MARK PLAN AND EXAMINER'S COMMENTARY

This report includes:
- a summary of the scenario and requirements for each question
- the technical and skills marks available for each part of the requirement
- a description of how skills should be demonstrated
- detailed points for a full answer
- examiner's commentary on candidates' performance

The information set out below was that used to mark the questions. Markers were encouraged to use discretion and to award partial marks where a point was either not explained fully or made by implication.

Question 1 solution

Scenario

The candidate is an audit senior working for Marr LLP, a firm of ICAEW Chartered Accountants. Marr is the statutory auditor of Panther for the year ended 31 December 2020.

The candidate is provided with Advance Information about an audit client called Panther Ltd which comprises:

(1) A document which includes the scenario, background information and a schedule of audit issues; and
(2) The nominal ledger data for Panther for the 11 months ended 30 November 2020, contained within the audit data analytics platform**.**

The audit issues identified in advance relate to proforma invoices and bill and hold transactions. Extracts are also provided from the strategic report which indicate price volatility for Nickel and supply issues with Cobalt.

An audit junior has identified two transactions in Account 4000 Nickel based alloy sales which were posted by Alain an employee who left the company. The two transactions cancel proforma invoices.

The candidate has the opportunity to interrogate the audit data analytics platform for other similar transactions. A proforma invoice transaction is discoverable posted by Alan in Account 4003 Nickel in April 2020 for £165k which appears to be duplicated by Sunil in August 2020. These transactions are identified for the candidate in the exam paper together with two further audit issues relating to a bill and hold sale of Chromium to YYM and goods in transit to GTEX. A schedule of preliminary analytical procedures for revenue and details of a potential hedging transaction are also provided. Specifically, the candidate is required to:

(1) In respect of each of the three audit issues identified by Jason Green (Exhibit 1), review relevant transactions in the audit data analytics platform; and

- Set out and explain the appropriate financial reporting treatment, including correcting journal entries; and
- Identify and explain the key audit risks.

(2) From Jason's preliminary analytical procedures for revenue (Exhibit 2), select **three** accounts which you regard as the highest audit risk. For each of these three accounts:

- Explain and justify why you have selected the account.

- Identify individual transactions which give rise to key audit risks and explain the nature of these risks.
- Set out the information and explanations that you need from Panther's management.

(3) Determine and justify an appropriate level of performance materiality for the audit of Panther's revenue.

(4) Set out and explain the financial reporting treatment for the illustrative example hedging transaction proposed by Paul (Exhibit 3).

You should include relevant journals and explain whether the suggested hedging transaction would reduce the volatility of future reported profits.

Requirements	**Marks**	**Skills assessed**
In respect of each of the three audit issues identified by Jason Green (Exhibit 1), review relevant transactions in the data analytics software; and • Set out and explain the appropriate financial reporting treatment, including correcting journal entries. • Identify and explain the key audit risks.	18	• Assimilate and demonstrate understanding of a large amount of complex information. • Distinguish between appropriate and inappropriate accounting treatments • Explain and recommend appropriate accounting treatments for financial assets • Set out correcting journal entries • Critically review and identify the audit risks
From Jason's preliminary analytical procedures for revenue (Exhibit 2), select **three** revenue accounts which you regard as having the highest audit risk. For each of these three accounts • Explain and justify why you have selected the account. • Identify individual transactions which give rise to key audit risks and explain the nature of these risks. • Set out the information and explanations that you need from Panther's management .	9	• Apply scepticism to identify further errors in the data set • Perform relevant calculations; explaining or stating the issues • Using the data & information given analyse the data and information to support requirement • Use technical & professional knowledge to analyse the data and identify audit risks
Determine and justify an appropriate level of performance materiality for the audit of Panther's revenue.	4	• Relate different parts of the question to identify critical factors • Use technical knowledge and judgement to determine appropriate performance materiality
Set out and explain the financial reporting treatment for the illustrative example hedging transaction proposed by Paul (Exhibit 3).	9	• Assimilate and demonstrate understanding of a large amount of complex information.

You should include relevant journals. Explain how the suggested hedging transaction may reduce the volatility of future reported profits.		• Recommend appropriate and accounting treatments for the hedge transaction • Set out journal adjustments
Max	40	

1) In respect of each of the three audit issues identified by Jason Green (Exhibit 1), review relevant transactions in the data analytics software; and

Set out and explain the appropriate financial reporting treatment, including correcting journal entries. Identify and explain the key audit risks

Audit issue 1 Proforma invoices

Appropriate financial reporting treatment

Method using data analytics software to identify the issue

The Advance information sets out an issue with Alain posting proforma invoices

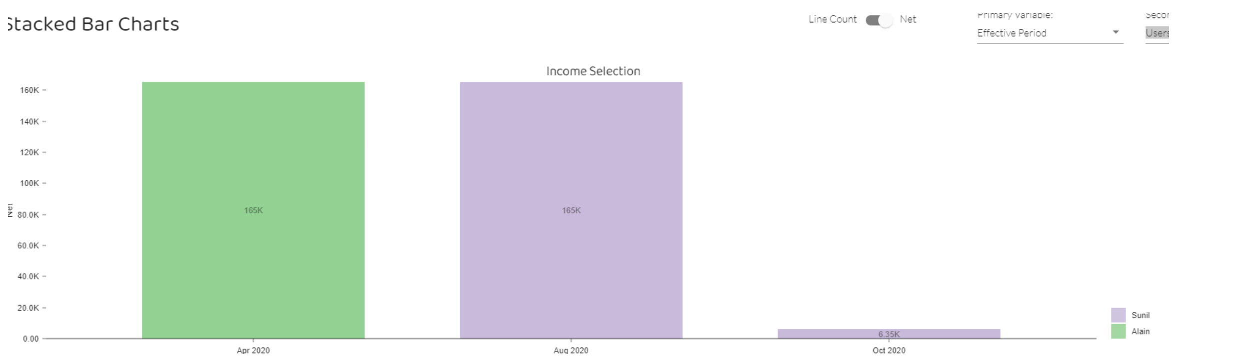
By using the DAS (Stacked bar chart of bump chart or heat map) - a proforma invoice posted by Alain in Account code 4003 Nickel can be identified.

Transaction ID	Description	Debit	Credit	Account code	Effective dates	User ID
132852	Proforma invoice	0	165,424	4003	24/04/2020	Alain

In August, Sunil has posted a further sales invoice to the same account for the same amount –(this was discoverable in the advance 11 month DAS). Jason has now ascertained that the proforma invoice has been duplicated in August by the following transaction.

Transaction ID	Description	Debit	Credit	Account code	Effective dates
140552	Adjustment	0	165,424	4003	25/08/2020

There has been no credit note posted to cancel the duplication as the stacked bar chart for Account code 4003 Nickel highlights.



This is evident by examining the only other three entries processed to this account

IFRS 15 requires revenue to be recognised when control passes to the customer, this is also the nature of the commercial contracts with Panther's customers. The proforma invoice posted in April 2020 should be cancelled by a sales credit note or by journal.

JNL 1 Correcting journal entry

	£
Dr 4003 – Nickel	165,424
Cr 1100 – trade receivables	165,424

Being correction of double counting of proforma invoice

Audit risks

Duplication of transactions

The audit risk is that revenue and receivables may be overstated through early recognition of such transactions or double counting the revenue due to recording both the proforma invoice and also the actual invoice on delivery of the goods.

There is also an audit risk that revenue is being recognised early if proforma invoices are recognised before control passes - this appears to be a significant risk as a further proforma invoice has been posted by Julie in December 2020.

The following transaction can be identified by using the heat map.

Transaction ID	Description	Debit	Credit	Account code	Effective dates
140553	Proforma invoice	0	1,458,552	4000	27/12/2020

Cut off

There is also an audit risk of cut off as the goods may also be recognised in inventory at the year end if the goods have not been dispatched to the customer or are in transit and included in inventory as goods in transit.

A control risk also arises in how Alain has been able to process pro -forma invoices. This increases the potential for fraud and deliberate manipulation of the results.

Audit issue 2 Contract with YYM
Account code 4012 Chromium

Appropriate financial reporting

The sales transaction posted by Julie can be identified tin the 12 month DAS as follows:

Transaction ID	Description	Debit	Credit	Account code	Effective dates
140554	Bill and hold YYM	0	342,556	4012	1/12/2020

This is a bill-and-hold arrangement. However, Panther has recognised the transaction as both a credit to revenue for £342,566 and a credit to cost of sales by including the inventory for £270,500. The transaction is there in both revenue and in inventory.

There is no credit note posted to this account in the DAS to cancel this invoice therefore this is an error since Panther should not recognise the transaction in both revenue and inventory. This potentially overstates revenue and inventory and hence profit.

In order to propose an adjustment, I would need to be sure that it is correctly reflected as revenue. The advance information sets out the criteria under which Panther should be recognising revenue from bill-and-hold arrangements which do comply with the requirements of IFRS 15 – see below under audit risks.

Applying the criteria to the scenario

a) the reason for the bill-and-hold arrangement must be substantive (for example, the customer has requested the arrangement);

This criteria would appear to be satisfied as in the sales contract YMM agreed to assume risk for the chromium and had the rights to control the destination and timing of distribution

b) products can be physically identified separately as belonging to the customer;

Panther are storing the goods in the warehouse and assuming that the metal can be separately identified then this criteria is also met

c) products must be ready for physical transfer to the customer; and

d) products cannot be used or directed to another customer.

YYM has already identified a customer, Zeinn, so both these criteria also are met

JNL 2 Correcting journal entry

Assuming that the transaction meets these criteria – Panther should enter the following correcting journal:

	£
Dr 5201 – closing inventory (Cost of sales)	270,500
Cr 1001 - closing inventory (SOFP)	270,500

Being correction of double counting of bill-and -hold invoice as both revenue and inventory.

Audit risks

A key audit risk here is that the arrangement may not meet the criteria for revenue recognition and therefore revenue is overstated. This is a control risk – there is lack of oversight and inexperienced personnel are dealing with complex transactions.

A further key risk is cut off particularly if transactions are entered into around the year end – there may be other such transactions where "double-counting" has occurred and inventory belonging to customers has been recognised as inventory resulting in a risk of over or understating inventory.

Audit Issue 3 Goods in transit

Appropriate financial reporting treatment

There are two issues here:

The first issue is that the GTEX receivable balance may need to be impaired. The customer has made a payment on account of £150,000, in respect of an outstanding invoice of £352,411. I would need to ascertain whether the outstanding balance of £202,411 is impaired at 31 December 2020 and whether any other invoices are outstanding with this customer.

The second issue here is that the goods are still controlled by Panther at the year end and should be included in inventory. The proforma invoice for £450,562 has been correctly excluded from the revenue account for Tungsten (4007), (there are no proforma invoices in the DAS Account Code 4003 Tungsten) - the financial reporting issue is not that there is potentially duplication of revenue but no cost has been recognised in inventory.

JNL 3 Correcting journal entry for inventory

	£
Dr 1001 – closing inventory (SOFP)	395,500
Cr 5201 – closing inventory (cost of sales)	395,500

Being inclusion of goods in transit in closing inventory

Paul has raised journals at the year end to include consignment and transit inventories in account 5201 Closing inventory and account 1001 Inventory– see transactions 139237- 139238 and 139239 – 139240 – It is possible that these goods in transit have already been taken into account in this journal and I would need to ask for further information about these transactions.

Transaction Id	Description	Debit	Credit	Account Codes	Effective Dates	User Ids
139195 - 139196	JE01 - Reversal Nov 2020 Inventories	14,587,949	0	5201	01/12/2020	Paul
139235 - 139236	M12(2020) - Site Physical Inventories	0	12,235,411	5201	31/12/2020	Paul
139237 - 139238	M12(2020) - Consignment Inventories at Customers	0	576,200	5201	31/12/2020	Paul
139239 - 139240	M12(2020) - Transit Inventory from overseas	0	2,265,018	5201	31/12/2020	Paul
139241 - 139242	M12(2020) - Own Inventories at suppliers for processing	0	923,247	5201	31/12/2020	Paul
139954 - 139955	SH Inventory Review 06/03/2020	0	425,649	5201	31/12/2020	Paul
139980 - 139981	Inventory - FOREX TRANSLATION (OANDA RATES)	0	13,043	5201	31/12/2020	Paul
140244 - 140245	DDR	0	252,862	5201	31/12/2020	Paul

Audit risks

The audit risk is that inventory is understated and that the cut off on similar transactions will be incorrect.

There is also a risk that appropriate receivables allowance has not been made for the GTEX balance and other customer balances.

2. From Jason's preliminary analytical procedures for revenue (Exhibit 2), select **three** accounts which you regard as the highest audit risk. For each of these three accounts:

    - Explain and justify why you have selected the account.
    - Identify individual transactions which give rise to key audit risks and explain the nature of these risks.
    - Set out the information and explanations that you need from Panther's management.

Tutorial notes: screen shots from DAS are included here for illustration purposes only – Candidates were not able or expected ti include screenshots but were expected to describe transactions found in DAS.

Different methods at arriving at key transactions. Using the Heat map for revenue, identifies five large transactions which candidates could use in answering question 1.

ransaction Id	Description	Debit	Credit	Account Codes	Effective Dates	User Ids	Document Types	Created Dates
132863 - 132865	JE02 - 2020 Sales Provision (WASA & Forex)	155,174	155,174	7902, 4014, 1100	01/01/2020	Paul	Manual Journal	12/05/2020 11:34:06
140552	Adjustment	165,424	165,424	1100, 4003	25/08/2020	Sunil	Sales Invoice	28/08/2020 10:04:55
140553	Proforma Invoice	1,458,522	1,458,522	1100, 4000	27/12/2020	Julie	Sales Invoice	27/12/2020 14:35:12
140554	Bill-and-hold - YYM	342,556	342,556	1100, 4012	01/12/2020	Julie	Sales Invoice	01/12/2020 10:12:25
140555	Bill-and-hold arrangement	301,520	301,520	1100, 4001	10/12/2020	Paul	Sales Invoice	10/12/2020 17:12:35

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Another approach could have been to use the detect module.

4000 Nickel based alloys

Why?

The first account I would select for review is Account code 4000 Nickel based Alloys. The reason why I would select this account are -- that revenue has increased by £6.1 million which represents an 102% increase on the previous year. The revenue from Nickel based alloys represent £12m out of £35m revenue for the year (34%). It is therefore a very significant and material balance.

Individual transactions and key audit risk

Examination of the stacked bar chart visualisation in the data analytics software shows a large increase in revenue in December 2020 of £1,866,470 – analysing the detail of this and £1,458,522 (transaction 140553) relates to a posting with the description 'proforma invoices'. This has been posted by Julie on Sunday 27th December 2020. The date and time of this posting is highly unusual. This transaction almost certainly looks incorrect and needs investigating.

Alain a former employee had also incorrectly posted proforma invoices in 4003 Nickel -. And in the Advance Information, there are two transactions cancelling pro forma invoices in account 4000 - this is further evidence that this is clearly a key risk of overstating revenue.
The transactions posted earlier in the year by Alain were posted as manual journals – this transaction 140553 is a sales invoice – this would make it difficult to detect other similar incorrect entries.

Account 4000 Nickel based alloy - visualisation for information only.

Detail of transaction posted by Julie

Transaction ID	Description	Debit	Credit	Account code	Effective dates
140553	Proforma invoice	0	1,458,552	4000	27/12/2020

Nature of audit risk is that revenue recognition is potentially overstated – and revenue could be recognised before control has passed to the customer.

Reviewing the sales posted in this account indicates that many are dollar related sales which are subject to currency fluctuation and there is an audit risk that receivables at the yearend are incorrectly translated.

Additional information

1. If the transaction above has not been corrected by credit notes before the year end, revenue could be overstated by £1,458,522 – excluding this transaction, the increase in Nickel based alloy sales would be £4.7 million and the percentage increase 77% - I would need to ascertain whether control of the inventory in relation to this transaction has passed to the customer and how the goods have been treated in respect of the inventory count. I would need to examine any other pro forma invoices and ensure appropriate treatment in the accounting records.

2. The comment made in the strategic report refers to an increase in price of Nickel used in the alloys - see advance information - but also comments that the price fell in the second half of the year. The impact of the change in price and also in the dollar rate on sales would enable better analysis of the movement

"The purchase price of Nickel, which is used in many alloys, increased during the first half of the year due to supply concerns but it fell during the second half of the year.

Therefore, I would want to further information on the selling prices and also volumes of sales in this account.

I would question management on how this has impacted on the sales of Nickel and the inventory balance.

3. Nickel alloys expense only went up by 31% - we do not know the movement in Nickel Alloy inventory, but unless it has fallen considerably this rise seems inconsistent with that for Nickel alloy sales given the question states both are affected by market price. I would required further information regarding the nickel based alloy inventory to assess audit risk.

4002 Cobalt based alloys

Why?
The second account I would select is account code 4002 Cobalt based alloys - sales of cobalt have increased by £840,981 which represents a 55% increase on the previous year and is specifically referred to in the strategic report as experiencing price volatility. In the advance information, the extract from the strategic report stated:

"Another significant metal, Cobalt, experienced volatility of prices during the year ended 31 December 2020. Sales of Cobalt based alloys provided strong growth for Panther, but at some points in the year it was difficult to obtain sufficient supplies of Cobalt to match customer needs."

Individual transactions and key audit risk

Using the Heat Map the following transaction can be identified in Account code 4002

Transaction ID	Description	Debit	Credit	Account code	Effective dates
140555	Bill and Hold arrangement	0	301,520	4001	10/12/2020

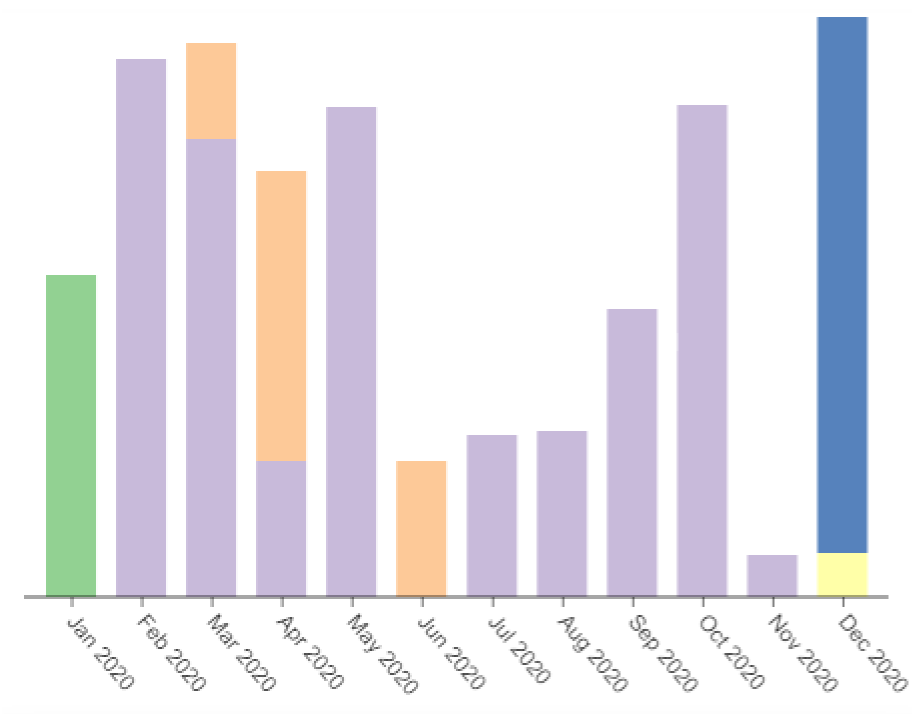
This transaction in December 2020 which is described as a bill-and-hold transaction for £301,520 requires further investigation to ensure correct cut off.

A cut off error has already been discuss relating to Account code 4012 Chromium – (see Audit issue 2) where goods sold on bill and hold basis were incorrectly included in inventory and therefore this transaction 140555 indicates an audit risk of further cut off errors and should be investigated to ensure a similar error has not occurred and that cut off is correct.

Additional information

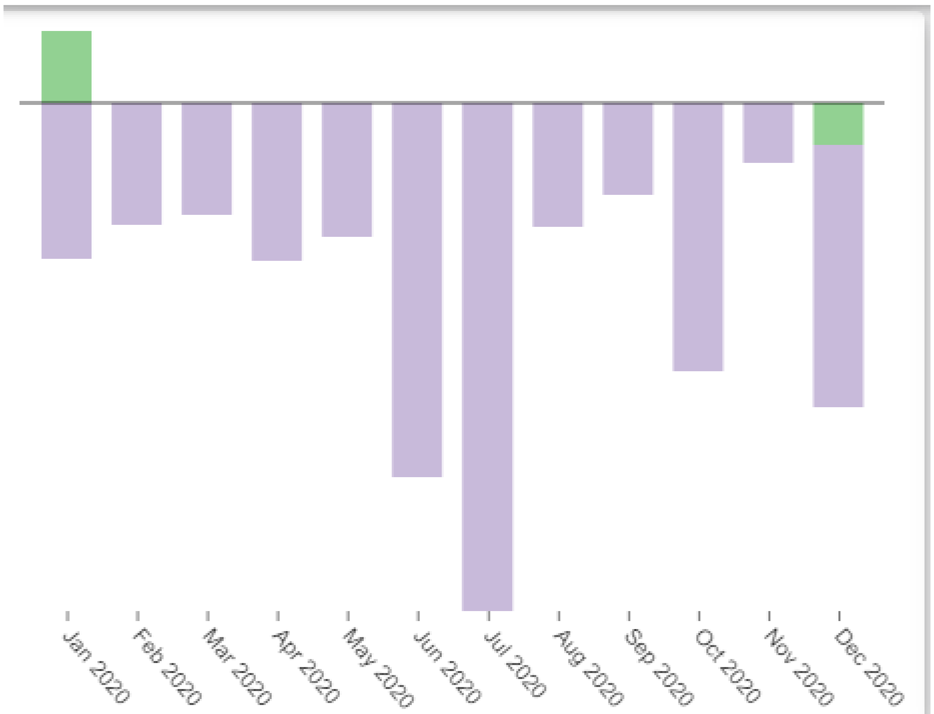
1. The strategic report refers to the difficulty of supplies at some points of the year.

Using the stacked bar chart, it can be seen that this pattern is reflected in the visualisation which shows consistent sales up to May 2020 and a fall for the months on June to October.



However, revenue increases in October and December 2020 seem to conflict with the information in the strategic report. An explanation could be that sales in those months is driven by pent up demand from those when orders could not be filled. Management should be questioned on this sales pattern.

2. Examining the stacked bar chart for cobalt purchases indicates that Panther purchased most of cobalt in July and therefore would support the comment in the strategic report. Also purchases have increased by 99% compared to revenue increase of 55% - explanation should be obtained for this difference.



3. I would need to obtain the contract to support the above bill and hold transaction to confirm that the revenue has been correctly recognised and the goods are not included in inventory by examining the inventory records. Also confirm the details of any other contracts signed on these terms to ensure excluded from inventory by agreeing to inventory records.

4014 Tantalum
Why?

Sales of Tantalum have fallen by £2,826,785 representing a 43% fall. Paul the accountant could not explain the fall in sales.

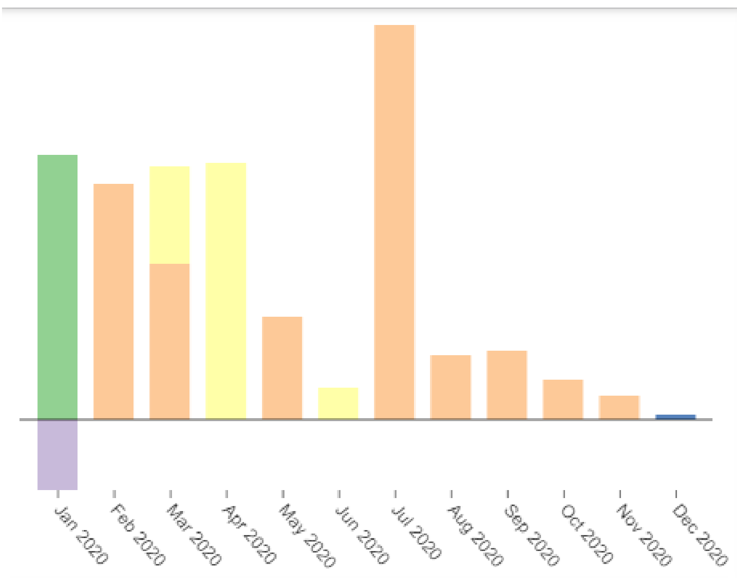
Individual transactions and key audit risk

There is a large credit note in January 2020 for £155,174 which is referenced as a 'JE20 -2020 Sales Provision WASA and Forex' which should be investigated to confirm whether there had been an allowance for this in the previous year financial statements. There is a risk that the opening balance on receivables may be incorrect or a similar provision may be required at the year end.

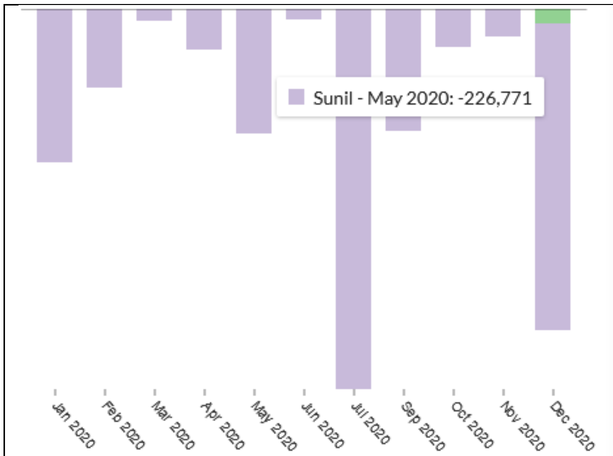
The detail of the transaction is as follows:

Transaction ID	Description	Debit	Credit	Account code	Effective dates
132863-5	JE20 -2020 Sales Provision WASA and Forex	155,174	0	4014	1/1/2020

Cobalt revenue compared to Cobalt purchases
There have been very few sales after July 2020 and no explanation was provided by the client.



However there is a significant purchase in December 2020 of £562k – sales in December are however only £10k. It is not unexpected that a matching sale would happen in the same month but confirmation should be obtained that this metal purcashe in December is included in inventory.



Additional information

Interrogate sales staff at client for an explanation.

Detail of the sales provision posted on 1 January 2020 and confirmation that it was covered by an allowance for sales returns in 31.12.2019.

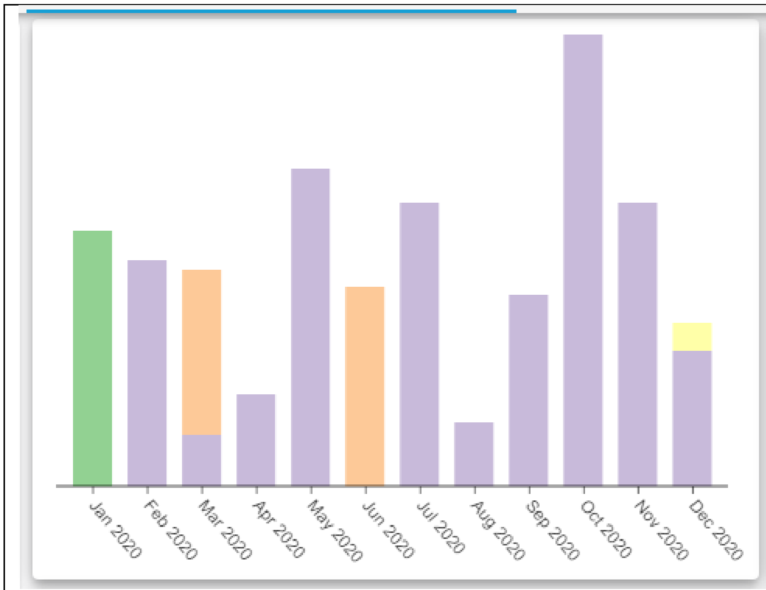
Enquire about the large purchase of Tantalum in December and check the cut off of this purchase – is it included correctly inclosing inventory.

4013 Molybdenum could also be chosen as one of the three key accounts

Why?
The third account I would select is account code Molybdenum - sales increased by £2,016,101 which represents a 58% increase on the previous year.

Individual transactions

The month of October shows a large increase in sales.



This increase would have been higher by £140,652 but for an unusual posting of a purchase invoice in this revenue account.

Transaction '137348'

Transaction Id	Account Code	Amount	Effective Date	Document Type	Journal Description	User Id	Line Description	Entered Date
137348	4013	140,652	27/10/2020	Purchase Invoice	S205000.00	Sunil	Cancel	10/11/2020
137348	2201	0	27/10/2020	Purchase Invoice	S205000.00	Sunil	Cancel	10/11/2020
137348	2100	-140,652	27/10/2020	Purchase Invoice	S205000.00	Sunil	Cancel	10/11/2020

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Using the tree map to identify other purchase invoices posted to this revenue account indicates that the above transaction has been cancelled by a purchase credit note.

Transaction '139166'

Transaction Id	Account Code	Amount	Effective Date	Document Type	Journal Description	User Id	Line Description	Entered Date
139166	2100	140,652	27/10/2020	Purchase Credit	Cancel - see tran 137348	Sunil	Cancel	10/11/2020
139166	2201	0	27/10/2020	Purchase Credit	Cancel - see tran 137348	Sunil	Cancel	10/11/2020
139166	4013	-140,652	27/10/2020	Purchase Credit	Cancel - see tran 137348	Sunil	Cancel	10/11/2020

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CANCEL

Another significant transaction is in Month 12 - Paul has posted one transaction – this is the only transaction that he has posted to this account and it is for a 'Missed ' invoice

Transaction '139977 - 139979'

Transaction Id	Account Code	Amount	Effective Date	Document Type	Journal Description	User Id	Line Description	Entered Date
139977 - 139979	1100	59,970	31/12/2020	Manual Journal	TRADE RECEIVABLES YEAR END PROVISION	Paul	M12(2020) - PROVN	05/03/2021
139977 - 139979	4000	-3,891	31/12/2020	Manual Journal	STERLING 2020/1140 (MISSED INV)	Paul	M12(2020) - PROVN	05/03/2021
139977 - 139979	4013	-56,079	31/12/2020	Manual Journal	ATI 2020/1142 (MISSED INV)	Paul	M12(2020) - PROVN	05/03/2021

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CANCEL

Key audit risk

These two transactions indicate that there is a control risk over the potential posting of purchase invoices to the wrong account and that invoices can be omitted from the nominal ledger.

Additional information

I would need to confirm the controls over posting of sales and purchase invoices and identify any further errors.

Tutorial note: Candidates could also have chosen other accounts as key revenue account but received limited marks if the justification was not appropriate and a significant transaction not identified –
For example, Account 4003 Nickel – this account has been discussed in audit issue 1 and a candidate may identify that there is a comparative debit balance on this account which requires further examination. However, there are no significant transactions other than those identified in issue 1.

Candidates who selected more than three accounts received no marks for the discussion of the 4th account

(3) Determine and justify an appropriate level of performance materiality for the audit of Panther's revenue.

5% of profit before tax and profit before tax are the most commonly used measures for calculating materiality

From the DAS – the profit is £3,381,566 and materiality would be 3,381,566 x 5% = £169,078 – The materiality for the overall engagement was £165,000.

However, using this materiality figure which relates to the financial statements as a whole, the error found above in Issue 1 would not have been detected – therefore a performance materiality for revenue should be set at a much lower level of £165,000.

1% of revenue – in the case of Panther this would indicate a planning materiality of 35.3 million x 1% = £353,000 – which would be too high to identify the transactions above - would suggest a lower materiality given the nature of errors found.

I would suggest a lower performance materiality figure for revenue equal to error on the proforma invoice found in the AI of £145k.

Set out and explain the financial reporting treatment for the illustrative example hedging transaction proposed by Paul (Exhibit 3).

You should include relevant journals. Explain how the suggested hedging transaction may reduce the volatility of future reported profits

Panther is hedging the volatility of the future cash flow from selling nickel alloy currently held in its inventory.

The nickel content is the major component of the nickel alloy and is a recognised non-financial asset. However, all of the cash flows of the entire item (nickel alloy) may be designated as the hedged item and hedged for only one particular risk, commodity price risk.

The nickel commodity futures contracts is the hedging instrument so can be accounted for as a cash flow hedge in respect of those inflows, providing the criteria for hedge accounting are met. There is historic evidence that this type of contract is an effective hedge .

The gain on the forward contract should be calculated as:

	£
Forward value of contract at 30 September (540 x £14,000)	7,560,000
Forward value of contract at 31 December 2021 (540 x £13,500)	7,290,000
Gain on contract	270,000

The change in the fair value of the expected cash flows on the hedged item which is not recognised in the financial statements should be calculated as follows:

	£
At 30 September 2021 sales value of nickel alloy	7,540,000
At 31 December 2021 sales value of nickel alloy	7,330,000
Loss	210,000

As the change in the fair value of the expected cash flows on the hedged item is less than the gain on the contract, the hedge is not fully effective and only £210,000 of the gain on the contract should be recognised in other comprehensive income.

	£
Debit Financial asset	270,000
Credit other comprehensive income	210,000
Credit profit or loss	60,000

Rebalancing

A hedging relationship continues to qualify for hedge accounting if it is effective. In this case:an economic relationship continues to exist between the hedged item and hedging instrument (since they are both nickel); and the effect of credit risk does not dominate the value changes that result from the economic relationship.

The third criterion for hedge effectiveness is that the hedge ratio of the hedging relationship is the same as that resulting from the quantity of hedged item that the entity actually hedges and the quantity of hedging instrument that the entity actually uses to hedge that quantity of hedged items.

Since this hedge relationship results in a gain on futures contract of £270,000 but a loss on hedged item of only £210,000, it appears that the relationship should be rebalanced.

The current hedge ratio is 1:1 (with hedged item and hedging instrument both based on 540 tonnes of nickel); to maintain 100% effectiveness this should be reset by reducing the quantity of hedging instrument to 420 tonnes (210/270 x 540) or increasing the quantity of hedged item to 694 tonnes (270/210 x 540).
Profit volatility Profit for the year is affected but only to the extent that the hedge is ineffective, the gain or loss is taken to OCI and recycled when the impact of the cash flow is recognised in the profit or loss. The gain on the futures contract is matched in the same accounting period as the loss in the sale of the goods.

Examiner's comments

1.1 In respect of the three audit issues, review relevant transactions in the DAS and

- **Set out and explain the appropriate financial reporting treatment, including correcting journal entries.**
- **Identify and explain the key audit risks.**

This was the first use of AI and interrogation of DAS and this requirement was attempted enthusiastically and most candidates scored well. Marks reaching or close to the maximum were often awarded.

Most candidates were able to successfully identify the main financial reporting issues and describe the audit risks caused by the pro-forma invoices, sales to YYM and goods in transit. It was pleasing to see how candidates were able to scrutinise the DAS to discover details only presented within the impact information for December 2020.

Candidates who were less successful often failed to identify the direction of audit risk associated and were unable to identify for example whether inventory was overstated (in the bill and hold arrangement) or understated (as in the goods in transit situation) and also commonly incorrectly identified overstated revenue as a risk for all of the scenarios.

Common areas where candidate performance could be improved include the following:

- Some candidates lost marks on audit risks as they failed to express clearly what the risk was – i.e. what was potentially under or over stated and why. A description of what has gone wrong is not the same as specifying what is the consequent audit risk. In general, long and expansive descriptions often repeating the question or AI wasted time and gained few marks.
- Under the GIT issue, surprisingly few spotted that there was also a potential issue concerning the recoverability of receivables. Those who did often concluded that the whole amount should be written off rather than recognising the level of judgement likely to be required.
- Those who included audit procedures were given no credit for these as they were not asked for.
- Journal entries only gained marks if the amounts were shown – general entries with no value were given no marks.

1.2 Three revenue accounts with highest risk.

Another very well attempted requirement. Most candidates correctly focused on the Nickel alloy account. Encouragingly, many candidates that chose this account identified the significant transaction in December totalling £1.4m posted by Julie, out of hours, as a contributing factor to the increased audit risk. This was presented within the impact DAS, highlighting candidate's abilities to react to the receipt of new data.

Candidates who were less successful would either fail to discuss 3 revenue accounts, spent disproportionate amounts of time discussing each account (One account with a good discussion followed by two with one liner attempts) or highlighted lower risk or accounts already covered in Issue 1 and 2 (e.g. Nickel, Monel, 17/4 ph type).

Many candidates wasted time setting out audit risks and procedures which were not asked for in the question. The additional information required was that to assess audit risk and not to complete the audit procedures.

No marks were awarded for suggesting that management should be asked for detailed analyses already available in the DAS.

1.3 Performance materiality

Many candidates scored maximum marks here, being able to link the effects of the heightened risk surrounding revenue and the current materiality levels of £165k to the required performance materiality to be used on the audit of revenue.

Weaker answers simply calculated materiality based on typical benchmarks on revenue, net assets or profits, negating the increased risks already discovered and presenting performance materiality levels considerably in excess of current materiality level and the numerous mistakes already discovered. Very weak candidates stated that because of the increased risk performance materiality should be higher.

1.4 Financial reporting treatment of the hedging

This was the part of the question with the weakest candidate performance, which would be as expected as it tested a technical area of the syllabus. However, many candidates successfully identified cash flow hedging and correctly calculated the movements in the hedge item and instrument. Better candidates were able to identify the over-hedge recorded in profit or loss. Repeating sections of the manual gained no marks unless applied to the particular scenario.

Very few candidates at all identified that a reassessment of the hedge quantities was necessary to make the hedge effective.

Question 2 solution

Scenario

E-Van Ltd is a component manufacturer for the electric vehicle industry. The Sennhauser family own 100% of E-Van's ordinary shares and the board is comprised entirely of Sennhauser family members.

The candidate is an assistant to Hanna Sennhauser, the finance director. The candidate and Hanna are both ICAEW Chartered Accountants.

The Sennhauser family intends to sell all its shares in E-Van and has identified a potential buyer, Karpart Ltd, which is E-Van's largest customer.

As part of Karpart's due diligence for the acquisition, the Karpart board has requested the financial statements of E-Van for the year ended 30 June 2021 as soon as they have been finalised. The reported profit of E-Van for that year will be one factor in determining a valuation for the E-Van shares.

The board wants to present E-Van's results as favourably as possible to maximise the sale price of E-Van's shares. However, the board recognises the need to comply with IFRS. The board has requested a review the financial reporting treatment of the following three areas:

- property plant and equipment (PPE)
- investment property
- the net defined benefit pension liability

The ethical dilemma for the candidate is that the company would like to show the results favourably but still comply with IFRS – however the candidate's manager stresses the importance of maximising profit over compliance with IFRS - this communication is also verbal and not in writing which places the candidate in a difficult position in trying to present results fairly and at the same time manage pressure from above.

Specifically, the candidate is required to:

(1) For each of the three areas identified above, set out and explain your recommended financial reporting treatment for E-Van's financial statements for the year ended 30 June 2021 which complies with IFRS but still maximises reported profit. Justify any differences from my proposed adjustments.

(2) Prepare revised draft financial statements for E-Van for the year ended 30 June 2021 (Exhibit 1), which reflect your recommendations. Show your workings.

(3) Explain the ethical implications for you arising from Hanna's comment and the actions you should take.

Requirements	Marks	Skills assessed
Set out and explain, for each of the three areas identified above, your recommended financial reporting treatment in E-Van's financial statements for the year ended 30 June 2021. The recommended treatment should comply with IFRS while maximising reported profit. Justify and calculate any differences from my proposed adjustments. Include journals.	16	• Assimilate and demonstrate understanding of a large amount of complex information. • Evaluate, using judgement and scepticism, the appropriate accounting treatments for complex transactions including PPE investment property and a Net DBO • Recommend appropriate accounting adjustments in the form of journal
Prepare revised draft financial statements for E-Van for the year ended 30 June 2021 (Exhibit 1), which reflect your recommendations. Show your workings.	6	• Assimilate information and use own accounting adjustments to prepare revised extracts from the financial statements
Explain the ethical implications for you arising from Hanna's comment and the actions you should take.	8	• Identify the threats in the scenario to the ethical principles of professional behaviour and objectivity arising from Hanna's request • Identify the self-interest threat for you from the telephone call and explain how you should respond to Hanna. • Explain the actions for you including contacting ICAEW for advice, discussion with Hanna to resolve the situation, recognising that speaking to the board may not be helpful as comprises of family members. • Explain the scenario from different perspectives. • Demonstrate understanding of the importance of contributing to the profession & appreciating the ethos & culture of the accountancy profession
	30	

(1) Set out and explain, for each of the three areas identified above, your recommended financial reporting treatment in E-Van's financial statements for the year ended 30 June 2021. The recommended treatment should comply with IFRS while maximising reported profit. Justify and calculate any differences from my proposed adjustments.

Note 1 Specialist plant and equipment

Recommended financial reporting treatment

The useful life of the asset can be revised, as this needs to be assessed every year. In addition to this, the residual value of the asset can also be re-assessed if there are reasons to suggest it may differ.

To determine the revised useful life and whether it is appropriate to use the industry average, I would need to consider whether E-Van has the same types of assets as the industry in general and uses and maintains them in the same way.

The useful life of an asset reflects the item's usefulness to that specific entity, which may well mean that the useful life is shorter than its economic life.

Here, the industry average may not be relevant, as an informed person, the production manager, has stated that the demand for the parts will cease after 4 years.

Therefore, the asset would then be depreciated prospectively from it's the depreciable amount over the remaining useful life.

The key issue is the policy determined for the individual assets. We could look at evidence of historic profits or losses on disposal on similar assets.

Also, would need to consider why E-Van is applying this change only to this specialist equipment, does it hold similar assets at other production facilities?

The production manager's view is that the industry average would not apply to E-Van's production line as demand is expected to cease in 2024 – but that is his judgement.

Justify and calculate any differences from Hanna's proposed adjustments

Using the production managers estimate, this would suggest the following adjustment:

		£000
Carrying amount		32,000
Depreciable amount	32,000 – 8,000	24,000
Depreciate over 4 years to 2024		6,000
Depreciation already charged	(36,000 – 8,000) / 7 years	4,000
Increase in depreciation		2,000
Journal		
Debit Operating profit (retained earnings)		2,000

Credit PPE		2,000

Hanna's proposal is to use the industry average from 1 July 2020 - This would result in a write back of the depreciation charged during the year.

IAS16 says that as the change is prospective, we should calculate the new depreciation charge (and carrying amount) using the carrying amount at the date of the change (36m – one year depreciation = 32m). The revised useful life of 8 years would mean that there are 7 years remaining at 1 July 2020.

Revised depreciation charge at 1 July 2020

		£000
Depreciable amount using original residual	32,000 - 8,000	24,000
Depreciation charge	7 out if 8 years remaining	3,428
	Depreciation already charged	4,000
	Reduction in depreciation	(571)
Depreciable amount using revised residual of 30%	32,000 – 10,800	21,200
Depreciation charge	7 out of 8 years remaining	3,029
	Depreciation already charged	4,000
	Reduction in depreciation	(971)

Tutorial note: detailed calculations of Hanna's suggestions not required if candidate assumes that should use production manager's suggestion – either of the above calculations are acceptable on an own figure principle if the candidate goes with Hanna's suggestion.

Revised residual value?

While the industry average may be 30%, the calculation of residual value should still be based on the best estimate for this specific item. It is unclear if the reduced useful life of the asset has an impact on its residual value, now that the asset usage is ceasing earlier. If so, this could be incorporated into the calculation. If the asset is being used less than originally planned, it may be reasonable that the residual value is higher than the original estimate of £8m. In the absence of further information, this will be assumed to still be £8m.

Conclusion

It is difficult to conclude on this adjustment without further information. Currently Hanna's proposal would increase profit by £571k but using the estimate provided by the production manager, would be result in a reduction of profit by £2m.

Note 2 Investment property

Recommended financial reporting treatment

This is an accounting policy choice permitted by IAS 40 which would apply to all investment property - this appears to be the only property so the board can make this choice.

The reclassification from PPE to investment property seems appropriate. It is acceptable to use the fair value model for investment properties if the entity believes this will result in a more reliable and relevant presentation of information about the asset. The entity should not simply select the policy which gives the highest profit, but the one producing the most relevant information for the user. However, it is reasonable that an appropriately calculated fair value could be justified a more reliable and relevant presentation of information about the asset than the current policy of depreciated historic cost.

The property has already been transferred to investment property as can be seen on the draft financial statements.

On 1 July 2020, the building was recognised as an investment property at its IAS 16 carrying amount of £24.75m.

	£000
The office building was bought on 1 July 2015	27,500
At 1 July 2020 the office building had a carrying amount of :	
£27.5 m x 45/50	24,750

At 30 June 2021 the carrying amount is £24.2 million and £550,000 depreciation was recognised in the statement of profit or loss.

£24.75 m x 44/45	24,200

Therefore, to reflect the adoption of fair value at 1 July 2020, the depreciation charged during the year should be reversed which will increase reported profit for the year.

Debit Investment property	550,000
Credit Operating profit (retained earnings)	550,000

Fair value should reflect the actual market state and circumstances as of the date of recognition. [IAS 40.38]. The best evidence of fair value is normally given by current prices in an active market for similar property in the same location. The valuation of £35 million should not be used because the buyer was not knowledgeable of local conditions and therefore not a market participant in an orderly transaction.

Per IFRS 13 fair value represents a price that would be achieved in an orderly transaction between market participants. The public auction would be using Level 2 inputs being a similar asset with market corroborated inputs.

The IAS 16 carrying amount should be adjusted to reflect the fair value at 1 July 2020 of £30 million. The revaluation gain of £5.25m (£30,000 - £24,750) is recognised according to IAS 16 and is recognised in reserves as a revaluation surplus though OCI.

	£000
Fair value at 1 July 2020	30,000
Carrying amount	24,750
Change to reserves	5,250
Debit Investment property	5,250
Credit OCI - revaluation reserve	5,250

As the fair value is assumed to be unchanged at 30 June 2021, there is no further adjustment be made.

If the value had changed the difference would have been recognised in profit or loss for the year ended 30 June 2021.

Justify and calculate any differences from Hanna's proposed adjustments

The difference between my recommended treatment and Hanna's is that Hanna would have credited an additional £5m to OCI - I can justify my treatment because it complies with IFRS and Hanna's is in contravention with IAS 40 with respect to using the higher fair value – the write back of the depreciation charge would be the same under both my recommendation and Hanna's proposed adjustment.

Note 3 Net defined benefit pension liability

Recommended financial reporting treatment.

- Interest rate

It is unlikely that using the BBB bonds would be acceptable, as the AA rated corporate bonds would be seen by any objective user as a better indication of high-quality corporate bonds. Even if the BBB bonds were used, it would actually reduce the current year's profits.

The opening net liability of £51m would be increased by the interest rate of 4.2% rather than 2%, giving a net interest cost of £2.142m rather than the £1.02m currently shown by the actuary. This would therefore result in a reduced profit of £1.122m.

It is true that the year-end net liability would be lower because of a higher discount rate, but the resulting change would go through Other Comprehensive Income as part of the remeasurement component and would not affect the current year profit. It does however result in lower net defined benefit pension liability on the SOFP.

An increase in the discount rate decreases the present value of the obligation. This is because a higher interest rate means future cash outflows in paying pensions are discounted at a higher rate resulting in a lower present value. This explains why the present value of the obligation is estimated to fall from £72 m to £35 m.

I would therefore recommend that the AA rate is used and not adopt Hanna's proposal.

- Curtailment gain

The curtailment gain of £3.8 m would reduce the obligation because there will be a lower obligation in the future as pensioners will not be given increases in their pensions in the future.

The adjustment for the curtailment gain would credit profit or loss with £3.8 m and reduce the net defined benefit obligation. However, I would need to confirm whether the curtailment had actually occurred by the year end and whether the actuarial valuation of £54 million would also need to be reconsidered - any change would go to OCI. Given the scale of the amount an actuary would be required to confirm the amounts as appropriate.

Justify and calculate any differences from Hanna's proposed adjustments

Hanna is proposing an increase in the discount rate and a curtailment of the future rights of the scheme's members would result in an additional interest cost of £1.122m and a curtailment gain of £3.8m

If these were recorded, it would result in a remeasurement gain of £12,842m, which would be shown in Other Comprehensive Income, replacing the current remeasurement loss.

My recommended treatment would be make no adjustment to the net defined benefit obligation as further information is required from the actuary.

Prepare revised draft financial statements for E-Van for the year ended 30 June 2021 (Exhibit 1), which reflect your recommendations. Show your workings.

Tutorial note: Adjusted Financial statements below assume that the depreciation is increased by £2m for PPE and the investment property is adjusted to 30m for issue 2 and no adjustment is proposed for issue 3. Own figure principle applied for different adjustments. Candidates are expected to use the spreadsheet function in the exam software to demonstrate the correct direction of the adjustments and impact on the revised financial statements. Adjustments which change the profit or loss must be reflected in retained earnings. Adjustments recognised through OCI must be reflected in reserves.

	Draft	Note 1	Note 2	Note 3	Total
	£000	**£000**	**£000**	**£000**	**£000**
Revenue	50,353				50,353
Operating profit	10,655	-2000	550		9,205
Finance costs	-6,150				-6,150
Profit before tax	4,505				**3,055**
Other comprehensive income:					
Remeasurement (loss) on net defined benefit obligation	-3,480				-3480

Gain on revaluation			5250	5,250
	£000			
Assets				
Non-current assets				
Property, plant and equipment	83,700	-2000		81,700
Investment property	24,200		+550 + 5,250	30,000
Current assets	39,500			39,500
Total assets	147,400			151,200
Equity and liabilities				
Equity				
Ordinary share capital (£1 shares)	50,000			50,000
Other reserves	5,000		5250	10,250
Retained earnings	12,600	-2000	550	11,150
	67,600			71,400
Non-current liabilities				
Net defined benefit pension liability	54,000			54,000
Non-current payables and provisions	7,000			7,000
	61,000			61,000
Current liabilities	18,800			18,800 0
Total equity and liabilities	147,400			151,200

Explain the ethical implications for you arising from Hanna's closing comment and the actions you should take

Most of Hanna's proposed adjustments, other than the adjustment to interest rate for the pension liability, show improvements in the profit for the year.

This may not be an issue if there is full disclosure of the assumptions made to the acquisition team (e.g. revision of useful lives and fair value of investment property.). Except in the case of the

adjustments which are directly not in compliance with IFRS (proposed interest rate change for the defined benefit liability) Jo is facing potentially a threat to her professional behaviour and objectivity arising from a self-interest threat – Jo may be offered a job if Hanna recommends her.
Hanna is demonstrating a lack of professional competence, objectivity and professional behaviour.
The selection of accounting policies should be made based on providing the most relevant and reliable information for the users. Selecting the policies to give the highest profit figure is not an appropriate basis. Similarly, any accounting estimates used must reflect the best estimate of management based on the facts at hand. Here it appears that Hanna is deliberately attempting to select estimates which would increase the reported profit figure. Hanna clearly has a self-interest threat, as she stands to benefit financially from a higher sales price of the entity. Any adjustments she makes to increase the profit figures are likely to increase the sale price and the benefit she will gain. As most of the proposed treatments from Hanna appear to have the aim of improving profits, this casts doubt over her integrity and objectivity. As Hanna is an ICAEW chartered accountant, she has a duty to be honest in business dealings and produce unbiased figures. In addition to this, some of the treatment suggests she is operating with a lack of professional competence and due care. Her suggestions for the adjustment to the pension liability seem to suggest she may not be familiar with some of the more technical aspects of accounting, and her knowledge may be out of date. The hint towards Jo being offered a promotion represents a self-interest threat, and possible intimidation threat as she is being incentivised to overlook some subjective judgements and incorrect treatment by a person in a superior role. Hannah's telephone call to Jo, creating the threats as described above, does not represent professional behaviour on Hannah's part, neither in what she is wanting to achieve, nor in the way she is trying to ensure this. She is a fellow member of the ICAEW and this behaviour would be likely to discredit the profession if known about. As well as acting appropriately in terms of the accounts, Jo therefore also needs to act in terms of Hannah's behaviour. As Hanna is retiring, she is unlikely to be interested in any form of CPD. Normally Jo would consider reporting this to an independent member of the board or a non-executive director. As the board consists entirely of Hanna's family, this is unlikely to be possible. Due to this nature Jo should ring the ICAEW helpline for confidential assistance.
Actions: Jo should: Document clearly the assumptions in preparing the working paper and draw attention to the fact that these should be made available to the acquisition team. Be sure to make a definitive statement with regard to the net defined benefit pension obligation that the adjustments are not in compliance with IFRS. Discuss with board. This will require professional judgement to carefully but confidently present what is technically accurate and to confirm that of course as ICAEW professional accountants that must be uppermost. Discuss concerns over her competency with Hanna. Point out to Hanna, in as helpful a way as possible, what the current technical rules are on the valuations.

Contact the confidential ICAEW helpline for assistance with regard to how Hannah is behaving and also for support in what is a difficult situation.

Examiner's comments

2.1 Set out and explain recommended financial reporting treatments for three issues

Answers to this question were, in general, disappointing with a minority of candidates engaging in any meaningful way with the scenario or comparing the valid accounting treatment with what has been suggested by Hanna.

Despite the first section relating to assumed knowledge from Financial Accounting and Reporting, a worrying number of candidates did not know how to apply the provisions of IAS 16. A significant failing was thinking changes in accounting estimates were accounting policy decisions and attempted to retrospectively apply changes in residual values and useful lives.

The calculations of depreciation were often inaccurate. Common errors included a failure to take account of residual value; the belief that residual value was deducted from carrying value in the financial statements; and a complete failure to apply the change in rates prospectively even where the candidate had clearly stated that this should be done.

For PPE, some candidates wanted to make a prior year adjustment and others thought that there was an impairment rather than a change in estimated life.

The investment property section was generally answered better, with many candidates demonstrating good knowledge of the accounting principles and applying them correctly to the given scenario. However, few made any explicit comment on the effect of Hanna's proposed adjustment.

Those who did poorly on this section often wrongly focussed on lease accounting.

A surprising number of candidates failed to see that the transfer to investment property had already been made in the financial statements.

Answers to the pension element of the question were mixed. Many candidates rightly spotted that the proposed change in discount / interest rates was inappropriate, although less were able to articulate why or went on to discuss what the effect of the change would have been (as required by the question). Those who did spot that it would have increased the interest charge to the PorL scored well.

Some candidates wasted time by setting out general accounting principles for pensions rather than addressing the question or by reproducing journals for accounting entries already made. This scored no marks.

Only a small number of candidates demonstrated understanding that the actuary's calculation of discounted future liabilities would have used the discount rate and many candidates made clear statements that the rate would not affect the net pension liability.

Most candidates made a reasonable attempt at the past service element but there were a significant number who proposed journal entries which made no sense or did not balance or who believed that there would be a charge rather than a credit to PorL.

There were a few candidates who identified the right accounting treatment and then concluded they should do what Hanna requested as it increased profit! No marks were awarded for such conclusions or entries.

Despite this, there were also some excellent answers.

2.2 Prepare revised financial statements

Many candidates scored well gaining full marks for this section on an own figure principle.

Many candidates used the spreadsheet functionality to produce adjusted financial statement but marks were lost for posting adjustments in the wrong direction or which did not balance.

Those who failed to add across and present restated figures as required were awarded no marks.

Also, it is extremely disappointing that a significant number of candidate fail to recognise the effect on retained earnings of PorL adjustments. This is very basic and with the use of the spreadsheet in the exam software is easily avoided.

2.3 Ethics

Very well attempted ethics requirement with most candidate producing good answers identifying the issues surrounding self-interest and intimidation threats and suggesting some sensible actions.

A common mistake in the weak candidates was to fail to consider the specific scenario and fall into 'audit autopilot' when discussing actions. As the scenario was set from the perspective of Jo Maine, an employee of E-Van's (and not the auditor of E-Vans), actions such as 'consult the ethics partner' or 'refuse the engagement' were irrelevant and did not score marks.

Question 3 solution

Scenario

The candidate is an audit senior at Hughes Watson LLP (HW), a firm of ICAEW Chartered Accountants. Numilla plc, an audit client of HW, is listed on the London Stock Exchange. It is the parent company of a group which supplies wind turbines and other equipment to the renewable energy industry in the UK. The candidate has been assigned to the group audit of Numilla for the year ended 30 June 2021.

On 30 June 2021, Numilla acquired 80% of the issued ordinary share capital of Localex Inc, a company based in Utopia. An assistant in Numilla's corporate finance team has provided background notes on the acquisition and the Numilla financial controller has set out his preliminary calculation of goodwill arising on the acquisition of Localex.

The candidate is responsible for interim audit work at a listed client which has just made an overseas acquisition. The question is focussed on accounting for that acquisition and specifically the goodwill calculation. The candidate is presented with a calculation performed by the client which includes multiple errors and omissions. A successful candidate will need to apply their technical knowledge of acquisition accounting, fair valuation determination and the goodwill calculation to identify and evaluate these errors and omissions. They are then required to set out a revised and corrected calculation. Finally, the candidate is asked to identify audit risks and to design and explain audit procedures for the goodwill, requiring a good knowledge of procedures for judgemental matters and accounting estimates in particular.

The candidate is required to:

Requirements	**Marks**	**Skills assessed**
In respect of the calculation of goodwill on the acquisition of Localex: Identify and explain fair value adjustments and any errors or omissions made by the Numilla financial controller. Where possible, quantify the effect of each fair value adjustment, error or omission on goodwill, showing all relevant figures.	13	• Using the data & information given analyse the data and information to support requirement • Use technical & professional knowledge to analyse the data
As far as the information permits, set out a corrected calculation of goodwill in the functional currency and the amount to be recognised in Numilla's consolidated statement of financial position at 30 June 2021. Where appropriate, use an annual discount rate of 5%.	5	• Perform relevant calculations, explaining or stating the issues • Assimilate complex information to produce appropriate accounting adjustments
Explain the key audit risks HW should address in its audit of the goodwill arising on the acquisition of Localex. For each key audit risk identified, set out	12	• Use technical knowledge and judgement to determine appropriate audit approach of substantive analytical procedures or tests of detail

the appropriate audit procedures for the year ended 30 June 2021."		• Explain the additional procedures required • Relate different parts of the question to identify critical factors • Identify potential weakness in controls and the ability of management to override controls
	30	

(1) Identify and explain any errors and omissions made by the Numilla financial controller. Where possible, quantify the effect of each error or omission on the goodwill.

Introduction

Goodwill arising from the acquisition of a foreign operation is a foreign currency asset. It should initially be calculated in the functional currency ($) of Localex as subsidiary and then be treated as an asset of the foreign operation and translated at the closing rate each year. Numilla's financial controller has done the calculation in £, although in this case the period end 30 June 2021 is the same as the acquisition date so there is no retranslation. The financial controller has not calculated goodwill in this way.

The carrying amount of goodwill in the consolidated financial statements is in the presentation currency (£)

Adjustments made to the fair values of assets and liabilities of a foreign operation under IFRS 3 should be treated in the same way as goodwill. The adjustments are recognised in the carrying amounts of the assets and liabilities of the foreign operation in its functional currency. The adjusted carrying amounts are then translated at the closing rate.

Consideration – errors and omissions

- The financial controller has omitted to include the contingent consideration payable in shares if Localex achieves average growth in profit before taxation of 10% or more per annum over the 3 years ending 30 June 2024. Contingent consideration should be included in the goodwill calculation at fair value at acquisition date, even if it is not deemed probable that it will be paid.

- The contingent consideration will be valued at its fair value based on the acquisition date share price but adjusted for probability and discounted = 500,000 shares @ £4.2 per share x 40% = £840,000. This should be converted into dollars for the calculation of goodwill £840,000 x 0.8 = $672,000.

- Further consideration may also be required as to whether any element of this contingent consideration is really a bonus to Mattie given that he continues to work in the business.

- The financial controller has included in error the acquisition costs of £100,000. If these relate to due diligence work and general professional fees they should be expensed through profit or loss. If they are costs relating to the issue of shares then they should be accounted for in accordance with IFRS9.

- Treating the costs correctly will result in a reduction of £100,000 in the goodwill figure.

- The financial controller has correctly used the group policy to calculate the non-controlling interest but has taken 20% of the net assets from the financial statements rather than calculating the fair value of the net assets and then taking 20% of that figure.

- See below in part 2 for correct calculation of this once fair values corrected too.

Net assets

- The financial controller has treated the net asset figure in $ as if it is in UK £ and has not correctly translated it into UK£ at the exchange rate of £1 : $ 0.8.

- For example, if translated correctly, the net asset figure should be $5 million = £6.25 million reducing the goodwill figure by £1.25 million. However, we need first to adjust for fair adjustments.

Fair Value adjustments

- In all cases adjustments to the fair value of the net assets will affect also the amount attributed to the non-controlling interest – because the NCI is calculated on the carrying amount adjusted for fair values.
- The Financial Controller has rightly considered whether there are identifiable intangibles which should be recognised separately from goodwill and has identified the licence to supply energy as one such intangible. This appears to arise from a contractual or legal right and so would meet the definition of an identifiable intangible.

  What is less clear is whether it has been correctly valued. It appears that the financial controller has performed an NPV calculation himself and has not involved any experts. Further information is needed on the basis of valuation to be able to evaluate whether this valuation is correct.

- It is incorrect to include the post-acquisition cost of acquiring a UK patent in the calculation of goodwill because it is post acquisition, although it is possible that this will form part of the consideration of the fair value of the MiniMax intangible – see below.

Fair Value adjustments - omissions

- No fair value adjustment has been made in respect of the freehold property. While this is already held at valuation this may not be the same as the fair value on acquisition as, under IFRS13, this should be valued at its highest and best use. While there is a presumption that this will be its current use, that is not the case where market factors suggest otherwise. An external valuation is also required to support the fair value of an asset of this nature.

- Fair value of plant and equipment also needs further consideration as this may not be equal to depreciated historic cost.

- Included in Localex's net assets is an intangible relating to development costs for the MiniMax wind turbine. These have presumably been capitalised at cost which is unlikely to be equal to their fair value so it appears that the Financial Controller has omitted to make a fair value adjustment where one should be made. Further information is needed to determine both the bases for valuation and the valuation amount.

- Numilla intends to continue and indeed to extend the supply of the MiniMax. However, to measure the fair value of the project at initial recognition, the highest and best use of the project would be determined on the basis of its use by market participants. IFRS 13 presumes that an entity's current use of an asset is its highest and best use, unless market or other factors suggest that a different use of that asset by market participants would maximise the value of that asset. That seems unlikely to be the case here as Numilla clearly intends to extend the benefit from the asset but it does still need to be considered. Even if current use is appropriate as a basis, measurement is likely to be different from cost as it will be based on the net cashflows to be generated from the product and its continuing development. Whether this will increase or decrease goodwill is difficult to assess.

- There may also be other intangibles which have been omitted altogether and that needs further consideration.

- In the financial statements of Localex, the decommissioning liability will have been measured on the basis of a discounted best estimate as required by IAS37. On acquisition it needs to be measured at fair value which is equal to the expected NPV of what it would cost to transfer its liability to a willing market participant. This has been calculated as $3.3 million which needs to be discounted at 5% per annum (0.784) for 5 years = $2.58 million. This will increase the liability by $1.08 million.

The adjustment would probably go to PPE – potentially there is no overall impact on net assets unless there is a deferred tax adjustment.

Deferred tax on fair value adjustments

- No tax effect has been recorded in respect of any fair value adjustment – this is an error

- The fair value adjustments will not impact either taxable profits or the tax base for Localex. However, for the Numilla group, they do result in taxable temporary differences as the asset or liability in the group accounts will be different to that in the Localex financial statements, which is equal to the tax base of that asset or liability in Utopia. Deferred tax will be calculated on the net total fair value adjustment at Numilla's rate of tax – 19%. Some of this will go to OCI. See requirement 2 for calculation

Total

(2) As far as the information permits, set out a corrected calculation of goodwill to be recognised in Numilla's consolidated statement of financial position at 30 June 2021.

Consideration	**$000**
Cash	1,000
2 million shares @ £4.20	6,720
Contingent consideration 500,000 x £4.2 (also accept £5 discounted)	672
Professional fees incurred in respect of the acquisition and associated issue of shares	0
Non-controlling interest (6,036 x 20%)	1,207
Total consideration	9,399
Net assets	
As reported in the Localex draft financial statements at 30 June 2021 5,000	5,000
Fair value adjustments:	
Contractual right to supply power and equipment in Utopia	1,280
UK patent costs	0
Increase in PPE for decommissioning liability	1,080
Increase in decommissioning liability	-1,080
Total FV adjustments	1,280
Deferred tax at 19%	(244)
	1,036
Total net assets	6,036
Goodwill	3,363
	@ £1 = $0.8 = £4,203,000

(3) Explain the key audit risks HW should address in its audit of the goodwill arising on the acquisition of Localex. For each key audit risk identified, set out the appropriate audit procedures for the year ended 30 June 2021.

- The Localex financial controller has made a lot of errors in calculating goodwill so there is a higher level of audit risk associated with the basic calculation than usual. All figures will need to be agreed to supporting documentation and there needs to be careful consideration of the currency in which balances are reported.

- Valuation of the contingent consideration is a key audit risk as determining this value requires consideration of the probability that the consideration will be paid. This will depend on how achievable the increase of 10% per annum in profit is.

- Audit procedures will include:
  - Review of forecasts to see if targets met

- Review of the historic accuracy of forecasting to see whether forecasts likely to be reliable
- Inspect the sale and purchase agreement to confirm details of circumstances in which the additional consideration will be paid, in what form it will be paid and when
- Inspect Mattie's contract of employment to assess whether that rewards him fully for his ongoing service or whether some element of the contingent consideration is really a bonus.

- Valuation of Localex's assets and liabilities at fair value is a key audit risk with particular focus on those involving judgements or accounting estimates

- Guidance on audit procedures for all accounting estimates is set out in ISA540. This requires auditors to consider inherent risk; complexity and subjectivity and to exercise greater levels of professional scepticism.

- Scepticism is particularly important in this case as Mattie has a large amount of contingent consideration riding on future profitability and therefore an incentive to reduce the value of net assets on acquisition.

- Specifically there is risk in separately identifiable intangibles for development costs and the contractual right to supply power in the following respects:

  - Whether they meet the definition of identifiable assets
  - Whether the right basis of valuation has been used for the identifiable assets
  - Whether data included in the valuation models is reliable

- Specific audit procedures on intangibles will include:

  - Involving auditor experts on both the method of valuation and the inputs to the models used
  - Reviewing the contract for power supply and ensuring that there is appropriate input from local advisors in interpreting it
  - Conducting sensitivity analysis to determine which assumptions have most effect on the valuation of the assets
  - Comparing any forecasts included in the models with historic data for the same or similar projects
  - Considering the assumed lifetime for MiniMax revenues and comparing this to similar products taking into account the changing market and technological advances
  - Consideration of the experience and expertise of those who have produced the valuations – it may be that the financial controller has appropriate expertise to value the contract for supply but he may not.
  - Consideration of factors which might affect the market for power in Utopia or the market for the MiniMax in Utopia and the UK

- Another area of judgement and estimate is in the valuation of the property (and potentially the plant and equipment). Specifically there is risk in:

  - Assessing the highest and best use
  - Valuing the property on that basis
  - Obtaining an appropriate understanding of an overseas property market

- Specific audit procedures will include:

  - Obtaining expert valuations
  - Assessing the qualifications of the valuer
  - Considering the evidence as to whether there is a higher and better use than the current use of the site as an industrial site.

◦ Considering whether there is any element of bias in the valuations adopted or assumptions used.
• There is also judgement in assessing the fair values of the liabilities for decommissioning. There will be assessments made of the probability of various outcomes, the costs and time scales associated with those outcomes, and the profit / premium any willing market participant would require to take on the liability and its associated risks. These are complex and subjective matters and involve a lot of judgement. They are made more complex here in that they involve legal matters in an overseas environment which may not be familiar to the local team so it is important local experts are involved as necessary. • Specific audit procedures will include: ◦ ◦ Obtain and check the accuracy of the client calculations of liability and review them as for other models used to produce estimates Agree to third party evidence to support the estimate ◦ Review relevant contracts and obtain an understanding of relevant local law ◦ Review correspondence with lawyers, claimants etc ◦ Obtain input from Localex's legal advisors to provide evidence of the estimate ◦ Examine the outcome of any similar contractual obligations or cases in the past
• There is less judgement associated with the deferred tax balance but it will still be necessary to gain our own understanding of the local tax regime and rules and not simply rely on the client's summary • A tax expert should be involved in considering whether there are any tax issues or provisions required and also in the deferred tax calculations and the basis for them.
• The NCI % appears to be straightforward here but it is still important to review the sale and purchase agreement and to ensure that there are no unusual provisions regarding control etc

Examiner's comments

3.1 Identify and explain fair value adjustments and any errors or omissions made by the Numilla financial controller. Where possible, quantify the effect of each fair value adjustment, error or omission on goodwill, showing all relevant figures.

While most candidates made a reasonable attempt at this element of the question, surprisingly few showed any real understanding of the determination of fair values for assets on acquisition. In particular, there was a commonly held view that internally generated assets such as development costs would be considered as they would be for normal financial reporting, rather than considering what separable intangibles existed and how they should be valued on acquisition.

The FX elements of this question were complex and, while some candidate addressed them really well, others missed the point and failed to notice at all that the calculation was in a mixture of £ and $.

This was a challenging question with a lot of issues to manage and assimilate. However, the number of issues involved (forex, omitted consideration, a variety of fair value adjustments, incorrectly recorded provisions and professional fees) meant that candidates were able to demonstrate knowledge and skills without always getting answers fully ’correct’. Very short answers for the discussion element were common traits of weaker answers.

3.2 Corrected calculation of goodwill in the functional currency and the amount to be recognised in Numilla’s consolidated statement of financial position at 30 June 2021

Most candidates attempted corrected goodwill calculations incorporating their conclusions and so were able to chip away at marks. Common errors included not recalculating NCI based on the adjusted net assets, muddling £ and $ figures (or not making it clear which currency the calculation was in) and translating individual figures incorrectly.

3.3 Audit risks for goodwill and audit procedures

There were many good answers to this section. Those who scored well focussed in on the key risks and judgemental areas rather than taking a more scattergun approach to procedures.

No marks were awarded for auditing figures (such as R&D at cost) which would have no relevance in a goodwill calculation, or the future need to consider impairment.

Those whose procedures comprised “discussions” or “management representations” did not score well.

While some mention of the audit of the Localex figures on which the calculation was based was rewarded, there were limited marks for this and undue focus on a component auditor wasted time and gained little credit.

Another common problem with answers to this section was that candidates would waste time describing general consolidation risks and failed to appreciate that the requirement was specifically aimed towards the testing of the goodwill balance.

Candidates spent time suggesting audit procedures that did not actually give an audit procedure and that failed to consider the principles of reliable audit evidence e.g. ‘check the foreign currency rate is correct, check the calculation of the decommissioning liability’ etc and therefore did not score marks.