years, the company has not generated enough profits to meet the expectations of its shareholders. Many shareholders anticipate that the company will continue to underperform. However, the company directors are optimistic that future earnings will surpass previous years and result in a boost in profits. As a result, they have decided to recompense the shareholders by issuing a right issue, granting one new share for every four shares already held, at a 17% discount to the current market value of Rs 10 per share. The cost of the issue is estimated to be Rs 124,000, which will be covered by the funds raised. The company plans to use 60% of the proceeds to pay off a loan at a 15% premium to its redemption value, while the remaining 40% will be invested in a project with an estimated 25% pre-tax profit. The following is a summary of Tyga Co's financial position:

Equity		**Rs 000**
Ordinary shares (1 Rs nominal value)		2000
Reserves		400
Total equity		2400
12% bond par Rs 1000		2500
Current liabilities		
Trade payable	200	
Over draft@14%	150	350
		5250

The price-to-earnings ratio of Tyga Co is 9.62, which has remained steady in recent years. If the company invests in a new project, the ratio is projected to increase by 10%. The tax rate is 30%.

Required:

(a) Calculate the theoretical ex-right price after the right issue and assess the impact on shareholder wealth. Evaluate if shareholders will approve the right issue proposal. **(10)**

(b) If company want to raise funds to finance property investment of new project, how company can arrange finance through Islamic finance and what are different sources of Islamic products are available. **(04)**

(THE END)

Answer: 1

(a) Discuss why a company may prefer to use the adjusted present value (APV) method, rather than the net present value (NPV) method (6 marks)

Why we use APV method?

Conceptually, the APV is relatively easy to understand. The method separates the investment decision from the financing decision by breaking the traditional DF into two parts. The first part (the investment decision) discounts cash flows at an equity rate of return/ cost of equity (Key) to calculate base case NPV. The second part (the financing decision) discounts the interest tax shield to the present value at a rate of return that reflect the risk in actually achieving these tax benefits. The two parts are then summed to derive the value of the entire enterprise. The traditional discounted cash flow method where in debt free cash flows are discounted to the present at the WACC may not be appropriate in every circumstance. The WACC assumes a static debt to equity ratio presumably at an optimal capital structure. However, many companies do not expect to have static level of debt to equity, particularly in situations involving highly leveraged transactions. Under these types of situations, the Adjusted Present Value Method may be a better method. The APV separates the value of operations from value created or destroyed by how the company is financed. The APV maybe a better tool to analyze the value of entities with unique financing. As such, the APV can also be used as a management tool to break out the value created from specific managerial decisions. The APV is based upon a principle of value addition that analysts can use with valuations.

This makes APV flexible enough to cover many different types of real-world financing arrangements such as

- Change in gearing level over the project life
- Issuance cost of equity and debt properly
- The proper impact of subsidized loan
- Using debt for financing has the tax advantage and interest payment is deductible.

This tax deduction has a source of value for the firm. In the normal NPV calculation, this additional value is accounted for in the WACC. Unlike APV, the normal assumption in NPV is that all cash flows are financed using the same WACC and remain constant each year. Therefore, when dealing with changing financial risk and more complicated financial situation, APV is preferable appraisal method over NPV.

Answer: 1 (b)

Forward rate Agreement

Exports Eur	100,000
Forward rate Agreement Rs/Eur	318.2
Expected Receipts	31,820,000

Money Market Hedge

PV of fcy using borrowing rate	98,425
Convert into HCY	30,531,496
Invest in HCY	32,424,449

Money Market hedge is better, company should do the money market hedge instead of forward.

Investment Side

'Rs 000''

Years		**0**	**1**	**2**	**3**	**4**
Revenue @ 12%inflation		-	17,640	35,562	66,383	36,348
Production cost @ 16% inflation		-	7,099	14,411	33,434	14,775
Cost Rs		-	2,256	3,634	8,023	3,261
Depreciation		-	10,000	7,500	5,625	4,219
Disposal loss						2656
Profit			(1,715)	10,017	19,300	11,438
Tax @ 29%			497	-2905	-5597	-3317
Depreciation			10,000	7,500	5,625	4,219
Disposal loss						2,656
Working capital change		(1,575)	(1,890)	(2,835)	3,623	2,678
Investment		(40,000)				10,000
Net cashflows		(41,575)	6,893	11,777	22,951	27,673
	15%					
NPV		4236				

Remaining amount borrowed	7,575,551.18
Financing require	40,000,000
Issuance cost	3%
Gross amount raised	7,809,846.58
issuance cost	234,295.40
Tax savings	61,768.79
Net issuance cost	172,526.61

APV

	'Rs 000''
Base case NPV	4,236
Financing side	
Net issuance cost	173
Pv of tax shield	718
PV of after tax interest savings	879
APV	5,661

Pv of tax savings

Tax savings	226,485.55
Aunnity factor @ 10%	3.169865446
Pv of tax shield	717,928.72

PV of after tax interest savings

After tax interest savings	277249.5535
Aunnity factor @ 10%	3.169865446
PV of after tax interest savings	878843.7798

Working

		'Rs 000"			
Years	**0**	**1**	**2**	**3**	**4**
Revenue		15,750	28,350	47,250	23,100
Revenue @ 12%inflation		17,640	35,562	66,383	36,348
Production cost		6,120	10,710	21,420	8,160
Production cost @ 16% inflation		7,099.20	14,411.38	33,434.39	14,774.82
Imported components					
Cost (GBP)		6000	9000	18500	7000
Exchange rate Rs/GBP	350	375.9	403.8	433.7	465.8
Cost Rs		2,255.56	3,633.95	8,023.10	3,260.64
Investmenment	40,000				
Depreciation		10000	7500	5625	4218.75
Carrying value					12656
Scrap value					10,000
Loss					2656
working capital requirement					
Working capital change	-1575	-1890	-2835	3622.5	2677.5

Regards: Saboor Ahmad (0302-9114479)

Answer: 1 (c)

KD

Year	**0**	**1**	**2**	**3**	**4**
Cashflows	-105.59	6.4	6.4	6.4	110.4
KD	5.72%				

'Rs 000"		**'Rs 000"**	**'Rs 000"**	**'Rs 000"**	**'Rs 000"**	**'Rs 000"**
Years		**0**	**1**	**2**	**3**	**4**
Pre tax profit			8,700	11,600	15,200	15,500
tax 20%			(1,740)	(2,320)	(3,040)	(3,100)
TAD			2,600	5,200	6,700	6,700
Working capital change		(3,000)	(450)	(550)	200	3,800
Capex		(20,000)	(15,000)	(10,000)		
Net cashflows		(23,000)	(5,890)	3,930	19,060	22,900
	10%					
NPV		**4,854**				

'Rs 000"	'Rs 000"		'Rs 000"	'Rs 000"	'Rs 000"	'Rs 000"
Years		0	1	2	3	4
working capital requirement		3000	3450	4000	3800	
Working capital change		-3000	-450	-550	200	3800

Answer: 1

(d) Discuss why Omaan Co's subsidiary company may be exposed to economic risk (economic exposure) and how it may be managed.

Explanation of why the subsidiary company may be exposed to economic risk and how it may be managed Companies face economic exposure when their competitive position is affected due to macroeconomic factors such as changes in currency rates, political stability, or changes in the regulatory environment. Long-term economic exposure or economic shocks can cause a permanent shift in the purchasing power and other parity conditions. Normally, companies face economic exposure when they trade internationally. However, even companies which do not trade internationally nor rely on inputs sourced internationally may still face economic exposure. In the case of Omaan Co's subsidiary company, economic risk may have occurred because interest rates have been kept at a high level, causing the original parity conditions to break down. High interest rates will be attractive to international investors, as they can get higher returns and may lead to the Rs becoming stronger relative to other currencies. This in turn would allow international competitors to produce goods more cheaply than the subsidiary company and thereby enhance their competitive position relative to the subsidiary company. Managing economic exposure is difficult due to its long-lasting nature and because it can be difficult to identify. Financial instruments, such as derivatives, and money markets cannot normally be used to manage such risks. Omaan Co's subsidiary company can try tactics such as borrowing in international or eurocurrency markets, sourcing input products from overseas suppliers and ultimately shifting production facilities overseas. None of these are easy or cheap, and can expose the company to new types of risks. Omaan Co would also need to assess that any action it takes to manage economic risk fits into its overall risk management strategy.

Answer: 2 (a)

Option on Future		**Rs.**
Amount of borrowing	84,000,000	84,000,000
Put Option		
September option		
Strike rate	82.05	82.05
Contracts	84	84
Premium	0.44%	0.44%
Decide to exercise the option or not		
Put Option	82.05	82.05
closing future	0.162	0
Gain	81.888	82.05
borrowing at market rate	19.500%	19.500%
Gain	1.75%	1.75%
	0.44%	0.44%
	18.190%	18.190%
closing future	0.162	0
Closing spot	19.000%	19.000%
current future		
current spot	14.00%	14.00%

Swaps

	Fixed rate	Floating rate	
Lahore co	18.60%	K+0.5%	K+19.6%
Counter party	19.10%	K+2.5%	K+21.1%
		savings	1.50%

Lahore co should borrow at floating rate K+0.5% and counter party should borrow at fixed 19.1%

Before fee savings		After Fee savings			fee	
Lahore co	0.75%		Lahore co	0.75%	0.10%	0.65%
Counter party	0.75%		Counter party	0.75%	0.10%	0.65%
	1.50%					

After swap cost

	without swap cost	savings	After swap cost
Lahore co	18.60%	0.65%	17.95%
Counter party	K+2.5%	0.65%	k+1.85%

	Lahore co	Counterparty
borrow from bank	(K+0.5%)	-19.10%
Receive	K	17.35%
pay	-17.35%	(K)
Before fee cost	17.85%	K+1.75%
Fee	0.10%	0.10%
After swap cost	17.95%	k+1.85%

	%
FRA	18.38
Future	18.36
Option on Future	18.19%
Swaps	17.95

Swap is the financial derivative which has lowest cost compare to other derivatives. Although option on future cost is higher then swap cost, however if interest rate moves downward option will give company an edge that company will lapse the option and get cheaper market rate.

Fra and future cost is high compare to options and interest rate swap .

In swaps compant floating rate exposure has shifted to fixed rate, if rate moves downward company will bear the risk.

Regards: Saboor Ahmad (0302-9114479)

Answer: 2

(a) Discuss the advantages and disadvantages of using swaps as a means of hedging interest rate risk for Lahore Co.

Advantages of swaps

Transaction costs are generally relatively low. If Lahore Co arranged the swap itself, the costs would be limited to legal fees. The transaction costs may also be lower than the costs of terminating one loan and arranging another. Lahore Co can, as here, swap a commitment to pay a variable rate of interest which is uncertain with a guaranteed fixed rate of interest. This allows Lahore Co to forecast finance costs on the loan with certainty. Swaps are over-the-counter arrangements. They can be arranged in any size and for whatever time period is required, unlike traded derivatives. The period available for the swap may be longer than is offered for other interest rate derivatives. Swaps make use of the principle of comparative advantage. Lahore Co can borrow in the market where the best deal is available to it, and then use the swap to access the loan finance it actually wants at an overall cheaper cost.

Disadvantages of swaps

Swaps are subject to counterparty risk, the risk that the other party to the arrangement may default on the arrangement. This would apply in particular if Lahore Co arranged the swap itself. If it is arranged through a bank, the bank can provide a guarantee that the swap will be honored. If Lahore Co swaps into a fixed rate commitment, it cannot then change that commitment. This means it cannot take advantage of favorable interest rate changes as it could if it used options. This may be a particular problem if the swap period is more than a few months and interest rates are expected to be volatile.

(b) Explain how Lahore company reduce its cost by having a central treasury department instead of having a decentralized treasury department for subsidiaries

The centralized treasury department should be able to evaluate the financing requirements of Lahore Co's group as a whole and it may be able to negotiate better rates when borrowing in bulk. The department could operate as an internal bank and undertake matching of funds. Therefore, it could transfer funds from subsidiaries which have spare cash resources to ones which need them, and thus avoid going into the costly external market to raise funds. The department may be able to undertake multilateral internal netting and thereby reduce costs related to hedging activity. Experts and resources within one location could reduce duplication costs. The concentration of experts and resources within one central department may result in a more effective decision-making environment and higher quality risk monitoring and control. Further, having access to the Lahore Co group's entire cash funds may give the company access to larger and more diverse investment markets. These factors could result in increasing the company's cash inflows, as long as the benefits from such activity outweigh the costs.

Answer: 3

(a) Valuation of the bond under new credit rating of BBB

The government yield curve can be estimated as under:

Bond A: Rs103 = Rs107/ (1+r1)
r1 = (Rs107/Rs103) – 1 = 3.88%

Bond B: Rs102 = Rs6/1.0388 +Rs106/ $(1+ r2)^2$ r2 = [Rs106/ (Rs102 – 5.78)]$^{1/2}$ – 1= 4.96%

Bond C: Rs98 = Rs5/1.0388 + Rs5/1.0496^2 + Rs105/$(1+r3)^3$ r3 = [Rs105/ (Rs98 – 4.81 – 4.54)]$^{1/3}$ – 1= 5.81%

Bond D: Rs92 = Rs4/1.0388 + Rs4/1.0496^2 + Rs4/ 1.0581^3 + Rs104/ $(1+ r4)^4$ r4 = [Rs104/ (Rs92 – 3.85 – 3.63 – 3.38)]$^{1/4}$ – 1= 6.40%

Valuation of Bond under the old (A) credit rating

Year	**Payment Rs**	**Old Spread rating %**	**Discount Factor**	**Discounted cash flow Rs**
1	8	(3.88+0.21=4.09)	1/1.0409^1	7.69
2	8	(4.96+0.30=5.26)	1/1.0526^2	7.22
3	8	(5.81+0.42=6.23)	1/1.0623^3	6.67
4	112	(6.40+0.56=6.96)	1/1.0696^4	91.53
				113.11

Valuation of Bond under the new (BBB) credit rating

Year	**Payment Rs.**	**New Spread rating %**	**Discount Factor Discounted cash flow Rs.**
1	8	(3.88+0.55=4.43) 1/1.0443^1	7.66
2	8	(4.96+0.71=5.67) 1/1.0567^2	7.16
3	8	(5.81+0.87=6.68) 1/1.0668^3	6.59
4	112	(6.40+1.00=7.40) 1/1.0740^4	84.18
			105.59

Yield to maturity under the old (A) credit rating

Year	**Payment**	**Discount Factor**	**Cash flow**	**Discount Factor**	**Cash flow**
	Rs	**8 %**	**Rs**	**5 %**	**Rs**
0	(113.11)	1	(113.11)	1	(113.11)
1-4	8	3.312	26.50	3.546	28.37
4	104	0.735	76.44	0.823	85.59
			(10.17)		**0.85**

Using the IRR approach, yield to maturity = 5 + ((0.85/(10.17+0.85))

x (8-5)) = 5.23% Yield to maturity under the new (BBB) credit rating

Year	**Payment Rs**	**Discount Factor 8 %**	**Cash flow Rs.**	**Discount Factor**	**Cash flow 5 %**	**Rs**
0	(105.59)	1	(105.59)	1	(105.59)	
1-4	8	3.312	26.50		3.546	28.37
4	104	0.735	76.44		0.823	85.59
			(2.65)			**8.37**

Using the IRR approach, yield to maturity = 5 + ((8.37/(2.65+8.37)) x (8-5)) = 7.28%

Market Value of Rs100 bond has fallen by Rs7.52 and the yield to maturity has risen by 2.05%.

(b) Asian Co's Market value of Debt = Rs20,000,000 x 105.59/100 = Rs21.118 million Asian Co's Market value of Equity = Rs22 million

Estimate of risk adjusted cost of capital to be used as a discount factor

Tulip Co equity value = Rs5 x 5 million = Rs25 million
Tulip Co debt value = 1.08 x Rs24 million =

Rs25.92 million Tulip Co Asset beta = 1.5 x

[25/ 25 + (25.92 x 0.8)]=0.82

Tourism Project's asset beta (TPAB)

0.82 = TPAB x 0.20 + 0.75 x 0.80
TPAB = 1.1

Project's risk adjusted equity beta
1.1 x (22 + 21.118 x 0.8)/22 = 1.94

Project's risk adjusted cost of equity

3% + 1.94 x 6% = 14.64%

KD					
Year	0	1	2	3	4
Cashflows	-105.59	6.4	6.4	6.4	110.4
KD	5.72%				

Project's risk adjusted cost of capital

[(14.64% x 22 + 5.72% x 21.118)/ (22 + 21.118)] = 10.27%, approximately 10%

Value of Project

'Rs 000"	**'Rs 000"**	**'Rs 000"**	**'Rs 000"**	**'Rs 000"**	**'Rs 000"**
Years	**0**	**1**	**2**	**3**	**4**
Pre tax profit		8,700	11,600	15,200	15,500
tax 20%		(1,740)	(2,320)	(3,040)	(3,100)
TAD		2,600	5,200	6,700	6,700
Working capital change	(3,000)	(450)	(550)	200	3,800
Capex	(20,000)	(15,000)	(10,000)		
Net cashflows	(23,000)	(5,890)	3,930	19,060	22,900
10%					
NPV	**4,854**				
'Rs 000"	'Rs 000"	'Rs 000"	'Rs 000"	'Rs 000"	'Rs 000"
Years	0	1	2	3	4
working capital requirement	3000	3450	4000	3800	
Working capital change	-3000	-450	-550	200	3800

Answer: 4 (a)

Answer: 4 (a)

COMBINED CO's VALUE (USING FCFF)

	1	2	3	4	5
Sales Revenue	820.00	902.00	992.20	1091.42	
Post Tax Operating Cashflows	123.00	135.30	148.83	163.71	
Additional CAPEX	-25.00	-24.60	-27.06	-29.77	
Free Cashflow to Firm	98.00	110.70	121.77	133.95	2009.21
DF=15%	0.89	0.80	0.71	0.64	0.64
PVs	87.50	88.25	86.67	85.13	1276.89

Value of Business	1624.43
Value of Debt	406.11
Equity Value of Combined Company	1218.33

BENEFITS FROM ACQUISITION TO SHAREHOLDERS OF PARENT

Combined Co's Equity Value	1218.33
Value of Acquirer pre-acq.	620
Value of Target pre-acq.	340
Premium Paid to Target's Shareholders	68
Benefit/(Loss) to Shareholders	190.33
Gain % to Shareholders	31%

sss

Combine WACC

	Ba	Market values	
Pakiza Ba	0.95	620	589
Aleeza Ba	0.67	340	227.8
Weighted average BA	0.8508333	960	816.8
D/E ratio	25%		
Be	1.0493611		
rf	6%		
Risk premium	8%		
Ke	14.39%		
KD	4.550%		
WACC	11.93%		

Regards: Saboor Ahmad (0302-9114479)

Answer: 4

(b) Discuss the assumptions made in the calculations in (a), including whether the expected synergies are likely to be achieved.

Assumptions

It is assumed that the sales growth rate, margins, the taxation rate and incremental capital investment can be determined accurately and remain constant. Whether Pakiza Co's proposals, particularly for marketing Aleeza Co's titles, can maintain the sales growth rate of 10% from Year 2 until Year 4 may be doubtful. The profit margin may change as integration progresses and may depend on volume of sales. The incremental capital investment may be underestimated, due to developments in the technology used in online publishing.

A growth rate of free cash flows after year 4 is also assumed to be maintainable in perpetuity, which may be unrealistic, even though some of the magazines have a long history. Information on long-term market trends is needed to assess this figure.

Costs of acquisition are assumed to be estimated fairly. Due diligence will be needed to confirm that there are no further hidden costs which need to be considered in the valuation. Costs associated with combining the two companies, for example, IT integration costs and HR costs including redundancy, may have been under-estimated.

Synergies

Assumptions about the synergies which will be gained will underpin the free cash flow estimates. Synergies in some areas appear to be realistic. Buying paper in greater quantities could lead to bulk discounts, and there may well be some savings from removing duplication of administration functions.

Other synergies may be more difficult to achieve. Adopting Pakiza Co's methods of e-marketing may give Aleeza Co greater reach and a more appealing online presence. However, cross-selling between the two groups of magazines may be limited by their appealing to differing readerships. The appeal of Aleeza Co's titles appears to be primarily based on their specialist content, which would not be affected by changes resulting from the acquisition. The differing subject matter of the two companies' magazines would mean there was little or no opportunity to share common content.

There would also seem to be limited opportunity to realize synergies regarding publishing staff. Aleeza Co's business has been based on the expertise of its staff and Pakiza Co's staff may need to develop knowledge of the showbiz to be able to work on Aleeza Co's titles. Staffing issues may represent the biggest barrier to sufficient value being gained from the acquisition. If Aleeza Co's staff dislike the environment of the merged company, they may leave, and the best staff may easily find jobs at competitor titles.

(c) Explain the actions which Pakiza Co's board can take to ensure that the companies are integrated successfully and synergies are realized.

Integration and realization of synergies is most likely to happen if first Pakiza Co can make a thorough investigation of Aleeza Co and possible sources of synergy. The investigation should identify key personnel whom Pakiza Co would wish to retain, and should also cover staff remuneration and redundancy provisions. IT needs to be thoroughly reviewed, to understand.

if there are barriers in the way of integration. Communication with Aleeza Co's staff throughout the acquisition process is an important aspect of trying to minimize staff turnover. Initially, staff are likely to be fearful for their jobs and require reassurance that they will be retained; Pakiza Co also needs to make decisions early on about aspects of the business which are important to staff. These include matters relating to organization and culture, in particular how much autonomy staff will continue to be given and areas where there is likely to be greater central direction, for example, online presence. Pakiza Co also needs to communicate to key staff what opportunities and incentives they will be offered by the merged company. As current Showbiz can be means of attracting readers to magazines, Pakiza Co also needs to take steps to retain them as writers.

A flexible plan will be needed for the acquisition process and for integrating Aleeza Co's business into Pakiza Co. Pakiza Co's management needs to spend sufficient time in making sure the plan achieves its objectives. Development of the magazines acquired also needs to be included as an important part of Pakiza Co's longer-term strategic planning.

Business Finance Decisions
Suggested Answers
Certified Finance and Accounting Professional Stage – Mock Summer 2023

Answer: 5

(a) Previous earning per share =10 Rs/9.62 = 1.0395

Total earnings= 1.0395*2000 = 2079	**(01)**
Fund raised in right issue = (10*0.83)*(2000/4)=4150	**(01)**
Issuance cost = 124	
Net funds = 4150-124 = 4026	
Increase in earnings =4026 x 40% x 0.25 x(1-0.3) = 281.82	**(01)**
Loan pay off = 4026* 60 % / 115 * 100 = 2100	(01)
Interest savings =2100*12%* (1-0.3) = 176.4	**(01)**
Total earnings = 2079+ 281.82+ 176.4= 2,537.22	**(01)**
Total shares = 2000+500=2500	
Revised EPS = 2,537.22 / 2500 = 1.0149 Rs /share	**(01)**
New P/E ratio = 9.62 * 1.1 = 10.582	**(01)**
New MV = 1.0149 x 10.582 = 10.74 Rs	**(01)**
TERP=(2079*9.62)+4026/2000+500=9.61	**(02)**

Shareholders will accept this proposal because it is increasing mv from 9.61 Rs to 10.74 Rs. (1)

(b) A company looking to raise funds to finance property investment in a new project may consider using Islamic finance. Islamic finance operates under the principles of Sharia law and prohibits interest-based transactions. Some sources of Islamic finance products for property investment include:

Ijara: This is a lease-to-own arrangement where the financier leases the property to the customer and allows them to purchase it at the end of the lease period.

Musharaka: This is a partnership arrangement where the financier and the customer share the ownership and profits of the property.

Sukuk: This is a form of Islamic bond where investors can invest in a property project and receive returns in the form of rental income.

Islamic equity financing: This involves the financier providing equity financing in exchange for a share of the ownership and profits of the property.
These are just a few examples of Islamic finance products available for property investment. The specific options available to a company may vary depending on the local market and the specifics of the project.

(THE END)

Certified Finance and Accounting Professional Stage Mock Examinations
27th May, 2023
3 hours – 100 marks
Additional reading time - 15 minutes

Tax Planning & Practices

Q.1 Mahad Limited (ML) is a listed company engaged in the business of manufacturing, trading and supply of multiple products across the country. The company also owns multiple retail outlets across different cities.

On December 2022, ML purchased two point of sale machines amounting to Rs. 120,000 and Rs.250,000 respectively for installation and integration with Board's computerized system.

ML's taxable income for tax year 2023 was Rs.12,000,000. The income was arrived at after adjustment of the following items:

(i) Stock consumed has been computed as follows:

Opening stock	5,000,000
Purchases	65,000,000
Closing stock	(32,000,000)
	38,000,000

The net realizable value of the closing stock is Rs.40,000,000 against its cost of Rs.35,000,000

(ii) An amount of Rs.2,500,000 received a compensation from Sui Northern Gas Limited (SNGP) for partial loss of profits on account of disrupted gas supply, as per the terms of agreement.

(iii) Legal and other fees of Rs.200,000 paid in connection with acquisition of piece of land during the year amounting to Rs.5,000,000.

(iv) Gain of Rs. 1,000,000 on sale of piece of land (sale value Rs.6,000,000) acquired during the year at (iii) above. The entire sale proceed was received in cash.

(v) ML Sold a machine for total consideration of Rs.1,000,000. The machine was purchased for Rs.1,500,000 on 01 August 2021 and was used in manufacture of IT products. No gain or loss has been recognized in the accounts as the sale proceeds were still recoverable by the company as on 30 June 2023.

(vi) Gain of Rs.200,000 on sale of locally manufactured 1500CC motor vehicle which was sold prior to its registration. ML purchased the vehicle from local manufacturer in 2023.

(vii) Rs.1,000,000 received as return on investment in sukuks from Sarmaya Bank Limited.

(viii) Administrative expenses including the following:

a. Rs. 1,000,000 paid as rent for an office for two years from 01 July 2022.

b. Rs.50,000 as donation to a political party which is staunch supporter of lower taxation for corporate sector.

c. Rs.100,000 as legal expenses for filing a court case against a former employee for the recovery of loan advanced

d. Rs.200,000 to Karachi Port Trust (KPT) for not lifting imported goods from the docks within the time stipulated in KPT rules.

Required:

(a) Compute correct total income, taxable income and tax liability of ML under the appropriate heads of income for the tax year 2023. **(14)**

(b) Give comments/reasons for the inclusion or exclusion in the computation of taxable income of each of the item listed above. **(12)**

Q.2 (a) Mahad (Pvt.) Limited incorporated in 2020 is engaged in transmission line project located in Peshawar. Following information is available in respect of its two shareholders namely Shifa and Sana having 10,000 and 20,000 shares respectively:

Tax year	Accumulated profits	Loan to shareholders	Loan repaid	Dividend
2020	200,000	50,000 (to Shifa)		Nil
2021	-	-	30,000 (by Shifa)	Nil
2022	300,000	Nil		Rs. 3 per share
2023	450,000	Nil		Rs. 5 per share

Required:
In the light of the provisions of Income Tax Ordinance, 2001 calculate the tax liability of both the shareholders for tax year 2020, 2021, 2022 and 2023. **(04)**

(b) Under the provisions of the Income Tax Ordinance, 2001 what would be the cost of an asset in tax year 2023 for each of the following circumstances?

(i). Usaid an employee of ABC Ltd got 5000 shares under employees share option @ Rs.5 per share. The market value of these shares was Rs. 15 per share. After 10 days the market value increased to Rs.20 per share.

(ii). ABC Ltd set up a factory in an industrial Zone and purchased asset at subsidized cost of Rs. 55 million from Government. The actual cost of the asset was Rs. 65 million.

(iii). Yasir purchase a building costing Rs. 500,000 in 2019. In tax year 2023 Govt. of Punjab Compulsory acquired the building by paying Rs. 1,000,000. Till tax year 2022 Yasir had claimed total tax depreciation of Rs. 300,000. He purchased a similar building in tax year 2023 for Rs. 1,200,000.

(iv). XYZ Ltd is planning to purchase a new software amounting to Rs.25million. Sales tax at a rate of 17% shall be levied on its purchase. The new system is an already developed system by a software firm and shall be customized to meet the needs of XYZ Ltd. Customization will cost Rs 5 Million and implementation team will be paid Rs 2 Million. Customization and implementation will not attract sales tax. XYZ Ltd is not registered for Sales Tax.

(v). On 01 July 2021 ABC Ltd purchased machinery from USA through foreign currency loan worth US $ 50,000 at Rs.104/$. The loan was repayable in two equal annual installments of US $ 25,000 each at the end of every year. At the time of second installment on 30 June 2023 the exchange rate was Rs.260/$.

(05)

(c) Fatima Pakistan Limited (FPL) is engaged in the business of providing designing and web hosting services to corporate clients in Lahore. FPL has paid up capital of Rs. 30 million and undistributed reserves of Rs.15 million. Due to constantly increasing volume of work, FPL had to appoint Omer Financials (OF), a debt collection agency against 2% service charges for recovery of debt.

During tax year 2023, OF recovered Rs. 10,185,000 which was after deduction of applicable withholding tax by various clients. OF retained 2% services charges and remitted Rs.9,981,300 to FPL. Following information is available from FPL's record for tax year 2023:

Description	Rupees
Gross turnover	43,500,000
Taxable income	2,745,000

Required:
In the light of provisions of Income Tax Ordinance, 2001 calculate the following:

(a) Withholding tax deducted by corporate clients on payment to FPL
(b) Withholding tax to be collected by FPL
(c) Tax liability of FPL for tax year 2023.

(07)

Q.3 Respond to the following independent scenarios, under the provisions of the Income Tax Ordinance, 2001.

(i) Mujtaba Hussain is engaged in the business of cashew nut processing. On 31 July 2022, he entered into a six-month forward contract for the purchase of raw materials used in his business to safeguard against losses due to price fluctuations. On 31 January 2023 i.e. the maturity date of the forward contract, he took the delivery of the raw materials and settled the contract by making the due payment.
Discuss the tax treatment of the above transaction to Mujtaba Hussain. **(02)**

(ii) On 1 July 2022, Kulsoom, a widow, established an online garment retail business and employs various ecommerce platforms to market a diverse range of garments to customers throughout Pakistan. She operates the business from her residential house. During the year, the sales from online business were Rs. 6,000,000 and total expenditures including her personal expenses were Rs. 5,800,000. At the year end, her sole assets consisted of a 1300cc personal car and Rs. 800,000 as cash on hand.

Advise the requirement of filing of return of income and tax treatment of the above to Kulsoom. **(03)**

(iii) Sidra, a Pakistani national, left Pakistan on 1 July 2022 for employment in a Singapore based company at a monthly salary of SGD 10,000. However, due to personal reasons, she returned back to Pakistan on 20 December 2022 and remained in Pakistan till 30 June 2023. She brought the entire foreign salary amount to Pakistan.

Discuss the tax treatment of the above transaction to Sidra. **(02)**

(iv) Being a tax consultant, you have been asked by Mr. Faheem to file his return of income along with wealth statement for tax year 2023. While reconciling his net wealth you have discovered the existence of two immoveable property. Details of the properties is as follows:

- Property 1 is an agriculture property which was acquired by Faheem in tax year 2019.
- Property 2 is a commercial property which was acquired by Mr. Faheem in tax year 2015.

Mr. Faheem wants to know about the consequences of non-disclosure or inaccurate disclosure of his property in the wealth statement or failure to offer any explanation about the nature and source of his investment in such property. **(05)**

(v) Import of telecom equipment from non-resident where there is requirement to install and commission into service the equipment.

Discuss the tax treatment of the above transaction for non-resident. **(02)**

Q.4 Mr. Azhar has intentionally created an offshore entity in a Dubai where there is no taxation due to presence of double taxation treaty with Pakistan.

Required:
In the light of the provisions of the Income Tax Ordinance, 2001 briefly explain whether this will be treated as tax avoidance or tax evasion. What powers does Commissioner have to counter any such tax avoidance/evasion? **(04)**

Q.5 (a) Under the provisions of the Sales Tax Act, 1990 explain the provision under which Commissioner Inland Revenue cannot recover any tax due from the taxpayer till the disposal of appeal by Commissioner Inland Revenue (Appeals). **(02)**

(b) Hamza & co a ca firm is engaged in the business of providing accounting and audit services in Punjab and Sindh. Their head office is located in Karachi and is registered with Sind Revenue Board (SRB) as well as Punjab Revenue Authority (PRA). Hamza & co. pays the sales tax in the province from where the services are rendered. Recently they have received a notice from Punjab Revenue Authority (PRA) asking them to pay tax on invoices raised in respect of services rendered from Sindh to Punjab.

Required:
Under the provisions of the Provincial Sales Tax on Services Acts, advise Hamza & co. on the notice issued by PRA. **(03)**

(c) Under the provisions of Sales Tax, on receipt of the demand note from the referring authority, a recovery officer shall serve upon the defaulter a notice attaching his moveable and immovable property.

List any four particulars which are not liable to attachment and sale in execution of such notice. **(04)**

(d) After providing a reasonable opportunity of showing cause and of being heard, Mr. Khayanat was declared a defaulter by the Officer Inland Revenue under the Sales Tax Act, 1990. However, at the time of issuance of a demand note to the Recovery Officer, Mr. Khayanat died.

Required:
In view of the provisions of the sales tax, explain the status of the proceedings against Mr. Khayanat under the above circumstances and provisions relating to the payment of the dues as stated in the demand note. **(03)**

(e) A machine of Rs. 38 million was purchased in July 2022 but it was put to use in November 2022.

Required:
In the light of the provisions of the Sales Tax Act, 1990 and Rules made thereunder, identify and discuss the time (month) of supply for the chargeability of sales tax in respect of the above transaction. **(02)**

Q.6 MODAM Limited (ML) is engaged in the business of production and supply of large variety of goods. ML is registered with the Inland Revenue Department for sales tax purposes. Following data has been extracted from ML's records for the month of May 2023:

	Rupees
Purchases:	
Raw material:	
▪ from local registered suppliers	9,200,000
▪ cane molasses from local un-registered suppliers	2,000,000
▪ import	900,000
Import of finished goods	1,200,000
Supplies:	
Local:	
▪ taxable supplies to registered persons	7,200,000
▪ taxable supplies to un-registered persons	3,500,000
▪ exempt goods	250,000
▪ sale of imported finished goods	1,500,000
Supply of stores for consumption on plane proceeding from Lahore to UAE	600,000

Additional information:

(i) ML imported specific machinery at Rs. 588,235 for the production of bio diesel after obtaining certification from Alternative Energy Development Board (AEDB) and machinery of Rs. 1,000,000 under export facilitation scheme, 2021.

(ii) Purchases from local registered suppliers include purchase of gold and silver in unworked condition amounting to Rs.1,500,000 from Tele Limited.

(iii) 7,500 boxes of biscuits without retail packing were purchased from registered suppliers, not included above, at a wholesale price of Rs. 60 per box for onward sale. The retail price of these boxes was Rs. 90 per box.

(iv) Taxable supplies to registered persons include the following:
- Shampoo worth Rs. 700,000 supplied to a registered exporter Baramad Limited.
- Tiles of Rs. 650,000 supplied to Raja (Pvt) Limited. These Tiles were purchased directly from the manufacturer in April 2023. The retail price of tiles is Rs.800,000.

(v) Taxable supplies to un-registered persons include supply of Storage Batteries worth Rs. 400,000 to a private school. Purchase invoice confirms that these Batteries were purchased in March 2023 from an importer for Rs. 325,000 against payment of sales tax at the rate of 17%. The retail price of storage batteries is Rs. 500,000.

All the above figures are **exclusive of sales tax**, wherever applicable. Except for the item specified under Eight Schedule, sales tax is payable at the rate of **17%.**

Required:
In the light of the provisions of the Sales Tax Act, 1990 and Rules made thereunder, compute the amount of sales tax payable by or refundable to ML for the tax period May 2023. **(17)**

Q.7 Roshni Limited (RL) is engaged in the business of manufacturing and supply of tobacco products in the district of Dir and is registered under the Federal Excise Act, 2005. Following information is available from RL's records for the month of November 2022:

(i) Purchase of 2,000 kg of un-manufactured black leaf tobacco worth Rs. 228,000 from Dera Ghazi Khan. RL manufactured 46,000 packs of chewed smokeless tobacco commonly known as 'Naswar' and sold them to various stores in Khyber Pakhtunkhwa at a retail price of Rs. 10 per pack.

(ii) Import of 1,000 kg of un-manufactured tobacco from Brazil. The value assessed by the customs authorities at import stage amounted to Rs. 880,000. RL used 768 kg of un-manufactured tobacco for the production of 8,000 packs of tapered shape biris with the help of manually operated machine. Each pack consisted of 480 biris. RL sold 6,500 packs to dealers at a wholesale price of Rs. 600 per pack whereas 1,500 packs were supplied as provisions for consumption on board a ship that was proceeding to Bangladesh at a price of Rs. 650 per pack. These packs are usually sold in the market at a retail price of Rs. 696 per pack.

The remaining quantity of 232 kg of un-manufactured tobacco was sold to a manufacturer in District Mardan at Rs. 1,050 per kg.

(iii) Inland carriage charges of Rs. 25,000 were paid to an air cargo company for shipping the consignment of biris to Karachi Port.

(iv) Advertisement charges for the promotion of biris on a local cable T.V network amounted to Rs. 30,000. RL agreed to pay the amount to the cable network in the first week of December 2022.

Required:
Under the provisions of the Federal Excise Act, 2005 compute the amount of duty payable by or refundable to RL for the tax period November 2022.

Note: Show all relevant exemptions, exclusions and disallowances.

(09)

(The End)

Answer: 1 (a)

Mahad Limited (ML)
Computation of taxable income
Tax Year: 2023

			Marks
Income from Business			
Taxable income		12,000,000	
Add inadmissible expenses/admissible incomes			
Adjustment in the value of closing stock	3,000,000		1
Compensation from SNGP-No adjustment	-		1
Legal and other fee-capital nature expense	200,000		1
Tax gain on sale of IT machinery	212,500		1
Rent paid in advance	500,000		0.5
Donation paid to political party	50,000		0.5
Legal expenses for loan recovery	100,000		0.5
Fine to KPT	-		0.5
	4,062,500		
Less admissible expenses/inadmissible incomes			
Sale of land-taxable as separate block	1,000,000		0.5
Gain on sale of 1500 CC motor vehicle-taxable as capital gain	-		0.5
Return on investment in sukuk-taxable as separate block	1,000,000		1
	2,000,000		
	14,062,500		
Capital gain			
Gain on sale of land (Rs.6,000,000-5,200,000)-taxable as separate block	800,000		0.5
Gain on sale of 1500 CC motor vehicle-taxable as capital gain	200,000		0.5
	1,000,000		
Income from other source			
Return on investment in sukuks-taxable as separate block	**1,000,000**		0.5
Total income	16,062,500		0.5
Less income subject to separate block/FTR	1,800,000		0.5
Taxable income	**14,262,500**		
Tax liability @ 29%	4,136,125		0.5
Tax credit being lower of actual amount invested or Rs.150,000 per machine:			
Machine A	120,000		0.75
Machine B	150,000		0.75
	270,000		
Advance tax on sale of 1500CC vehicle prior to registration	200,000		0.5
NTR Liability	3,666,125		
Gain on sale of land @ 15%	120,000		0.5
Return on investment in sukuks @ 25%	250,000		0.5
Total tax liability	**4,036,125**		**14**

Regards: Saboor Ahmad (0302-9114479)

Answer:1 (b)

(b) Comments

(i)	The closing stock for the tax year can be lower of cost or net realizable value. It cannot be lower than both of these values. The amount of Rs.3,000,000 is therefore, added back to income to make the value of closing stock equal to cost.		1
(ii)	Compensation received on account of loss of revenue due to disruption of the production process is revenue in nature and is covered in the definition of income. No adjustment is required.		1
(iii)	Land is a capital asset of the company. Any expenditure incurred to acquire or improve capital asset is treated as capital expenditure and is not allowable as deduction against income from business. Hence legal and other fees spend to acquire land are not allowable as revenue expenditure but are capitalized.		1
(iv)	Legal fee of Rs.200,000 will be added in cost of the land and gain will be taxable as separate block. There will be no consequences for receiving sale proceeds in cash.		1
(v)	Business income is chargeable to tax on accrual basis. Gain will be calculated in the following manner:		
	Cost	1,500,000	
	Initial allowance @ 25%	375,000	
	WDV	1,125,000	
	Depreciation @ 30%	337,500	
	WDV at start of tax year 2023	787,500	
	Sale value	1,000,000	
	Gain on sale of machinery	**212,500**	
	Full year depreciation is allowed in the year of purchase whereas no depreciation is allowed in the year of disposal. Moreover, depreciation rate on machinery used in manufacture of IT products is 30%		1.5
(vi)	As vehicle has been sold without being used in business, no depreciation would have been allowed on it. Therefore, the said amount will be taxable as capital gain.		1
	Every motor vehicle registration authority of Excise and Taxation department shall at the time of registration collect tax at the rate of Rs.200,000 for vehicle of engine capacity 1000-2000CC. The said tax will be collected only if the locally manufactured motor vehicle is sold prior to registration by the person who originally purchased it from local manufacturer. The said tax collected is adjustable against normal tax liability.		1.5
(vii)	Return on investment in sukuks from a company is taxable as separate block @ 25% in case sukuk holder is a company.		1
(ix)	(a) Since half of the rent paid relates to the next tax year, it is disallowed at Rs.500,000		0.5
	(b) Donation of Rs.50,000 made to political party is not allowable expense because it was not for the purpose of business. Further, a donation paid to a political party does not qualify for any tax credit.		0.5
	(c) BL is not in the business of lending money. The legal expense of Rs.100,000 incurred in connection with a loan given to a former employee is not an expenditure incurred wholly and exclusively for the purpose of business. Therefore, Rs.100,000 is not deductible.		0.5
	(d) Rs.200,000 paid to KPT for not lifting the imported goods from the dock is an expenditure incurred wholly and exclusively for the purpose of business and is therefore deductible expense. The payment is not a fine or penalty for violation of any law, rule or regulation.		0.5
(x)	A person who is required to integrate with Board's computerized system for real time reporting of sale or receipt shall be entitled to tax credit in respect of amount invested in puchase of point of sale machine subject to lesser of actual amount invested or Rs.150,000 per machine.		1
			12

Answer: 2 (a)

(01 Mark for each year's correct answer)

Tax year	Loan to shareholder		Loan repaid	Actual dividend		Dividend for tax		Tax liability @ 25% as trans.income is exempt	
	Shifa	**Sana**	**Shifa**	**Shifa**	**Sana**	**Shifa**	**Sana**	**Shifa**	**Sana**
2020	50,000	-		Nil	Nil	50,000	Nil	12,500	-
2021			30,000			Tax of Rs. 7,500 should be refunded to Shifa on Rs.30,000		(7,500)	-
2022	Nil	Nil		30,000	60,000	10,000	60,000	2,500	15,000
2023				50,000	100,000	50,000	100,000	12,500	25,000
Total				**80,000**	**160,000**	**80,000**	**160,000**	**20,000**	**40,000**

Answer: 2 (b)

1 Mark for each correct answer

(i)

Amount that will be added in his salary on exercise of option 10 x 5000	50,000
Amount paid by him	25,000
Cost of shares in the hand of Usaid	**75,000**

(ii)

Cost of asset does not include any subsidy except to the extent to which the amount is chargeable to tax. The cost in the hands of ABC Ltd will therefore be only Rs. 55 million.

(iii)

Cost of the asset disposed of + excess consideration given for replacement asset

Rs. 500,000 + (Rs. 1,200,000- 1,000,000) = Rs.700,000

(iv)

Since XYZ Ltd is unregistered for Sales Tax purposes, sales tax paid will be included in the cost of the Asset.

Cost	25,000,000
Customization	5,000,000
Implementation	2,000,000
Sales tax @ 17% on Rs. 25 million	4,250,000
Total cost	**36,250,000**

(v)

Cost determined at the time of acquisition	5,200,000
Add: increase in liability due to price fluctation 25,000 x (260-104)	3,900,000
	9,100,000

Answer: 2 (c)

(02 Marks for (i), (ii) and 3 marks for (iii))

(i)
Web designing and web hosting services are subject to withholding at reduced rate tax of 3%. Therefore receipt of Rs. 10,185,000 must be grossed up by 97% to arrive at withholding tax of Rs.315,000. Tax on remaining amount of Rs. 33,000,000 (Rs.43,500,000-10,500,000) will be deducted at the time of payment by corporate clients.

(ii)
Where the recipient of the payment receives the payment through an agent or any other third person and the agent retains service charges or fee from the payment remitted to the recipient, the agent shall be treated to have been paid the service charges by the recipient and the recipient shall collect tax along with the payment received. In this scenario calculation will be as follows:

Total debt recovered by OF	Rs.10,185,000
Service charges retained by OF @ 2%	Rs. 203,700
Balance amount to be remitted to FPL	Rs. 9,981,300
Tax collectible by FPL @ 10% on Rs.203,700	Rs. 20,370
Total amount to be paid by OF to FPL	Rs. 10,001,670

(iii)

Liability under NTR @ 20% of taxable income	549,000	A
Minimum tax deductible on 43.5M @ 3%	1,305,000	B
Higher of A or B	1,305,000	
Less tax already deducted	315,000	
Balance payable	**990,000**	

Answer: 3

(i) The forward contract entered into by Mujtaba Hussian for the purchase of raw materials used in his business is in the nature of a hedging contract. He entered into this contract to safeguard against losses due to price fluctuation. Such contracts have specifically been excluded from the definition of speculative business. Consequently, payment to settle the forward contract is an expenditure incurred in the normal course of business and is a deductible expenditure. ***(02 Mark)***

(ii) As a widow, she has been exempt from filing an income tax return despite owning a 1300 cc car. However, starting a new business during the tax year 2023 obligates her to file an income tax return if her income from business exceeds Rs. 300,000. Although the reported figures in the question depict income of Rs. 200,000, which is below the threshold limit of Rs. 300,000, the expenditure amount is comprised of both personal as well as business expenses. However, for computing taxable income, only business expenses shall be allowed. Therefore, by considering business expenses only, her income may exceed Rs. 300,000 and consequently, she will be required to file the income tax return. Moreover, if her taxable income from business exceeds Rs. 600,000, she is required to pay tax based on rates given in the First Schedule of the Income Tax Ordinance. ***(03 Mark)***

(iii) Foreign source salary of Sidra shall be exempt from tax if she paid foreign income tax in respect of her salary. In this scenario there will be no implication of amount remitted to Pakistan. In case no foreign income tax is paid, salary will be fully taxable in Pakistan. ***(02 Mark)***

(iv)

For property acquired in tax year 2015, since 5 years would have elapsed in tax year 2021 therefore it is time bared and no proceedings can be initiated u/s 111. ***(01 Mark)***

For property acquired in tax year 2019,if Mr. Faheem offers no explanation about the nature and source of his investment in immoveable property or the explanation offered is not, in Commissioner's opinion, satisfactory, the value of the investment shall be included in Mr. Faheem's income chargeable to tax under the head "Income from other sources" to the extent it is not adequately explained.

The amount of the above investment shall be included in the income chargeable to tax in the tax year to which such amount relates. Further, if the declared cost of his investment in immoveable property is less than reasonable cost of the investment, the Commissioner may, having regard to all the circumstances, include the difference in Mr. Faheem's income chargeable to tax under the head "Income from other sources" in the tax year to which the investment relates. ***(1.5 Marks)***

Valuation of asset ***(0.75 Marks)***

For purpose of section 111, average sale price of the sales recorded in the revenue record of the estate in which agriculture land is situated for relevant period of time will be used.

Penalty: ***(0.75 Marks)***
If Mr. Faheem conceals his investment in immoveable property or furnishes inaccurate particulars of his investment, in the course of any proceeding under the Ordinance before any Income Tax Authority or the Appellate Tribunal, he shall pay a penalty of Rs.100,000 or an amount equal to the tax evaded whichever is higher.

Prosecution for concealment of investment in property: ***(0.5 Marks)***
Moreover, in the course of any proceedings under the Ordinance, Mr. Faheem, either in the course of that proceeding or in any earlier proceedings conceals his investment or furnishes inaccurate particulars of his investment and the revenue impact of such concealment or inaccurate particulars is five hundred thousand rupees or more, he shall be guilty of an offence punishable on conviction with imprisonment up to two years or with fine or both.

Default surcharge: ***(0.5 Marks)***
Mr. Faheem shall also be liable to pay default surcharge at a rate equal to 12% per annum on the tax or penalty unpaid computed for the period commencing on the date on which the tax or penalty was due and ending on the date on which it was paid.

(v) Import of goods whether or not the title to the goods passes outside Pakistan will be Pakistan sourced business income of the non-resident if the import is part of an overall arrangement for the supply of goods, installation, construction, assembly, commission, guarantee or supervisory activities and all or principal activities are undertaken or performed either by associates of the persons supplying the goods or by its permanent establishment whether or not the goods are imported in the name of the person, associate of the person or any other person.

(02 Marks)

Answer: 4

(01 Mark for each correct point)

- It will be treated as tax avoidance.
- As per section 109 of the ITO,2001 Commissioner may disregard an entity or a corporate structure that does not have an economic or commercial substance or was created as part of tax avoidance scheme.
- Tax avoidance scheme means any transaction where one of the main purpose of a person entering into the transaction is the avoidance or reduction of any person's liability to tax under the Ordinance.
- Since objective of the transaction was to avoid tax, therefore, CIR may initiate proceedings under section 109.

Answer: 5

(a) Commissioner Inland Revenue shall not issue notice for recovery of any tax due from a taxpayer if the said taxpayer has filed an appeal to Commissioner Appeals under section 45B in respect of the order under which the tax sought to be recovered has become payable and the appeal has not been decided by CIR-A, subject to condition that ten percent of the amount of tax due has been paid by the taxpayer. ***(02 mark)***

(b) The Sindh Sales Tax on Services Act 2011 operates on the basis of principle of origin, whereby tax is levied at the place from where services are initiated. Accordingly, tax is paid to the tax authority having jurisdiction of the place of origin, i.e., SRB. The Punjab Sales Tax on Services Act 2012 on the other hand, operates on the principle of both origin and destination whereby tax is imposed, levied and collected in Punjab if services are either initiated in Punjab or consumed or delivered in Punjab.

Therefore if services is booked in Karachi for onward delivery to Lahore, Sindh Sales Tax will need to be paid to SRB on the basis of origin. However, in Punjab also such service would again be exposed to Punjab Sales Tax on the basis of destination principle. ***(03 mark)***

(c)

(1 mark for each correct answer)

<u>Property not liable to attachment and sale in execution [U/R 80]</u>

Following particulars shall not be liable to attachment or sale, namely:

(i) The necessary wearing apparel, cooking vessels, beds and bedding of the defaulter, his wife and children, and such personal ornaments, as, in accordance with religious usage, cannot be parted with by any woman;

(ii) Tools of artisan, and, where the defaulter is an agriculturist, his implements of husbandry and such cattle and seed grain as may, in the opinion of the Recovery Officer, be necessary to enable him to earn his livelihood as such;

(iii) Stipends and gratuities allowed to a pensioner of a Government or payable out of any service or family pension fund notified in the official Gazette by the Federal Government or the Provincial Government in this behalf, and political pensions;

(iv) The wages of labourers and domestic servants, whether payable in money or in kind;

(v) Salary to the extent of first hundred rupees and one half of the remainder;

(vi) All compulsory deposits and other sources in or derived from any fund to which the Provident Funds Act, 1925, for the time being applies, in so far as they are declared by the said Act not to be liable to attachment;

(vii) Any allowance forming part of the emoluments of .any servant of the Government or local authority which the Federal Government or Provincial Government may, by notification in the official Gazette, declare to be exempt from attachment, and any subsistence grant or allowance made to any such servant while under suspension;

(viii) Any expectancy of succession by survivor-ship or other merely contingent or possible right or interest; and

(ix) A right to future maintenance.

(d)

Continuance of proceedings: [U/R 138 of Sales Tax Rules, 2006]

No proceedings shall cease to be in force by reason of the death of the defaulter (Mr. Khayanat).

If, at any time before or after the issue of a demand note to the Recovery Officer, Mr. Khayanat dies, the proceedings may be continued against the legal heirs of Mr. Khayanat, who shall be liable to pay, out of the properties left by the deceased defaulter to the extent to which the properties are capable of meeting the outstanding Government dues, and it would be considered that as if the legal heirs were the defaulter.

(3 marks)

(e)

July 2022: Time of supply is the time when goods are available to the recipient of the supply irrespective of their use. ***(02 Marks)***

Answer: 6

ML Limited

Computation of net sales tax liability

Tax Period: May 2023

Particulars	Workings	Value of supply	Tax rate	Sales tax	Sales tax withheld	Marks
INPUT TAX						
Raw material purchase from local register suppliers excluding gold and silver inunworked condition		7,700,000	17%	1,309,000		1
Purchase of silver and gold in unworked conditions		1,500,000	1%	15,000		1
Purchases from unregisterd supplier-full amount to be withheld		2,000,000		-	290,598	0.5
Import (own consumption)		900,000	17%	153,000		0.5
Biscuit without retail packing (Rs. 7500 x 60)		450,000	17%	76,500		1
Import of finished goods		1,200,000	20%	240,000		0.5
Machinery under export facilitation scheme-exempt		1,000,000				0.5
Import of bio diesal machinery @ 17% not to be considered for 90% rule		588,235		1,793,500		0.5
Input tax disallowed	3			(218,033)		2.5
Total		15,338,235		**1,575,467**	**290,598**	
OUTPUT TAX						
Taxable supplies to registered person	1	5,850,000	17%	994,500		0.5
Sale of finished goods Tiles-taxable at retail price		800,000	17%	136,000		0.5
Taxable supplies to un-registered persons	2	3,100,000	17%	527,000		0.5
Sale of finished goods storage batteries-taxable at retail price		500,000	17%	85,000		1
Zero rating (600 + 700)	4	1,300,000	0%	-		1
Exempt goods		250,000				0.5
Sale of finished goods imported		1,500,000	17%	255,000		0.5
		13,300,000		**1,997,500**	-	
Calculation of tax liability						
Output tax				1,997,500		
Less input tax being lower of:						
90% of Rs.1,997,500		1,797,750				
Actual input tax		1,575,467		1,575,467		
Balance payable				422,033		1
Input tax on fixed assets	4			(85,238)		1
3% Further tax on supplies to non-registered persons- Not applicable on storage batteries as they are 3rd Schedule items		3,100,000	3%	93,000		1
Add deducted as withholding agents				290,598		0.5
Balance sales tax payable				**720,394**		
Sales tax refundable on zero rated supplies				**195,248**		1
Workings:						17
W-1:						
Supplies to registered persons		7,200,000				
Export of shampo- Zero rated		(700,000)				
Tiles taxabe at retail price		(650,000)				
		5,850,000				
W-2:						
Supplies to un-registered persons		3,500,000				
Storage batteries- taxable at retail price		(400,000)				
		3,100,000				

W-3:	
Apportionment of input tax	
Taxable supplies	8,950,000
Exempt supplies	250,000
Zero rated supplies	1,300,000
	10,500,000
Residual input tax (excluding finished goods and machinery)	1,477,000
Sales tax Refundable on zero rated supplies	182,867
Sales tax pertaining to exempt supplies	35,167
Input tax disallowed	218,033
Residual input tax on machinery	100,000
Sales tax Refundable on zero rated supplies	12,381
Sales tax pertaining to exempt supplies	2,381
Input tax disallowed	14,762
Input tax allowed on fixed assets	85,238
W-4:	
Supplies made to exporters under the Duty and Tax Remission Rules, 2001 are zero rated. It is assumed that sales are made under the DTRR, therefore the same will be considered as zero rated.	

Answer: 7

Roshni Limited (RL)				
Computation of net federal excise duty				
Tax Period: November 2022				**Marks**
Input tax	**Value of supply**	**Rate**	**Amount**	
Purchase of un-manufactured tobacco-Inadmissible as used for exempt supplies	228,000	inadmissible	-	1
Import of unmanufactured tobacco (768kg x 390)	675,840	390/kg	299,520	0.75
Import of unmanufactured tobacco (232kg)-inadmissible as he is trading	204,160	inadmissible	-	1
Inland carrigage of goods-input not admissible on services	25,000			0.5
Advertisement on cable tv network-input not admissible on services	30,000		-	0.5
			-	
			299,520	
Less inadmissible duty due to zero rating (Rs. 299,520 x 1500/8000)			(56,160)	1
			243,360	
Output tax				
Sale of 46K packs of Naswar @ Rs. 10 per pack-Exempt under 3rd schedule	460,000	Exempt	-	1
Sale of 6,500 packs - retail price is 1,450 per thousand (i.e. 696/480×1,000) less than 6,660/1000	3,120,000	2050/1000 cigarettes	6,396,000	1
Supply 1,500 packs as provision for consumption on ship	975,000	0%	-	0.75
Sale of imported un-manufactured tobacco (232 kg @ 1,050)	243,600	Exempt	-	1
			6,396,000	
Net duty payable			**6,152,640**	
Duty drawback			**56,160**	0.5
				9

(THE END)

The Professionals' Academy of Commerce
Pakistan's Leading Accountancy Institute

Certified Finance and Accounting Professional Stage Mock Examinations

25th May, 2023
3 hours – 100 marks
Additional reading time - 15 minutes

Audit, Assurance & Related Services

Q.1 Protect and Serve Limited (PSL) manufactures and installs safety barriers which improve workplace safety in warehouses, car parks and airports. You are the audit manager responsible for planning the audit of PSL for the year ended 30 November 2022. Assume the date is 5 December 2022.
You have been provided with the following financial information:

Statement of profit or loss for the year ended 30 November (extract)

	2022 (draft) Rs. '000	**2021 (audited) Rs. '000**
Revenue	69,230	78,560
Gross profit	8,140	11,080
Profit before interest and tax	1,246	2,270

Statement of financial position as at 30 November (extracts)

	2022 (draft) Rs. '000	**2021 (audited) Rs. '000**
Current assets		
Cash and cash equivalents	–	96
Non-current liabilities		
6% bank loan	10,000	10,000
Current liabilities		
Bank overdraft	84	–

1. The year ended 30 November 2022 has been difficult for PSL due to the expiry of a patent in December 2021 as PSL was unable to renew it due to import related restrictions in Pakistan. This patent applied to 25% of product sales made by PSL. The expiry of the patent resulted in cheaper alternatives being produced by competitors. As a result, PSL has lost several major contracts. Two of PSL's largest remaining airport customers are due to put their contracts out to tender in February 2023. PSL has been funded by a bank loan for many years. The bank requires PSL to maintain a minimum interest cover of 3.0.

2. You reviewed PSL's board minutes and identified the following matters for further consideration:
   (a) In August 2022, PSL received a letter from the lawyers of a customer, Park First Limited (PFL), regarding the poor quality of safety barriers supplied to it by PSL in March 2022. The letter claims that an accident occurred in the manufacturing facility of PFL which should have been prevented by the safety barriers. PFL suffered significant business disruption and lost revenue and is claiming damages of Rs. 350,000 from PSL.
   (b) PSL's operations manager found that a batch of safety barriers produced in March 2022 had failed quality control checks. These safety barriers were shipped to customers, one of which was PFL, instead of being scrapped as intended.
   (c) In June 2022, Labor Department (LD) commenced an investigation into breaches by PSL of the Pakistan minimum wage legislation. LD has requested payroll records for the past five years. PSL's lawyers have advised that it is likely that Rs. 150,000 in wages and tax arrears and a penalty of Rs. 20,000 will need to be paid.
   (d) No adjustments have been made to the financial statements for the year ended 30 November 2022 in respect of PFL's complaint or the LD investigation.

Required:
Identify and discuss the audit risks that exist in the above scenario and how you would respond to these risks.
(22)

Q.2 You are an audit senior working for Zarrar and Company Chartered Accountants (ZC). You have just been assigned to the audit of Comfort Chappal Limited (CCL), for the year ended 30 September 2022. CCL is a footwear manufacturer. CCL claims that its business is sustainable as its footwear is long-lasting and durable and the leather that it uses is a by-product of the agricultural industry. From 1 October 2021, responding to high demand for its products, CCL outsourced some of its production to Ritz Company (RICO), a company based in Cambodia. In the year ended 30 September 2022, RICO produced 40% of CCL's footwear. There have been negative media stories about carbon emissions in the supply chains of the recycled plastic industry and CCL is concerned about the impact on its brand reputation.

Management has prepared draft disclosures on social and environmental issues in relation to products and the supply chain, for inclusion in CCL's published annual report. Information on other aspects of sustainability will be added later. In the year ended 30 September 2021, the data is for CCL's (Pakistan) PK operations only. The data for the year ended 30 September 2022 also includes, for the first time, data from CCL's outsourced supply chain manufacturer, RICO in Cambodia.

CCL has established KPIs to monitor its progress towards its long-term targets, as follows:

	30 September 2021 (PK only)	**30 September 2022 (PK and RICO)**	**Target 2030 (PK and RICO)**
Energy from renewable sources	10%	36%	100%
Materials from sustainable sources	40%	64%	90%
Waste per item	19 grams	26 grams	< 17 grams
% of product returns	15%	25%	< 10%

Commentary

- **Energy from renewable sources**

  RICO's factory in Cambodia uses solar energy as its main source of power. Therefore, CCL's progress towards using energy from renewable sources has increased from 10% to 36% between 30 September 2021 and 2022.

- **Materials from sustainable sources**

  The inclusion of data from RICO, our manufacturer in Cambodia, has improved KPIs on the use of sustainable materials because RICO uses recycled plastic for the soles.

- **Waste per item (in grams)**

  Leather is a major raw material in CCL's footwear. The high-quality sustainable leather used in PK production helps to minimise the waste sent to landfill. The waste per item in grams has increased because of difficulties that RICO management has experienced in obtaining high-quality sustainable leather. CCL is working with RICO's management to ensure that leather is traceable to a suitable supplier.

- **% of product returns**

  The increase in returns relates mostly to products produced by RICO. Customers complain of poor fit and quality resulting in an increase in returns to 25%. CCL is working with RICO to address production quality issues.

Required:

(a) Discuss ZC's responsibility as the auditor in respect of social and environmental disclosures in CCL's published annual report for the year ended 30 September 2022. **(06)**

(b) Explain any inadequacies with the draft disclosures relating to the product and the supply chain. **(09)**

(c) Evaluate the implications of these draft disclosures for the audit of the financial statements for the year ended 30 September 2022. (Impact on audit report is not required) **(04)**

Q.3 You are the manager responsible for the audit of Hashim Jewellers (HJ), a jewellery manufacturer and retailer. The final audit for the year ended 31 March 2017 is nearing completion and you are reviewing the audit working papers. The draft financial statements recognise total assets of Rs. 1,919 million (2016 – Rs. 1,889 million), revenue of Rs. 1,052 million (2016 – Rs. 997 million) and profit before tax of Rs. 107 million (2016 – Rs. 110 million). Three issues from the audit working papers are summarised below:

(a) **Cost of inventory**

Inventory costs include all purchase costs and the costs of conversion of raw materials into finished goods. Conversion costs include direct labour costs and an allocation of production overheads. Direct labour costs are calculated based on the average production time per unit of inventory, which is estimated by the production manager, multiplied by the estimated labour cost per hour, which is calculated using the forecast annual wages of production staff divided by the annual scheduled hours of production. Production overheads are all fixed and are allocated based upon the forecast annual units of production. At the yearend inventory was valued at Rs. 21 million (2016 – Rs. 20 million). **(07)**

(b) **Impairment**

At the yearend management performed an impairment review on its retail outlets, which are a cash generating unit for the purpose of conducting an impairment review. While internet sales grew rapidly during the year, sales from retail outlets declined, prompting the review. At 31 March 2017 the carrying amount of the assets directly attributable to the retail outlets totaled Rs. 137 million, this includes both tangible assets and goodwill.

During the year management received a number of offers from parties interested in purchasing the retail outlets for an average of Rs. 125 million. They also estimated the disposal costs to be Rs. 1·5 million, based upon their experience of corporate acquisitions and disposals. Management estimated the value in use to be Rs. 128 million.

This was based upon the historic cash flows attributable to retail outlets inflated at a general rate of 1% per annum. This, they argued, reflects the poor performance of the retail outlets. Consequently, the retail outlets were impaired by Rs. 9 million to restate them to their estimated recoverable amount of Rs. 128 million. The impairment was allocated against the tangible assets of the outlets on a pro rata basis, based upon the original carrying amount of each asset in the unit. **(07)**

(c) **Warranty provision**

Each year management makes a provision for jewellery returned under warranty. It is based upon an estimate of returns levels for each product type (rings, bracelets, necklaces, watches, earrings, etc.) and is calculated on an annual basis by the sales director. The breakdown for the current provision, as extracted from the notes to the financial statements, is as follows:

	Rs. million
At 1 April 2016	11·5
Provisions charged during the year	0·5
Provisions utilised during the year	(1·9)
Unutilised provisions reversed	(3·1)
At 31 March 2017	7·0

(06)

Required:

Comment on the matters to be considered and explain the audit evidence you should expect to find during your file review in respect of each of the issues described above.

Q.4 (a) You are an audit senior at Zaman and Company Chartered Accountants (ZC). The following situations have arisen at one of the audit clients for the year ended 31 December 2022.

Home Essentials Limited (HEL) sells household products online exclusively through a third-party web portal, owned by Hub Limited (HL). HL processes the sales transaction and payment and arranges delivery of products to customers. Sales are spread evenly across the year. Detailed monthly sales data are passed from HL's system to HEL's cloud-based general ledger through an automated process. A major IT incident at HL resulted in a breakdown due to which information of sales for the month of November 2022 was lost. As a result, HEL has been unable to provide your firm with a breakup of revenue for November 2022. However, a cash transfer for November sales was made by HL to HEL as normal. HEL's management has used this figure as November sales in the general ledger.

Required:

Discuss responsibilities of the auditor and any actions your firm should now take and suggest the implications for the auditor's report for the year ended 31 December 2022. (If any) **(07)**

(b) You are an audit manager at Asif Ali and Company (AAC) and are working on the audit of Avenue Shopping Malls Ltd (ASM) for the year ended 30 September 2022. ASM'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.

In order to raise immediate funds to take advantage of an opportunity to buy a shopping mall from a struggling competitor, ASM 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 ASM has recognised as income. At the date of sale, the carrying amount of the mall was its fair value of Rs. 9,720 million. ASM has continued to recognise the carrying amount of the mall in its statement of financial position. Legal title to the mall was passed to the purchaser, Synergy Bank, however under the terms of the arrangement, ASM 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 ASM to pay annual rental charges of Rs. 900 million to Synergy 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.

Required:

(a) Explain the above issue and also recommend adjustments in the draft financial statements. **(07)**

(b) Explain the impact on the auditor's report if management refuses to adjust the financial statements.

Q.5 You are working as quality control partner at Danish Nawaz and Company Chartered Accountant (DNC) and currently evaluating following situations with respect to two listed clients.

Samma Agricultural Industries (SAI)

i. Zainab Iqbal (audit partner) was introduced to Abdullah, finance director of Khaas 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.

ii. 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.

System Auto Limited (SA)

i. Zainab Hassan (finance director of SA) has asked DNC to perform an additional engagement to determine the fair value of the new production line from Germany which SA is hoping to purchase in next year.

ii. DNC has the policy to rotate audit engagement partner at every client after four years. Alina Shah was the previous audit engagement partner at SA for four years. A meeting has been arranged with SA, Alina Shah and the new audit engagement partner, Yusuf Abbas, later this week. Zainab Hassan has requested on phone that Alina Shah acts as audit engagement partner for the coming year. She is concerned that Yusuf Abbas is not as knowledgeable about SA's business and believes the audit will be more efficient and of a higher quality by continuing Alina Shah.

Required:

Discuss the professional and ethical issues and recommend the appropriate actions.

(14)

Q.6 You are the manager in Cashmir and Company Chartered Accountants (CC). Viana Limited (VL) has approached your firm in order to obtain an independent assurance opinion on a cash flow forecast which is being prepared for its bankers in support of an application for an increase in its existing overdraft facility.

VL cash flow forecast for the four quarters ending 30 June 2024:

	1st Quarter 30 September 2023 Rs. in million	2nd Quarter 31 December 2023 Rs. in million	3rd Quarter 31 March 2024 Rs. in million	4th Quarter 30 June 2024 Rs. in million
Operating cash and receipts				
Cash sales-high street shops	326	352	380	410
Cash sales-online	509	529	550	572
Receipts from credit sales-online	899	926	954	982
	1,733	1,807	1,884	1,965
Operating cash payments				
Purchases of inventory	(813)	(854)	(880)	(924)
Salaries	(544)	(533)	(539)	(554)
Overheads	(484)	(470)	(479)	(499)
	(1,842)	(1,857)	(1,898)	(1,977)

Other cash flows				
Initial costs of new high street shops	(161)	(85)	-	-
Online marketing campaign	(47)	(32)	(29)	(21)
	(208)	(117)	(29)	(21)
Cash flow for the period	(316)	(167)	(43)	(33)
Opening cash	(689)	(1,006)	(1,173)	(1,216)
Closing cash	(1,006)	(1,173)	(1,216)	(1,249)

The following information is also relevant:

i. VL is a retailer of academic textbooks which it sells through its own network of book shops and online through its website. The revenue from the website includes both cash sales and sales on credit to educational institutions. The company has provided historical analysis from its trade receivables ledger indicating that for sales made on credit, 10% pay in the month of the sale, 62% after 30 days, 16% after 60 days, 8% after 90 days and the remainder are irrecoverable debts.

ii. VL receives a settlement discount from its principal suppliers of 8% if it pays within 14 days of receipt of the inventory. It is company policy to make the early payment wherever possible. If the company pays after 45 days, it incurs a late payment penalty of 5%.

iii. The company already has an established presence in large cities with universities but has seen a decline in its core operations in recent years which has led to a decrease in revenue and a fall in liquidity. In order to reverse these trends, the company is planning to extend its operations by opening new shops in small cities with universities and large colleges.

iv. VL's management is planning an online marketing campaign targeted at the university sector which they believe will increase the company's market share by approximately 3%.

v. The company has an existing overdraft facility of Rs. 900 million with its bankers and has requested an increase in the facility to Rs. 1,275 million.

Required:

Assuming CC accepts the engagement, recommend the examination procedures to be performed in respect of VL's cash flow forecast. **(11)**

(THE END)

Audit, Assurance & Related Services
Suggested Answers
Certified Finance and Accounting Professional Stage – Mock Summer 2023

Answer: 1

Going concern op *(04 Marks)*

The gross profit margin has fallen from 14.1% to 11.8% and the profit before interest and tax margin has fallen from 2.9% to 1.8%. This is due to:

- difficult trading conditions.
- leading to cheaper alternatives being available.
- which has led to major contracts being lost.

Two major customers are putting contracts out to tender:

- PSL is unlikely to be competitive leading to further loss of business.

There have been cash flow issues during the year: - net cash outflow in the year of Rs. 180k.

- PSL is now using an overdraft.
- which is an expensive form of funding and can be withdrawn at any time.

The bank loan requires a minimum interest cover of 3.0:

- interest on the loan is Rs. 600k.
- interest cover has fallen from 3.78 to 2.08.
- PSL is no longer meeting loan covenant.
- which means the bank may recall the loan or apply penalties.

Audit Procedures *(04 Marks)*

Discuss with management future financing plans, the likelihood of the loan being recalled and the likely outcomes of other tenders.

Inspect board minutes for evidence of discussion of future financing plans, the likelihood of the loan being recalled and the likely outcomes of other tenders.

Obtain a written representation from management regarding future financing plans.

Assess whether plans for future financing are realistic.

Examine cash flow or profit forecasts for at least

12 months after the financial statements are expected to be approved, to ascertain whether PSL can:

- cover liabilities as they fall due.
- meet the interest cover covenant in future periods.

Consider the reasonableness of any assumptions underlying the forecasts particularly regarding:

- the two airports whose contracts are due for tender.
- payments for the claim by Fairlawn or the wages and tax arrears and penalty from LD.

Perform sensitivity analysis on key variables such as selling prices or volumes.

Inspect post year end management accounts for expected sales and profitability.

Inspect the loan agreement for consequences of breaching the covenant.

Inspect correspondence with bank for evidence of its relationship with PSL or its intention to recall loan.

Inspect correspondence with customers for evidence of plans to terminate contracts.

Revenue *(01 Mark)*

There is a risk of overstatement because:

- the patent expired in December 2021 and affected 25% of sales.
- yet revenue has fallen by only 11.9% which is significantly less than expected.

Audit Procedures *(02 Mark)*

Discuss with management why revenue has only fallen by 11.9% instead of the 25% for product sales previously covered by the patent.

Trace a sample of entries in the sales account to goods despatch notes to determine whether the recorded transactions have occurred.

Perform cut-off testing: eg, trace a sample of despatch notes around the year end to invoice entries (in the correct period).

Perform analytical procedures: eg, obtain a breakdown of revenue by geographical location and compare year on year.

Intangible assets *(0.5 Marks)*

There is a risk of overstatement:

- if an intangible asset was capitalised for the patent, it will need to be written down.

Audit Procedures *(0.5 Marks)*

Inspect the intangible asset register and confirm that any intangible asset for the patent has nil value.

Provisions *(3.5 Marks)*

PSL is being sued by a customer, PFL, for Rs. 350k:

- the amount of the claim is material at 54.1% of profit before tax (Rs. 350k / (Rs. 1,246k - Rs. 600k interest) or 0.5% of revenue.
- there may be other customers impacted.
- which could result in additional payments to other customers.

LD has commenced an investigation into breaches of minimum wage legislation:

- the amount of the LD wages and tax arrears and penalty material at 26.3% profit before tax (Rs. 170k / (Rs. 1,246 - Rs. 600k interest).
- PSL's lawyers have advised that the LD wages and tax arrears and penalty are likely to be payable.
- breaches of minimum wage legislation may be an indication of poor management integrity.

There is a risk of understatement because:

- the board is not adjusting for claims. however it appears probable that there will be an outflow of economic benefits as a result of past events.

The amount of any provisions will be based on estimates and the likelihood of payment based on management judgement.

The large outflow of funds may add to the going concern issues.

Audit Procedures *(04 Marks)*

Obtain a written representation from management on the completeness of provisions.

Discuss with management the reason for not making a provision.

Inspect post year end bank statements for evidence of payments to PFL and/or LD.

Obtain a second opinion from an auditor's expert regarding likelihood of PFL claim being successful or the likely amount of the

LD wages and tax arrears and penalty.

Inspect the contract with PFL regarding terms relating to quality issues.

Inspect correspondence with PFL regarding the nature of the quality issue and the amount of the claim.

Inspect any legal correspondence regarding the likely outcome of claim.

Discuss with management whether there has been an impact on other customers.

Inspect correspondence with customers for evidence of additional claims.

Inspect board meeting minutes for evidence of other quality issues or claims.

Inspect correspondence from HRMC regarding the basis of investigation.

Inspect legal correspondence regarding the amount of wage and tax arrears and the value of the fine.

Recalculate the wage and tax arrears.

Assess the reasonableness of any assumptions or estimates used to calculate the wages and tax arrears.

Inventory valuation ***(01 Mark)***

If there are quality issues, inventory may not be valued at the lower of cost and net realisable value.

Inventory may therefore be overstated.

Audit Procedures ***(01 Mark)***

Assess steps taken to recall or replace faulty barriers.

Obtain an inventory report and determine whether any inventories from the faulty batch are included and have been appropriately written down.

Window dressing ***(0.5 Marks)***

Management has an incentive to window dress the financial statements to meet the bank loan covenant and avoid the recall of the loan.

The damage to PSL's reputation and loss of a key patent has resulted in lost customers and an adverse impact on cash and profits.

Answer: 2 (a)

ZC has a duty to ensure that information published in the annual report does not conflict with other information in the audited financial statements.

Social and environmental matters have a material impact on financial statements. When these matters are significant to an entity, there may be a risk of material misstatement (including inadequate disclosure) in the financial statements. ***(02 Mark)***

ISA 720 makes it clear that no opinion is expressed but that an auditor is required to read the other information and do the following: ***(02 Mark)***

- Consider where there is material inconsistency with other information in the financial statements
- Consider where there is material inconsistency with other information and the auditor's knowledge obtained during the audit.
- Respond appropriately is a material inconsistency is identified; and
- Report in accordance with ISA 720.

ISA 720 requires auditors to include an 'Other information' section in the audit report which must include:

- A statement that management is responsible for other information.
- Identification of the other information,
- A statement that the auditor's opinion does not cover the other information and no opinion is expressed
- A description of the auditor's responsibilities regarding reading and considering the other information' and a statement to say that there is nothing to report or where there is material uncorrected misstatement a statement to describe this. ***(02 Mark)***

Answer: 2 (b)

The disclosures for 2022 include both CCL and RICO. It is therefore not possible to make meaningful like-for-like comparisons with the previous year and CCL should show its results separately. ***(01 Mark)***

Product and supply chain

Energy from renewable sources ***(03 Marks)***

Although the disclosure notes the positive effect of including RICO – The disclosure does not make it clear how the company will achieve the ambitious target of 100% by 2030. The figure of 10% for 2021 relates to CCL's PK factory only. In 2022, 60% of production was in the PK and 40% in Cambodia. The figure of 36% in the disclosure note assumes that 75% of RICO's energy is from renewable sources.

% production x renewable energy %	%
PK 60% x 10%	06
RICO 40% x 75%	30
36	

Materials from sustainable sources ***(04 Marks)***

Although the KPI for use of sustainable sources has improved because of the inclusion of RICO, the scenario notes that the negative media stories about the supply chain for the plastic recycling industry could lead to reputational and financial implications for CCL. Additional provisions or asset impairments may be required. The disclosures do not address these issues.

% production x sustainable sources %	%
PK 60% x 40%	24
RICO 40% x 100%	40
	64

The disclosure figure of 64% assumes that 100% of the materials used by RICO are from sustainable sources. This is contradicted by the disclosures relating to grams of waste per item.

CCL's definition of the meaning of 'sustainable sources' should be defined – in the introduction to the scenario the definition presented is subjective and challengeable – CCL "claims that its business is sustainable as its footwear is long lasting and durable and the leather it uses is a by-product of the agricultural industry."

How is this bench marked against other footwear manufacturers?

- Waste per item (in grams) and % of product returns

Using recycled material and lower quality leather has contributed to an increase in waste and returns – this could lead to provisions and allowances being required for returns and inventory in financial statements. The disclosures here are moving in the wrong direction to the aims stated by CCL.

Qualitative nature of disclosure ***(01 Mark)***

The disclosures contain terms such as 'sustainable sources' and renewable sources' which are not defined and are judgmental.

Answer: 2 (c)

ZC will need to consider the implications of social and environmental disclosures on the audit of the financial statements particularly when planning the audit, carrying out audit procedures and at the audit review stage.

CCL will need to consider the above disclosures as part of understanding the nature of the business and the inherent risk assessment. *(01 Mark)*

Substantive procedures *(02 Marks)*

CCL should consider the effects of social or environmental issues on the financial statements when designing audit procedures and substantive procedures will be required particularly for the following:

- Provisions (for returns – and inventory impairment)
- Contingent liabilities (for example, in relation potential breaches of laws and regulations)
- Asset values (issues may impact on impairment of inventory or intangibles)
- Going concern issues (considered below under audit reviews)

Audit review *(01 Mark)*

RICO is a key supplier to CCL – and should be included in the audit review.

ZC should consider the implications of the loss of this supplier on CCL's ability to continue as a going concern. Loss of reputation – may lead to fall in future revenue and impact on going concern.

Answer: 3 (a)

Cost of inventory
Matters
Materiality *(01 Mark)*
Inventory costs represent 1·1% of total assets and 19·6% of profit. Inventory is therefore material to both the statement of financial position and the statement of profit or loss.
Risk of material misstatement *(01 Mark)*
The calculation of the cost of inventory is complex. This complexity increases the risk of error in the calculation, which increases the risk of misstatement.
The calculation is also subject to a number of estimates; the average production time per unit, the forecast annual wage cost, the scheduled hours of production and the forecast units of production are all estimates. These estimates increase the risk of both error and manipulation of the calculation to suit management's bias.
Given both the complexity and subjectivity involved in the calculation there is a significant risk that the inventory cost may be misstated.
Evidence expected to be on file: *(05 Mark)*

i. Documentation of the system for obtaining the data used in the costing exercise and calculating the final cost. This should identify the key controls that operate in this system and there should be evidence on file that these controls have been appropriately tested.
ii. A copy of the summary of inventory purchase costs. A sample of the purchase costs, including the additional costs of transport and handling, should have been confirmed through inspection of original purchase invoices, copies of which should also be on file.
iii. Documentation of the results of a discussion with the production manager to ascertain how they estimate the average production time per unit of inventory. Any calculations referred to by management should have been reperformed by the audit team to confirm their mathematical accuracy and agreed to corroborating documentation.

iv. A copy of the calculation of the forecast annual wage cost. The initial staffing levels should have been confirmed through inspection of current human resource records and for a sample of the staff their initial wages should have been confirmed through inspection of payroll records.

v. Forecast wage increments should have been agreed to either post year end confirmation issued by human resources or minutes of board meetings approving pay rises.

vi. Documentation of the results of a discussion with management regarding how the forecast is made and who is ultimately responsible for reviewing and approving the forecast.

vii. A copy of the calculation of forecast units of production. This should have been analytically reviewed in comparison to the previous year's production levels. Where there are significant differences, explanations should have been sought from management.

viii. A copy of the calculation of forecast production overheads. This should have been analytically reviewed by category of overhead in relation to the previous year to identify any significant variances. Corroborating evidence, such as rental and utilities agreements, should have been obtained where possible.

ix. There should be evidence on all management's schedules that the figures have been recalculated by the audit team to confirm the mathematical accuracy of management's calculations.

Answer: 3 (b)

Impairment
Matters

Materiality ***(01 Mark)***
The impairment of Rs. 9 million represents 0·47% of total assets and 8·41% of profit. While it is not material to the statement of financial position it is material to the statement of profit or loss.

Calculation of recoverable amount ***(01 Mark)***
The fair value of the retail outlets, the disposal costs and the value in use are all management estimates. This increases the risk of material misstatement through both error and management manipulation of the reported figures.

In particular, while the estimate for the fair value appears to have a reasonable basis, the estimate of value in use appears to be too basic. The assumption that the cash flows attributable to the whole of the retail division will grow at 1% per annum is too simplistic and appears to lack commercial justification. It is likely that each retail outlet will be subject to regional variations in growth and growth rates will also be subject to annual fluctuations based upon economic variables. There is also no justification as to why 1% growth has been selected to represent 'poor performance', at the very least this should be benchmarked to more widespread and reliable growth forecasts, e.g. national forecasts of economic growth.

Allocation of the impairment ***(01 Mark)***
The impairment has been allocated against all of the tangible assets in the cash generating unit. This is incorrect as a cash generating unit the impairment should firstly be allocated against any goodwill relating to the cash generating unit. It should then be allocated against the remaining assets on a pro-rata basis bearing in mind that an asset should not be impaired below the highest of either its fair value less costs of disposal or its value in use.

Evidence expected to be on file: ***(04 Mark)***

i. Copies of the offers received to purchase the retail outlets, confirming the amounts offered. These should have been used to recalculate the average used for the estimate of fair value.

ii. Documentation of enquiries with management with regard to how they estimated the disposal costs and what experience they have had with the sale of similar operations.

iii. A copy of the forecast cash flows attributable to the retail outlets. This should contain evidence of analytical review in comparison to the year ended 31 March 2017 to confirm the accuracy of the base cash flows.

iv. There should then be evidence of a recalculation of the future cash flows using management's estimates of 1% growth to confirm the mathematical accuracy of management's calculation.

v. There should be evidence of a recalculation of the value in use using a range of growth rates to assess the sensitivity of management's calculations to economic variables. The differences between these valuations and management's valuation should have been reviewed to assess the likelihood of a material under or overvaluation.

vi. Evidence of an analytical review of performance by retail outlet or geographical area of operations, referenced to sales and cash flow records where available, to confirm whether growth rates are consistent across the brand or whether there are variances.

vii. Documentation of enquiries with management relating to their expectations for specific retail outlets or areas of operations and whether there are any specific matters which they are aware of which may affect regional performance, e.g. the opening of new out-of-town shopping facilities or competitors setting up in the same location.

viii. A schedule of any goodwill included in the statement of financial position with analysis of its various components to assess whether any part is attributable to the retail outlets as a cash generating unit. This is specifically relevant to any acquired brands which may be sold through the retail stores or any retail brands acquired by HJ.

ix. A recalculation of the allocation of the impairment by the auditor, firstly against any goodwill determined to be attributable to the cash generating unit, then against the remaining assets pro rata.

x. Copies of previous forecasts. Where the retail outlets forecast performance exceeds the 1% currently predicted by management there should be evidence of discussion with management to ascertain the reasons for changing their outlook.

Answer: 3 (c)

Warranty provision
Matters

Materiality *(0.5 Mark)*
The year end provision represents 0·36% of total assets and 6·54% of profit. It is not, therefore, material to the statement of financial position but it is material to the statement of profit or loss.

Estimates *(0.5 Mark)*
The estimate of returns is clearly subject to significant subjectivity. This increases the risk of material misstatement due to both error and manipulation.

The estimate is made by the sales director; while this may be the best person to forecast sales they may not be the best person to predict returns. Returns are likely to be influenced more heavily by product quality, which the production or quality control manager may be better placed to predict. This implies that the forecast amount is based on simplistic, general estimates using sales levels rather than consideration of specific product quality issues.

Evidence of prior overstatement *(0.5 Mark)*
The risk of misstatement is amplified by the evidence of large overstatements in the past. The reversal of unutilised provisions suggests that previous estimates were too high, which indicates inaccuracy in the forecasting

process. The reversal of unutilised provisions represents 2·9% of profit so is not individually material to the financial statements.

Possible creative accounting *(0.5 Mark)*

Provisions can be used to smooth profits; i.e. a provision made in a year where profits are high and reversed in future years (i.e. released back to the statement of profit and loss) when earnings targets are not being met.

The reversal of unutilised provisions in the year has increased HJ's profits by Rs. 3·1 million. While this is not a material amount on its own, with other creative accounting devices, such as the manipulation of estimates of the cost of inventory and impairments, this could lead to a material overstatement of profits.

This should be considered a particular risk for HJ as their profits have declined during the year, despite a 5·5% increase in revenue during the year. The decline in performance provides an increased incentive for management to adopt manipulative accounting practices to help achieve targets and smooth profits.

Evidence expected to be on file: *(04 Marks)*

- **i.** Copies of the terms of sale offered to customers to confirm the length of the warranty period.
- **ii.** Notes of a discussion with the sales director confirming the basis of the calculation for forecast returns. These should specifically note any general rates of return applied to the calculation and any specific matters the director has taken into consideration, such as known faults or poor quality.
- **iii.** A copy of the calculation of the provision. The components of the calculation should have been recalculated and analytically reviewed in comparison to previous years and any fluctuations should have been corroborated to supporting evidence.
- **iv.** A schedule analysing the total returns received following the year end. A sample of these returns should have been matched to the original sales invoice, confirming the date upon which the goods were first sold.
- **v.** This schedule should also have been analytically reviewed in comparison to the same period in previous years to identify whether returns levels were consistent. Any significant fluctuations should have been corroborated with evidence or management enquiry.
- **vi.** A schedule confirming the calculation of the total unutilised provisions reversed during the year. These should be accompanied with the notes of a meeting with management identifying the reasons why these provisions were not needed and, where possible, what time period the original provision related to.
- **vii.** Notes of a discussion with the production or quality control manager identifying whether there are any known problems with goods sold during the warranty period, and what products were affected. If any such matters exist there should be evidence that these have been traced through to the provision calculation.

Answer: 4 (a)

HEL

Auditor responsibilities and actions *(03 Marks)*

- **i.** Obtain sufficient appropriate evidence regarding the completeness of sales in order to conclude that the financial statements are free from material misstatement.
- **ii.** Attempt to confirm the completeness of sales using alternative audit procedures, which could include:
  - a. Analytical review versus sales in the months before and after November, and vs prior year
  - b. Agreement of sales for November to the cash received from HL
  - c. Consider if the cash received from HL is sufficient appropriate evidence.
- **iii.** Review the agreement with HL to establish if the cash received is net of commission.
- **iv.** Review correspondence with HL regarding the issue.

v. Obtain confirmation from HL of the sales made in November.
vi. Assess whether any potential misstatement of sales is actually material.
vii. Report the difficulties and the expected auditor's report effect to those charged with governance.

Implications for the auditor's report *(03 Marks)*

If sufficient evidence is found and Mattis LLP is satisfied that there is no material misstatement of sales and cash:
- an unmodified auditor's report can be issued
- 'The financial statements give a true and fair view…'

If Mattis LLP is unable to obtain sufficient appropriate evidence regarding the completeness of sales:
- A modified opinion should be issued
- as there has been a limitation on the scope of the auditor's work.

The possible effects on the financial statements of the misstatement, if any, would likely be material
- and not pervasive
- as the possible misstatement is confined to specific accounts of the financial statements (sales and cash).

A qualified opinion should be issued
- 'except for the possible effects of the matter described in the Basis for Qualified Opinion section of our report, the financial statements give a true and fair view…'

A 'Basis for Qualified Opinion' section is added:
- directly following the opinion section,
- explaining the reason for the modification (that insufficient evidence regarding the completeness of sales could be obtained).

The auditor's report will report by exception under the Companies Act 2017 that:
- proper books of accounts have not been kept by the company, and
- all information and explanations necessary have not been obtained.

Answer: 4 (b)

Sale and leaseback transactions fall within the scope of IFRS 16. The accounting treatment depends on whether the transaction results in the transfer of the asset. This is the case if conditions for the satisfaction of a performance obligation have been met. In this case, the Synergy Bank does not appear to have control of the mall as it cannot direct its use or collect rent from tenants.

IFRS 15 provides further indicators of the transfer of control, which should be applied to the sale of the mall by ASM:

- The transfer of legal title to Synergy Bank is an indicator that control of the mall has passed to the bank.
- The fact that ASM has not transferred physical possession of the mall to Synergy Bank and continues to operate and manage it is an indicator that control has not passed to the bank.
- The significant risks and rewards of ownership are retained by ASM. This includes the risk that units are not tenanted, that significant maintenance costs must be incurred and potential rewards in the form of rental income from retail tenants. All of these lie with ASM.

A further indicator that control of the mall has not passed to Synergy Bank is the existence of the option for ASM to repurchase the mall at the end of the lease term for an amount significantly less than the current fair value, so providing ASM with access to economic benefits associated with the mall after the lease has expired.

The transfer of the mall is therefore not a sale and IFRS 16 requires that it is accounted for as a financing transaction. Therefore, the initial sale proceeds of Rs. 8,000 million should be transferred from income to a financial liability and the Rs. 9,720 million carrying amount of the mall is retained in ASM's statement of financial position.

In the year ended 30 September 2022, ASM should recognise a finance cost associated with the financing arrangement of Rs. 240 million (Rs. 8,000m × 6% × 6/12 months). This is calculated using the given discount rate. As this amount remains unpaid, it is recognised as an accrual. ***(03 Marks)***

Impact on Report ***(04 Marks)***

If management refuse to make the adjustments regarding the sale and leaseback transaction, there will be an overstatement of Rs. 8,240 million in profits and corresponding understatement in liabilities on the statement of financial position. This is 5.7% (8,240/145,345) of total assets and 37.2% (8,240/22,130) of net profit and is a material misstatement of the financial statements.

The auditor's report will need to be modified due to material misstatement. The misstatement is not pervasive to the financial statements as it relates to a specific area. Therefore, the auditor's report will contain a Qualified Opinion paragraph which states that "except for" the matters described, the financial statements give a true and fair view.

A basis for qualified opinion paragraph will immediately follow the qualified opinion paragraph. This will explain the reason giving rise to the qualified opinion and a quantification of its financial effects.

Answer: 5 ***(3.5 Marks for each point)***

Samma Agricultural Industries (SAI)

(i) Acting as auditor for both KAG and SAI may create a threat to the principle of confidentiality.

Before accepting the engagement to act as auditor of KAG, DNC must disclose the potential conflict of interest to both KAG and SAI and obtain their consent to act. If either party refuses to provide consent, DNC cannot act as auditor for both companies.

If the engagement is accepted, DNC will need to apply safeguards to address the threat. Suitable safeguards include using separate engagement teams to audit both KAG and SAI who are each provided with clear policies and procedures on confidentiality. Additionally, DNC should also appoint an independent reviewer for each engagement to review the audit work performed to assess whether the key judgements and conclusions are appropriate.

(ii) The audit team have been invited to join the finance team of SAI for a trip to a luxury resort, which will be entirely paid for by SAI. If hospitality is accepted, this might create a familiarity threat to independence. The audit team will become familiar with the finance team on the trip and may be too trusting of what they say during the audit.

Additionally, if it is publicly disclosed that the auditors have accepted a trip to a luxury resort paid for by the audit client, this may be perceived as inappropriate. This creates an intimidation threat where the audit team may overlook audit issues or feel that they cannot issue a modified opinion due to the possibility that the trip is made public, damaging DNC's reputation.

A self-interest threat might also be created where members of the audit team are less willing to challenge SAI for fear of losing the opportunity to go to the luxury resort.

The Code of Ethics specifically prohibits audit team members from accepting gifts and hospitality from audit clients unless the value is trivial and inconsequential. The cost of a weekend in a luxury resort is not trivial and inconsequential and so the offer cannot be accepted.

System Auto (SA)

(i) SA has asked DNC to perform an additional engagement to value a production line which the company is hoping to purchase in November 2022. This might create an advocacy threat to independence in which DNC are seen to be acting on behalf of SA.

The figures from the valuation engagement will not be included in current financial statements, but they will be included in the financial statements for the following year. This might result in a self-review threat in the audit of the financial statements in next year whereby the auditors are reviewing their own work and may place too much reliance on the valuation figure.

SA is a listed company. The Code of Ethics, states that 'an audit firm shall not provide a valuation service to an audit client that is a public interest entity if the valuation service would have a material effect, individually or in the aggregate, on the financial statements on which the firm will express an opinion'.

Therefore, DNC cannot accept the valuation additional engagement whilst acting as auditors of SA since this is not permitted by the code. DNC will need to either reject the additional valuation engagement or resign from next year's audit.

(ii) Alina Shah has been in place as audit engagement partner of SA for four years. Since Alina Shah has been involved in the audit for a long period of time, this can result in a familiarity threat, where she has too close a relationship with the audit client and is too trusting of what they say.

Long association might also lead to a self-interest threat where Alina Shah is concerned about losing a long-standing client or has an interest in maintaining a close personal relationship with management at SA.

DNC has rightfully rotated Alina Shah to avoid the familiarity and self-interest threat.

The Code of Corporate Governance requires that an individual shall not act as an audit engagement partner for more than five cumulative years for a listed client. Since SA is listed, as per law, DNC (firm) can accommodate Zainab's request.

The matter should be discussed with the client and to know the reasons for Zainab's request. However, firm also needs to consider the risk being involved as client has requested for Alina to act as engagement partner for one year despite the fact that firm has a policy to rotate partner after four years which needs to be adhered.

DNC also has an option to make Alina the quality control reviewer to benefit from Alina's experience of SA.

Answer: 6 ***(0.75 Marks for each correct procedures)***

i. Cast the cash flow forecast to confirm its mathematical accuracy.

ii. Confirm the consistency of the accounting policies used in the preparation of the forecast financial statements with those used in the last audited financial statements.

iii. Agree the opening cash position of Rs. 689 million to the cash book and the bank statement.

iv. Discuss the key assumptions underlying the preparation of the forecast with management, including:

a. the predicted growth rates in operating cash receipts of 13·4% over the year compared to an equivalent growth rate of only 7·3% in operating cash payments.
b. the stated collection and payment periods in relation to receivables and payables.
c. confirm that the assumptions appear reasonable and are consistent with the firm's knowledge and understanding of the client.

v. Analytically review the forecast trends in cash flows comparing with them with historical cash flow statements and other forecast data which is available for the sector and local economy and investigate any significant differences.

vi. Agree the settlement discount of 8% and the late payment penalty of 5% penalty terms with suppliers to supporting contractual documentation, agree to purchase ledger payments in order to confirm that discounts are taken and penalties are paid.

vii. Agree the predicted collection and payment periods to the most recent sales ledgers and purchase ledgers.

viii. Recalculate the patterns of cash flows based on management's historical analysis of credit sales to confirm that the forecast has been properly prepared on the basis of these assumptions.

ix. Perform sensitivity analyses on the cash flow forecast by varying the key assumptions (in particular, in relation to growth rates and payment periods) and assessing the impact of these variations on the company's forecast cash position.

x. Agree the salary payments to the latest payroll records and cash book payments analyses to confirm accuracy and completeness.

xi. Obtain and review a breakdown of the forecast overhead payments and compare it to historical management accounts and current budgets. Review the schedule to ensure that non-cash items such as depreciation, amortisation and bad debts have not been included.

xii. For a sample of overhead costs, review the supporting documentation such as invoices and utility bills and agree the amount paid each month to the cash book.

xiii. Obtain and review budgets and analyses of costs to date for the new shops and the online marketing campaign ensuring that the forecast includes all of the budgeted costs and does not include any costs which have already been incurred. Agree a sample of costs to supporting documentation such as invoices, quotations and lease agreements.

xiv. Review board minutes for discussion of the new shops and the marketing campaign.

xv. Review the outcomes of previous management forecasts and assess their accuracy compared to actual data.

xvi. Assess the competence and experience of the preparer of the forecast.

xvii. Discuss possible cost omissions with the preparer of the forecast, for example, VL's cash flow forecast does not include finance costs, tax payments and does not include any capital expenditure other than the new shops.

xviii. Obtain written representations from management confirming the reasonableness of their assumptions and that all relevant information has been provided to CC.

xix. Request confirmation from the bank of the potential terms of the additional finance being negotiated, to confirm the interest rate.

xx. Consider whether the finance charge in the forecast cash flow appears reasonable.

(THE END)