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 Morton LLP, a firm of ICAEW Chartered Accountants. Morton is the auditor of Llama Ltd for the year ended 30 June 2021

The candidate is provided with Advance Information about Llama which comprises:

(1) A document including the scenario, background information and a schedule of audit issues; and

(2) The nominal ledger data for Llama for the 11 months ended 31 May 2021, contained within the data analytics software**.**

The audit issues identified in the advance information relate to PPE. Audit planning has been prepared using the 11-month data and Ben, the audit junior has raised two matters concerning two accounts 0010 leasehold improvements and 0040 Furniture and fixtures with the client.

The examination provides the candidate with the full 12-month data set and audit procedures carried out by Ben on PPE and intercompany balances and information concerning leases entered into by Llama.

The instructions for the candidate are set out in a separate exhibit, The candidate is required to:

1. In respect of the audit of each of: (a) additions to PPE; and (b) the depreciation charge:
    - identify and explain any weaknesses in the audit procedures performed by Ben Boreham (Exhibit 1); and
    - set out and explain the key audit risks and any additional audit procedures we should perform to address each risk. Use the data analytics software to identify specific key transactions which require further investigation.

2. Set out and explain the key audit risks, including inherent risks, arising from transactions and outstanding balances with CCC (Exhibit 2).

3. Using the information about property lease agreements (Exhibit 3):
    - set out and explain the appropriate financial reporting treatment for the property leases in Llama's financial statements for the year ended 30 June 2021;
    - prepare correcting adjusting journal entries; and
    - summarise the impact of your adjustments on Llama's profit or loss for the year ended 30 June 2021 as shown in the data analytics software.

Ignore any further adjustments for current tax and deferred tax.

Requirement	Marks	Skills assessed
1. In respect of the audit of each of: (a) additions to PPE; and (b) the depreciation charge: • identify and explain any weaknesses in the audit procedures performed by Ben Boreham (Exhibit 1); and • set out and explain the key audit risks and any additional audit procedures we should perform to address each risk. Use the audit software to identify specific key transactions which require further investigation.	22	• 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 PPE and leases • Set out correcting journal entries • Critically review and identify the audit risks
2. Set out and explain the key audit risks, including inherent risks, arising from transactions and balances with CCC (Exhibit 2).	6	• Use technical & professional knowledge to analyse the data and identify audit risks
3. Using the information about property lease agreements (Exhibit 3): • set out and explain the appropriate financial reporting treatment for the property leases in Llama's financial statements for the year ended 30 June 2021; • prepare correcting adjusting journal entries; and • explain the impact of your adjustments on Llama's profit for the year ended 30 June 2021 as shown in the audit software.	12	• Explain and recommend appropriate accounting treatments for PPE and leases • Assimilate and demonstrate understanding of a large amount of complex information. • Recommend appropriate and accounting treatments for the lease transaction • Set out journal adjustments
	40	

In respect of the audit of each of: (a) additions to PPE; and (b) the depreciation charge:

- **identify and explain any weaknesses in the audit procedures performed by Ben Boreham (Exhibit 1); and**

- **set out and explain the key audit risks and any additional audit procedures we should perform to address each risk. Use the data analytics software to identify specific key transactions which require further investigation.**

0010 Leasehold improvements - Additions to PPE

Weakness in procedures

Ben has not confirmed that the capital expenditure on the refurbishment has been authorised and correctly measured. Existence also not confirmed. He has agreed 4 amounts for interim applications to an interim valuation - he has also seen an unsigned contract. He has gained inadequate assurance from the fact that 80% of the amounts posted to the account are by Pierre, the finance director and has not obtained independent third-party verification of the amounts. Agreeing to an unsigned contract does not provide audit evidence, a budget (see Advance information), which is internally generated and a surveyors interim valuation are of limited value for audit evidence purposes. No work procedures have been performed on the substantial number of other transactions.

Audit risk and specific transactions of audit interest

Management override

The key risk here is management override – an internal control risk. As explained in the Advance information, Pierre is both responsible for the negotiation and oversight of the project and for the recording and payment of interim invoices to contractors. This is a small company and although it is expected that the finance director would be involved in the day to day operations of the business, the audit procedures should be designed to ensure that this risk is minimised.

Overstatement of assets

The four transactions Ben has examined are:

Transaction ID	Description	Debit	Effective date	User ID
46667	ALD interim application No 2	134200	23/9/2020	Pierre Delvenne
46700	Interim application No 1	151,500	1/9/2020	Pierre Delvenne
49266	Interim application no 3	142,850	1/11/2020	Pierre Delvenne
52195	Interim application no 3	142,850	1/12/2020	Pierre Delvenne
		571,400		

Examining the relevant account in the audit software using the stacked bar chart shows that two of the interim application invoices are for the same amount £142,850 and are both described as “Interim Application no 3” - and therefore there is a question over whether this amount is a duplication. A key risk exists that the additions are overstated – Audit procedures are necessary to ensure that assets are not overstated.

It is not clear what threshold Ben has applied in selecting the 4 interim application amounts above. However, there are a further two large payments which he has not examined which have been posted by Pierre.

Interim payment no 4 for £40,351 and Stamp duty and Land tax £30,799. Both these transactions give rise to audit risk and should be investigated further.

Transaction ID	Description	Debit	Effective date	User ID
61360	Interim application No 4	40,321	1/3/2021	Pierre Delvenne
44498	Stamp duty and land tax	30,799	1/9/2020	Pierre Delvenne

Also, Ben has only examined additions posted by Pierre, amounts over materiality have also been processed by Dianna. A review of invoices posted to 0010 using the stacked bar chart - (settings effective periods for both primary and secondary variables) reveals that a lease premium for £150,000 is included in 0010 Leasehold improvements. This has been processed by Diana. This is a key transaction of audit interest which Ben should have identified.

Transaction ID	Description	Debit	Effective date	User ID
44697	Project – Property lease Premium	150,000	10/8/2021	Dianna Stevens

Further enquiry is required about the nature of the lease for which this premium has been paid.

Existence

Ben has not confirmed existence of the assets. With a contract of this size, it is expected that there would be a completion statement to verify that total costs recorded are as agreed and that the works are complete.

Understatement of right of use asset and liability

There is a clear risk that liabilities and assets are omitted from the statement of financial position. Llama has entered lease arrangements for the restaurant properties.

007100 Rent account shows the following balances:

	2021	**2020**
	£	**£**
007100 Rent	391,560	5,000

The financial reporting of these lease transactions is almost certainly incorrect given the nature and investment in the restaurants it is unlikely that Llama would have signed a short-term lease for the properties.

There is no balance for right of use asset and no lease liability in the DAS,

In summary the additional procedures Ben should perform include:

- Reconcile and confirm interim payments on the contract to completion statement signed by both the contractor and authorised by the Llama board.

All interim payments should be agreed to a signed contract authorised at board level and to invoices provided by the contractor. The invoices should be reconciled to the contract to eliminate the possibility of over payment. A completion statement certifying the work should also be agreed to the contract. The contract should also be examined to identify any retention payments which may be due and which Llama has not recognised.

- Scrutinise Llama board minutes to obtain evidence of authorisation for the project and the budgeted expenditure.
- Obtain a copy of the lease contracts, agree the lease premium to the contract and ensure that the leases are correctly recorded. Agree any legal fees related to the lease to third party evidence.
- Scrutinise asset accounts for material, unusual (ie duplicated amounts) and tax sensitive items.
- Agree stamp duty payment to supporting documentation and ensure correctly recognised.

Additions in Account 0040 Furniture and fixtures

Weaknesses in Ben's procedures

A review of 0040 has performed by Ben at the planning stage when he identified a large transaction for £101,116 *(see Advance information) but as Ben merely agreed this transaction to a purchase order, procedures were inadequate. There has been no follow up of this transaction at the final audit.

A second transaction for £43,000 described as Interim application 1 has been identified by Ben at the final audit in 0040 Furniture and fixtures.

There is already a transaction described as an Interim application no 1 for £151,500 ID 46700 included in account 0010 and further confirmation should be obtained that the invoice is correctly described and recorded and not a duplication.

Ben has not performed any procedures on the remaining £470k of additions to this account on the basis that individually the amounts are below materiality. A scan of these items indicates that a significant number of the transactions are not capital additions but repairs and therefore incorrectly recognised as assets resulting in profit being overstated.

Ben has not verified that the assets exist by physical inspection.

Key risks and specific transactions of audit interest

As stated above, the key risk is that assets are overstated and profit understated because of the repairs, hire charges etc as capital items.

Reviewing the transactions in account 0040 shows that there are many items which are described as repairs/hire costs. Here are examples of this type of error entered by each staff member.

For example:

Transaction ID	Description	Debit	Effective date	User ID
41447	Gas leaks in ovens - assessed damage and replaced valves	1432	25/07/2020	Diana Stevens
50020	10 Week Hire. 5 instalments	18,758	20/11/2020	Pierre Delvenne
55722	Bar and equipment hire	4,750	12/1/2021	Susan Chu

Individually the amounts are small but collectively could represent a material adjustment to profit.

Using the Tree Map to review all manual journals posted to this account shows that some of the smaller transactions have been credited as manual journals and debited to CCC the intercompany loan.

Using the audit software Heat map the following transactions recorded in June 2021 are of audit interest because they suggest that Pierre has capitalised £50,000 of expenses.

See Transactions ID 74653 entered by Pierre in June 2021 and described as “transfer to assets”

Credit			Effective date
7552	Computers & Software	-30000	27/06/2021
8208	Venue decorations	-20000	27/06/2021
Debit			
0055	Computer Equipment	30000	27/06/2021
0040	Furniture and Fixtures	20000	27/06/2021

Asset additions in Account 0055 Computer equipment

Weakness in Ben’s procedures

Ben has not performed any audit procedures on Computer Equipment 0055 – the company capitalisation policy suggests that this is includes tablets and handsets – these are unlikely to last for more than 12 months and therefore again the increase of £42,550 may largely comprise items that should be expensed.

In summary the additional procedures Ben should perform include:

- Select a sample of additions to 0055 and 0040 and agree to invoices ensuring that the items are appropriately classified as an asset.
- Quantify the amount of the potentially incorrect capitalisation of repairs.
- Enquire and obtain supporting documentation for the journals posted by Pierre in June.
- Agree the invoice for £101,116 identified at the planning to documentation. Follow up on Susan’s comment that this was part of a leasing arrangement with ECC and ensure that appropriate adjustments are included in the financial statements.
- Select a sample of additions and physically verify.

Weaknesses in audit procedures for Account code 008000 Depreciation

Ben’s analytical procedure provides some comfort that the depreciation has been appropriately calculated according to the asset useful lives provided by Pierre. However, his analytical procedure, Ben does not ensure that the depreciation charge included in the financial statements is appropriate for the types of assets. Simply comparing the SOFP movement with the expense account does not provide audit evidence that the assets and the depreciation charge are fairly stated.

There is an audit risk that subsequent measurement of PPE is incorrect. The asset lives appear to be excessively long given the nature of the assets and the accounting policy should be challenged with management. Ben has not done this

There is a risk that management has deliberately manipulated the financial statements due to pressure to obtain finance after the year end. Llama is under pressure to provide audited financial statements to the bank which show the company in a favourable light – This increases the pressure on management to manipulate the profit figure and understate liabilities. The audit risk here from pressure to report a profit leads to an understatement of depreciation charge and an overstatement of profit.

Specific transactions of audit interest

The stacked bar chart for 008000 identifies the following transaction recorded in June 2021.

Transaction ID	Description	Debit	Effective date	User ID
72501	Tee-pee impairment	19,314	23/06/2021	Susan Chu

This transaction is of audit interest because it is described as an impairment. Ben has not identified this transaction and not enquired about the nature of this impairment. There may be other impairments required and assets may therefore not be fairly stated.

Audit procedures to be performed include

- Investigate the reason for the impairment charge and confirm whether any further impairment charges are required.
- Recalculate depreciation based on asset lives used for the year ended 30 June 2020 and quantify the difference.
- Challenge management about the asset lives which appear to be excessive particularly in respect of leasehold improvements

2. Set out and explain the key audit risks, including inherent risks, arising from transactions and balances with CCC (Exhibit 2).

Llama is reliant on support by its parent company CCC. This is a related party and there is an audit risk that disclosures are misleading.

The background information suggests that this support may be withdrawn and Llama is seeking a bank loan after the year end which raises a going concern risk

There is a risk that the financial statements are incorrectly stated arising from the lack of interest charge in the DAS. According to the loan agreement interest is charged at 8% but no interest appears to have been recorded in the DAS for Llama in respect of this loan for the year ended 30 June 2021.

The interest charge is not fairly stated The charge to the interest account 007903 shows a fall in comparison with the previous year.

	2021 £	2020 £
007903 Loan interest paid	5,203	30,041

Key transactions of audit interest

Examining the double entry for the transactions on account 007903 for the year ended 30 June 2021 indicates that £5,203 relates to the bank loan in account 002300 and no interest on the intercompany loan is recorded.

The Account code 2103 CCC intercompany contains many transactions - an example of a transaction of interest is the following:

A large debit transaction ID 61893 relates to cash received from Aurora leasing for £272,133 on 13/2/2021.

Transaction ID	Description	Debit	Effective date	User ID
61893	Aurora leasing cash received	272,133	13/2/2021	Susan Chu

This is a key transaction because it refers to a leasing contract which may be incorrectly recognised. See also the Account code 2310 HP Transaction ID 61310 £253,086 Cash received Agreement restaurant fitout and refit - which suggests that there is a sale and lease back of catering equipment.

Tutorial note: Any transaction adequately described and explained why it is an audit risk was accepted in the marking.

3. Using the information about property lease agreements (Exhibit 3):

- **set out and explain the appropriate financial reporting treatment for the property leases in Llama's financial statements for the year ended 30 June 2021;**
- **prepare correcting adjusting journal entries; and**
- **summarise the impact of your adjustments on Llama's profit for the year ended 30 June 2021 as shown in the audit software.**

Initial measurement

Under IFRS 16, a contract is deemed to be a lease if it conveys the right to control the use of an identified asset for a period of time in return for consideration. The terms of the leases for the restaurant properties satisfy this definition therefore Llama should recognise a right of use asset and a lease liability.

The right of use asset is measured at cost which includes the initial measurement of the lease liability plus any direct costs incurred relating to the asset – this includes the legal fees, the lease premium £150,000 and stamp duty £30,799 included in Account code 0010 Leasehold improvements.

The right of use assets should be measured at the commencement of the lease as follows:

	Llama One and Two	Llama Three
	£	£
Present value of future lease payments		
£249,996 x (DCF 8% for 10 years) 6.71		1,677,473
£118,548 x (DCF 8% for 15 years) 8.559	1,014,652	
Direct costs		
Lease premium £150,000 and stamp duty £30,799		180,799
Legal fees	6,443	2,738
	1,021,095	1,861,010

(Tutorial note: Some payments are made quarterly in the data but as a reasonable approximation the calculations have been annualised. Strictly the quarterly interest rate is $1.08^{1/4}$ = 1.943% (approx.). Reasonable calculations were accepted)

Subsequent measurement

The lease is amortised at the rate stated in the lease agreement. Payments made in respect of the lease will reduce the liability and should not be charged as rent. IFRS 16 requires total finance charges to be allocated to each period during the lease term so as to produce a constant periodic rate of interest on the outstanding lease obligation. For the purpose of this calculation the payments are assumed to be in arrears although they have actually been paid quarterly in respect of the Llama One and Two lease and monthly in the case of the Llama Three lease.

	Llama One and Two	Llama Three	Total
	£	£	
Present value of future lease payments	1,014,652	1,677,473	2,692,125
Add interest calculated at 8%	81,172	134,198	215,370
Less: Payments included in the rent account	(118,548)	(249,996)	(368,544)
Lease liability at 30 June 2021	977,276	1,561,675	2,538,951

<u>Depreciation</u>

The right of use asset will be measured at cost less accumulated depreciation and impairment losses in line with IAS 16 PPE. The right of use asset is depreciated over the shorter of the lease term and the useful life of the asset - unless the asset is expected to be transferred to the lease at the end of the lease terms. In that case, the asset will be depreciated over useful life of the property.

The lease does not contain a legal option to buy the property therefore depreciation should be calculated over the lease term as there is no other information concerning the life of the assets – leasehold improvements are depreciated over 25 years - therefore the board needs to set an accounting policy for leasehold property. For the purpose of illustration, I have used 15 years for the Llama One and Two leases and 10 years for Llama Three lease. Depreciation should commence when the asset is brought into use – which I would need to determine. A full year has been used in the calculations below.

	Llama One and Two	**Llama Three**	**Total**
	£	**£**	
Present value of future lease payments	1,014,652	1,677,473	2,692,125
Direct costs	6,443	183,537	189,980
Right of use asset	1,021,095	1,861,010	2,882,105
Depreciation 15 years / 10 years	(68,073)	(186,101)	(254,174)
Carrying amount at 30 June 2021	953,022	1,674,909	2,627,931

(Tutorial note: calculations amortising Llama three from November were accepted.)

Journal entries required:

	£
DR Right of use assets	2,692,125
CR Lease liability	2,692,125

Being recognition of right of use asset at PVFLP

Dr Right of use asset	189,980
Cr Rent 007100	9,181
Cr 0010 leasehold improvements	180,799

Being transfer of direct costs to Right of use asset

Dr Interest	215,370
Cr Lease Liability	215,370
Dr lease liability	368,544
Cr Rent	368,544
Dr depreciation	254,174
Cr accumulated depreciation	254,174

Being adjustments to profit for interest rent and depreciation

Net impact on closing loss for the year ended 30 June 2021 as shown in the data analytics software increases to £119,873

		£
Loss for the year per inflo		(20,054)
Decrease loss by Legal fees	9,181	
Decrease loss by Rent	368,544	
Increase loss by depreciation	(254,174)	
Increase loss by Interest	(215,370)	
Overall increase in loss of		(91,819)
Revised loss		(119,873)

Examiners comments on candidates' performance

Overall comments

This question was attempted well with most candidates able to identify numerous weaknesses in the audit work performed by Ben Boreham demonstrate skills of using the DAS and accounting for leases. Answers of weaker candidates would often be long and repetitive and lacking in focus - sometimes to the detriment of later questions illustrating poor time management. The shorter focussed answers tended to be the ones which scored the most marks.

Good candidates were able to incorporate the issues identified within the Advance Information as part of their answer and also spotted issues raised through the impact information in the exam. Evidence of focussed use of the DAS was also shown with many candidates finding the month 12 transactions 'transfer to assets' transaction ID 74653 £50,000 and the impairment charge transaction ID 72501 £19314.

Weaker candidates often focussed on the exam information exclusively with no appreciation for the issues raised from the June data and rarely linked information from the scenario set out in the Advance information.

1.1 In respect of the audit of each of: (a) additions to PPE; and (b) the depreciation charge:

- **identify and explain any weaknesses in the audit procedures performed by Ben Boreham (Exhibit 1); and**
- **set out and explain the key audit risks and any additional audit procedures we should perform to address each risk. Use the audit software to identify specific key transactions which require further investigation.**

Weaknesses in procedures

This requirement was typically well attempted with most candidates able to identify numerous weaknesses in the audit work performed by Ben Boreham.

Some candidates failed to appreciate the importance of third party evidence – the reason why agreeing to the budget is a weakness in audit procedures is not because the budget can be manipulated, as many candidates surmised, but because it is an internally generated document. Failure to check the qualifications of the surveyor is not necessarily a weakness in the audit procedure - it is because the valuation provided little evidence of audit assertions of existence, ownership nor measurement. It would have been good to see more explanation about why the audit procedures were poor. For example, the fact that the contract was not signed was often identified but many did not go on to explain why this is a problem.

Audit risks

Candidates at times did not always step back and look at the big picture. If they had identified immediately that the big risk was to overstate profit for funding purposes, they would have written more succinctly about what the key issues were and use the DAS to provide evidence of this. Answers often worked through the points in the question in order discussing each as they went so duplicating the fact that assets would be overstated rather than stating the risk and providing the evidence. It would have been good to see further development of the point to explain that as a result of the incorrect application of IFRS16, the liabilities could be understated too.

It was often noted that Pierre was posting transactions that he should not have been but not many went on to discuss why this could be: override of controls leading to overstatement of profit.

Weaker candidates failed to spot that lengthening the life of the lease resulted in understating the depreciation. They missed the big picture of why the client may be trying to do this – overstatement of profit. Weaker candidates thought the extension would decrease profit.

Significant transactions

It was good to see evidence that some candidates had prepared and examined the data in advance of the examination. However, often transactions were not clearly described – descriptions should be of a standard that would be expected in preparing a working paper for audit purposes. This was an area of weakness for many candidates and as the DAS content in question 1 increases in future sittings, should be improved in candidates answers. Many identified that PPE contained costs best described as repairs and could explain the implication of this. Transaction ID 74653 £50,000 'Transfer to assets' was identified as a June transaction and candidates scored well when the transaction was identified and the implications explained.

Audit procedures

Weaker candidates listed procedures as 'view the invoice' without explaining why this would be useful. Often the procedures were limited to 'talking to Pierre' – even though earlier the candidate may have described the risk of management override as being a key audit risk. Again, there was a lot of duplication and with a little planning, answers could have been briefer and more focussed.

The audit procedures recommended were at times vague, such as 'check that…' or 'confirm…' or 'speak to…'. Often procedures were missing the source document to find, or the reason it was being looked for. Weaker candidates failed to demonstrate the ability to challenge management for example on the change of useful lives. Answers showed that some candidates are too trusting of information given to them and are not being sceptical enough.

1.2 Set out and explain the key audit risks, including inherent risks, arising from transactions and balances with CCC (Exhibit 2).

Candidates were provided with the terms of the loan with the parent company CCC. Only a minority used the DAS to identify that an interest charge had not been recorded in the interest account 007903 – given the size of the account balances with CCC this would have been a very material transaction. (The large change in the interest account code 007903 was identifiable in advance of the examination.)

Weak answers just suggested that the loan may not have been accounted for correctly but did not get into anything more specific. It was good to see that many identified the loan renewal as a potential going concern issue.

Most candidates picked up marks for looking through Account 2103 and identifying large cash transfers and unusual transactions and demonstrated awareness of the potential for money laundering. However, sometimes descriptions of the transactions were often too vague for markers to award marks.

Weaker candidates wasted time by listing audit procedures which were not asked for in the question.

1.3 Financial reporting of the leases

This was answered well, with many achieving full marks.
Some candidates lost marks for not explaining the impact on profit as shown in the DAS.

Common mistakes for those that performed less well would be to fail to capitalise the legal costs or to capitalise them within both the right of use asset and the lease liability.

Question 2 solutions

Scenario

Eastoak plc is an AIM listed company that manufactures building products for the construction industry.

Eastoak has a 30 September year end. It does not have any subsidiary companies. Its functional currency is the £.

Eastoak has three divisions which each produce a separate product line:

- Ventilation division (based in UK)
- Lighting division (based in UK)
- Insulation division (based in France).

Shareholders have been concerned for some time about the results of Eastoak.

After extended discussion the Eastoak board decided to close the Insulation division. The division was closed on 1 July 2021.

Despite the closure, shareholders remained concerned and, following a board meeting in September 2021, the finance director and CEO resigned. A new CEO has been appointed and the candidate has been seconded to assist with the preparation of the financial statements.

A junior member of the finance team has prepared a draft analysis of overall performance of Eastoak for inclusion in the management commentary. The CEO expresses concerns in the scenario. He did not think the junior's interpretation was appropriate or complete. The candidate is required to:

(1) Set out and explain, for each of the three issues in Exhibit 1, your recommended financial reporting treatment in Eastoak's financial statements for the year ended 30 September 2021. Include correcting journal entries.

(2) Prepare a revised statement of comprehensive income for Eastoak for the year ended 30 September 2021 (Exhibit 1), suitable for publication, which includes your adjustments from 1. above. Show your workings.

(3) Evaluate Georg May's draft analysis of Eastoak's overall performance and its divisions (Exhibit 2). Include any relevant additional analysis. Use your revised statement of comprehensive income."

Requirements	Marks	Skills assessed
(1) Set out and explain, for each of the three issues in Exhibit 1, your recommended financial reporting treatment in Eastoak's financial statements for the year ended 30 September 2021. Include correcting journal entries.	**18**	• Assimilate and demonstrate understanding of a large amount of complex information. • Evaluate, using judgement and scepticism, the appropriate accounting treatments for complex transactions including closure of a division, refinancing arrangement and a share based payment • Recommend appropriate accounting adjustments in the form of journal
(2) Prepare a revised statement of comprehensive income for Eastoak for the year ended 30 September 2021 (Exhibit 1), suitable for publication, which includes your adjustments from (1) above. Show your workings.	**6**	• Assimilate information and use own accounting adjustments to prepare revised extracts from the financial statements
(3) Evaluate Georg May's draft analysis of Eastoak's overall performance and that of its divisions (Exhibit 2). Include any additional analysis. Use your revised statement of comprehensive income."	**6**	• Perform relevant calculations, explaining or stating the issues • Using the data & information given analyse the data and information to support requirement • Apply scepticism to identify errors and omissions in the narrative
	30	

1. Set out and explain, for each of the three issues in Exhibit 1, your recommended financial reporting treatment in Eastoak's financial statements for the year ended 30 September 2021. Include correcting journal entries.

Disposal of Insulation division

Loss from discontinued operations

The Insulation Division is a substantial and separate part of the Eastoak's business as it is one of only three divisions and it is a profit centre where revenues and costs are therefore separately identified.

In accordance with IFRS 5 it is therefore a component of the entity which has been closed and should be treated as a discontinued operation as a single line entry on the face of the statement of profit or loss. Eastoak should make appropriate presentation and disclosure of the effect of the division closure in the year ended 30 September 2021. It should also adjust the comparative figures to reflect the closure.

Administrative expenses

The allocation of administrative expenses needs investigating - it would seem unusual that the allocation of costs should increase when revenue for the division has fallen. Particularly as there is a separate line item for closure costs. Also, the division was closed on 1 July 2021 so a 12-month allocation would be incorrect. The costs identified as part of the discontinued operation should be those that will no longer be incurred when the division is disposed of. Therefore, further investigation is needed with regards the nature of the administrative costs before I can recommend an adjustment. See below for detailed analysis Allocated costs are not disclosed as part of discontinued operations.

The provision for redundancy appears to meet the conditions under IAS 37 as a formal announcement has been made.

Retraining costs should not be provided as these relate to on-going business. There may be other costs as they have relocation costs.

Journal adjustment required

Journal 1	£000
Debit: Provisions	800
Credit: Closure costs	800

Asset disposals - Held for sale

Plant and equipment appears to qualify as a held for sale asset in accordance with IFRS 5 from the date they are marketed (ie advertised for sale) - 1 July 2021

At this date, according to IFRS 5, the assets of the Insulation division should be stated at the lower of:

(1) Their carrying amount, less depreciation up to the time it is classified as held for sale; and
(2) Their fair value less costs to sell

The fair value is measured using the euro exchange rate at the date of sale.

Eastoak should charge depreciation up to the time of classification and then no depreciation for the last three months. Therefore, three months depreciation should be reversed out.

It is not a disposal group as assets are to be sold separately to a property developer and a competitor.

If fair value is lower than the carrying amount then an impairment charge should be made. In the case of plant and equipment the comparison results in a gain therefore the carrying amount is not adjusted and £7,632,000 (see working below) should be recognised as a current asset.

As Eastoak has adopted the revaluation policy, the land and buildings should be revalued immediately before being reclassified and the gain will be taken to the revaluation surplus through OCI.

On reclassification, the selling costs would be included in the statement of profit or loss as an impairment charge of £455k (€500k/1.1).

Thus, the land and buildings held for sale should be recognised as a current asset and measured at £12,272,000. The details are shown in the working below together with the journals required to be processed.

	Land	**Buildings**	**Plant and equipment.**
	£000	**£000**	**£000**
Cost at 30 September 2021	5,000	5,880	8,600
Depreciation charged for the 9 months to 30 June 2021 140 x 9/12 / 1290 x 9/12		(105)	(968)
Carrying amount at 1 July 2021	5,000	5,775	7,632

Land and buildings	
Carrying amount before reclassification (£5,000,000 + £5,775,000)	10,775
Revalue land and buildings immediately before sale	
Fair value €14 million @ £1 = €1.10	12,727
Revaluation gain recognised in revaluation reserve through OCI	1,952
Fair value before reclassification	12,727
On reclassification the €500,000 selling costs would be recognised as an impairment loss in the statement of profit or loss	
€500,000 @ £1 = €1.10	(455)
Carrying amount at 30 September 2021 is the fair value less costs to sell	12,272
Plant and equipment	
Fair value less selling costs	
€9.7 million - €100,000 = 9.6 million	8,727
£1 = €1.10	

Therefore, the carrying amount is the lower of the fair value less costs to sell	7,632

Journal 2	**£000**
Dr Plant and equipment accumulated depreciation (1290 – 968)	322
Dr Property accumulated depreciation (140 – 105)	35
Cr Administrative expenses (discontinued operations)	357

Being write back of depreciation for 3 months on reclassification of division assets to held for sale.

Journal 3	**£000**
Dr Property (1,952 – 455)	1,497
Cr Revaluation reserve through OCI	1,952
Dr Administrative expenses (discontinued operations)	455

Being revaluation and impairment of land and property on reclassification of division assets to held for sale.

Journal 4	**£000**
Dr Current assets - held for sale	19,904
Cr Property	12,272
Cr Plant and equipment	7,632

Being transfer of assets held for sale.

2. Refinanced bank loan

The original loan is measured at amortised cost. The initial fees and transaction costs are minimal so the effective interest rate (EIR) of the original loan is equal to its nominal rate of 5% pa.

If a new loan is agreed between a borrower and a lender, or the two parties agree revised terms for an existing loan, the financial reporting treatment depends on whether the original liability should be derecognised (extinguished) and a new liability recognised, or whether the original liability should be treated as modified.

A new liability should be recognised if the new loan terms are a substantially different from the terms of the original loan. The terms are substantially different if the present value of the cash flows under the new loan terms, including any fees payable/receivable, discounted at the original effective interest rate (of 5% pa in this case), is 10% or more different from the present value of the remaining cash flows under the original terms. There is said to be an 'extinguishment' of the existing liability. In these circumstances:

- the difference between the carrying amount extinguished and the fair value of the new loan should be recognised in profit or loss; and
- the fees payable to the bank should be recognised as part of that gain or loss.

If the difference is below this cut-off point of 10%, there is said to be a modification of the terms. In these circumstances, the existing liability is not derecognised; and its carrying amount is adjusted by the fees payable/receivable and amortised over the remaining term of the modified liability.

The present value of remaining cash flows is compared with the present value of cash flows under the new terms. The present value of the cash flows arising on the old terms is £20 million:

Original Loan cash flows (2015 to 2020)			
			£000
£1m	DCF 5 years at 5%	4.329	4,300
£20m		0.784	15,700
			20,000
New loan (2020 to 2025)			
Principal = £30 million	DCF 5 years at 5%	0.784	23,500
Fees		1.0	500
			24,000

Tutorial note: Figures include roundings.– using a calculator will produce different numbers but will not change the conclusion

Discounting the new loan, for this purpose, uses the effective interest rate on the original loan of 5% pa.

The fees of £500,000 are required to be treated as integral to the cash flows of the new loan for the purposes of comparing it with the original loan. These fees are therefore expensed immediately as part of the extinguishment loss and do not form part of the fair value of the new loan in future reporting periods. The fees have already been expensed in the financial statements.

The increase in cash flows represents more than a 10% change from £20 million.

Therefore, the original financial liability is derecognised and a new financial liability on the new terms is recognised.

The new financial liability is initially measured at fair value in accordance with IFRS 9 and any difference between this amount, plus fees, and the derecognised financial liability is recognised in profit or loss.

Fair value of the new loan is £22.418 million.

Journal 5 for the extinguishment is:

	£000
Dr Original loan (carrying amount)	20,000
Dr Loss on extinguishment (profit or loss)	2,418
Cr New Loan - fair value	22,418

£500,000 fees have already been recorded in profit or loss and should be added to the loss on extinguishment

New loan

The fair value of the new loan is recognised at its fair value on 1 October 2020 of £22.418 million. The fees of £500,000 do not form part of the loan liability, having been recognised in profit of loss as part of the extinguishment loss.

For the year ended 30 September 2021, the finance charge is 6% x £22,418k = £1,345k

Journal 6 for the finance charge for the year ended 30 September 2021 is:

	£000
Dr Finance charge	1,345
Cr New loan	1,345

3. Share-based payment

Because the employees – the recipients – have the right to choose the form settlement will take, IFRS 2 regards the transaction as a compound financial instrument to which split accounting must be applied.

This means that the entity has issued an instrument with a debt component in so far as the recipient may demand cash and an equity component to the extent that the recipient may demand settlement in equity instruments.

IFRS 2 requires that the value of the debt component is established first. The equity component is then measured as the residual between that amount and the value of the instrument as a whole.

The fair value of the *cash route* at grant date is: £4,760,000 = £4 (share price) x 700 (employees expected to satisfy the vesting conditions) x 1,700 (number of shares)

The fair value of the *share route* at grant date is: £4,900,000 = £3.50 (estimated fair value) x 700 (employees expected to satisfy the vesting conditions) x 2,000 (number of shares)

The fair value of the *equity component* is therefore: £4,900,000 - £4,760,000 = £140,000

Year ended 30 Sep	**Workings**	**Liabilities (£)**	**Equity (£)**	**Expense (£)**
2021	(1/4) x 1,700 x £4.5 x 600	1,147,500		1,147,500
	£140,000 x (1/4)		35,000	35,000
				1,182,500

Journal 7

	£
Dr Compensation expense (income statement)	1,182,500
Cr Liability	1,147,500
Cr Equity through OCI	35,000

2. Prepare a revised draft statement of revised statement of comprehensive income for Eastoak for the year ended 30 September 2021 (Exhibit 1) suitable for publication, which includes your adjustments from 1 above. Show your workings.

The post-tax loss for the division amounts to £792 and is shown in working 1 below.

	£000
Loss for the year	(1,494)
Journal 1 remove provision for retraining	800
Journal 2 remove depreciation for 3 months	357
Journal 3 Include impairment charge for land and buildings	(455)
	(792)

	2021	**2020**
	£000	**£000**
Revenue		
385,000 - 76,600	308,400	
376,000 - 99,416		276,584
Cost of sales		
283,388 - 52,088	231,300	
263,200 - 69,591		193,609
Gross profit	77,100	82,975
Administrative expenses		
92,120 + Jnl 7 1,183 – 24,357	(68,946)	
82,720 – 21,872		(60,848)
Closure costs		
2,000 – Jnl 1 - 800 – 1200		
Operating profit	8,154	22,127
Finance costs 500 + Jnl 5 + 2,418, + JNL 6 1,345	(4,263)	(1,100)
Profit before tax	3,891	21,027
Income tax expense		
1328 + 351	(1,679)	
5506 - 1511		(3,995)
Profit for the year from continuing operations	2,212	17,032
Loss from discontinued operations	(792)	-
Profit for the year	1,420	17,032
Other comprehensive income		
JNL 3 Revaluation gain on reclassification	1,952	
JNL 7 Share based payment	35	-
	1,987	
Total comprehensive income for the year	3,407	17,032

3. Evaluate Georg May's draft analysis of Eastoak's overall performance and that of its divisions (Exhibit 2). Include any additional analysis. Use your revised statement of comprehensive income

Georg says:

"Overall revenue has increased by 2.39% but this hides a 23% fall in revenue from the Insulation division and an increase of 11.5% in the revenue for the Ventilation and Lighting divisions."

Georg's calculations are accurate, and revenue overall has increased

(£385k – £376k) /£376 x 100 = 2.39%

and the Insulation division revenue has fallen by 23%

(£76.6k – £99.4k) /£99.4 x 100 = 23%

The revenue for Ventilation and Lighting divisions have increased by 11.4%

(£308.4k – £276.6k) /£276.6 x 100 = 11.5%

However, it does not represent a fair picture of the performance in terms of revenue generation of the three divisions:

	Lighting and ventilation	Insulation	Company
% Increase/ (decrease) in revenue	11.50%	(23.0%)	2.39%

The Insulation division was closed on 1 July 2021 and therefore the 9-month results for Insulation for 2021 are not comparable with 2020.

A like-for-like period would have resulted in a comparable level of revenue.

	£000
2021 Revenue £76,600 x 12 months / 9 months	102,133
2020 Revenue for 12 months	99,416

Georg should have made clear in the analysis that the revenue for the Insulation division was for a shorter period.

Georg notes that:

"The revenue for the Ventilation and Lighting divisions has increased due to a 15% increase in demand for these products compared to the year ended 30 September 2020"

If the revenue for the Ventilation and Lighting divisions is flexed to reflect the increase in demand in order to produce a comparison, it shows that the increase in demand has been achieved potentially through a fall in price.

			Like for like volume
2021	308,400	x 100/115	268,174
2020	276,584		276,584
Fall due to price ?			8,410

So, Georg's statement may be accurate but does not explain what has caused the increase in demand which may have been a fall in price.

Georg notes that the Insulation division's prices have fallen due to currency movements. These are probably outside the Insulation division management's control, but Georg does not make this clear.

Recalculating the division's revenue, controlling for 20% price fall shows only a small fall in volume comparing 9 months to 12 months results.

	£000
2021 Revenue 76,600 x 100/80	95,750
2020 Revenue for 12 months	99,416
Fall due to volume	3,666

And using the full 12 months as a comparison indicates that potentially demand has increased.

	£000
2021 Revenue 76,600 x 12 months/ 9 months x 100/80	127,667
2020 Revenue for 12 months	99,416
Increase due to volume	28,251

Georg states:

"The impact of currency movements on the prices charged by the Insulation division have contributed to a fall in the gross profit for the company from 30% to 26.4%."

Gross profit %	Lighting and ventilation	Insulation	Company
2020	30.00 %	30.00%	30.00%
2021	25.00%	32.00%	26.40%

Georg is correct again in saying that the GP has fallen from 30% to 26.4% - but analysing the divisions gross profits shows that the Insulation division GP has actually increased, and the Ventilation and Lighting has fallen.

Further investigation would be needed to explain the movements in gross profit – which is only partly explained by currency movements – The Insulation division may have benefited from the potential upside of currency movements on purchases.

Georg also says:

"The Insulation division has made a loss for the year ended 30 September 2020 of £1,494,000 compared to a profit of £6,442,000 for the year ended 30 September 2020."

Much of the fall in the division's profit can be explained by Eastoak allocating a full year of administrative overheads to the division and also incorrectly recognising retraining costs of £800k.

For 2020, the company appears to have allocated the overheads based on revenue.

	Lighting and ventilation	Insulation	
	£000	£000	£000
Allocation based on revenue			
82,720 x 276,584/376,000	60,848		
82,720 x 99,416/376,000		21,872	82,720

For 2021, the method has been changed and the company allocated 2021 administrative expenses in the proportion of administrative expenses allocated in 2020. (The analysis below does not include the adjustment for compensation expense – JNL 5 – this would affect continuing operations only)

	Lighting and ventilation	**Insulation**	
	£	**£**	**£**
Original allocation based on previous year			
92,120 x 60,848/82,720			
92,120 x 21,872/82,720	67,763	24,357	92,120
I			
Allocation if based on revenue			
92,120 x 308,400/385,000	73,791		
92,120 x 76,600/385,000		18,328	92,120
	(6,028)	(6,028)	

Putting through the adjustments as noted above shows that the divisions loss is £792 this would become a profit of £5,236 if the administrative expenses had been allocated based on revenue which appears to have been the basis used in 2020.

Georg refers to the Insulation division making a loss but does not mention that the continuing operations profit has also fallen. His analysis is incomplete.

In summary

Evaluating Georg's comments indicate that his analysis is not fair and incomplete.
There are four factors which Georg has not been balanced and fair in his analysis.

(1) 9 month period v 12 month period
(2) Volume/price changes and gross profit
(3) Implications of euro and exchange rates
(4) Allocation of administrative expenses

Examiner's comments on candidates' performance

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

This question included the explanation of 3 financial reporting issues:

a. a disposal of the insulation division
b. a refinancing of a financial liability
c. a choice of settlement share based payment

Disposal of insulation division

Generally answered well with candidates demonstrating good knowledge and application of IFRS 5. A point of confusion was where the land and buildings because it was held under the revaluation policy, needed revaluing under IAS 16, and many candidates deducted the selling costs to reflect the new valuation of the land and buildings instead of treating these as an impairment.

Candidates' answers tended to go straight to the PPE and missed the points on the provisions for redundancy and retraining and whether these are in line with IAS 37.

Refinanced bank loan

Many calculation errors here especially on those for the present value on the existing terms and on the new ones. An astute candidate should have noticed that as the coupon is 5% and there is no redemption value, the PV will be £20m. For the new loan it was often discounted at 6% and the fees were ignored.

Knowledge about the rules was clearly explained. Marks were given for follow through.

Share based payment

Most identified the compound instrument but failed to apply the rules for valuing the transaction at the date of issue and at the end of the first year. Despite writing that the equity element is valued at issue and not changed throughout the vesting period, a significant minority of candidates went on to recalculate this each year. The value of the liability at the end of year 1 was often correctly calculated.

2.2 Prepare revised financial statements

Most candidates failed to appreciate the need for comparatives in published accounts and so missed the marks available for the presentation of 2020 figures and the appreciation of the adjustments required to them.

Those that successfully stripped out the discontinued operations (and there were lots that did) and provided totals in line with published content would easily pass their attempt at this section.

2.3 Evaluation of comments

Answers were often uninspired and provided the candidates own generic analysis of ratios with little or no evaluation of Georg's currently existing work.

Those that were able to highlight the distorting factors that weakened Georg's analysis e.g., 9 months vs 12 months, the allocation of overheads, scored well. They were few and far between unfortunately.

Question 3 solutions

Scenario

The scenario is a Group which is considering selling either all or 40% of its investment in a wholly-owned subsidiary to a MBO team or to the subsidiary's CEO who is also a member of the MBO team. The candidate is asked to explain the accounting for each potential transaction in both the consolidated accounts and the separate accounts of the parent. The candidate works for an audit firm which has not previously audited the subsidiary in question but has been asked to do so for the current year. The candidate is asked to identify the risks which arise for this audit, many of which are directly linked to the fact that the financial statements will be used to determine the price at which the MBO team acquire the shares.

Ethics

The ethical element of the question arises from an email which makes it clear that the subsidiary CEO, a member of the MBO team, is in possession of information which might affect how development costs are presented in the financial statements and the price negotiated for the deal. The candidate is asked to assess the issues arising for the CEO and the audit firm and to set out actions the audit firm should take. The candidate is required to:

(1) Explain the financial reporting treatment for the year ending 31 December 2021 of the disposal of shares in Thetaron (Exhibit 1) for each of:

a) Offer 1; and
b) Offer 2,

for each of

- the separate company financial statements of Circeon plc; and
- the consolidated financial statements of the Circeon Group.

For each offer (a) and (b), include relevant calculations and assume that the disposal of the shares takes place on 31 December 2021 and that Thetaron's results are in line with the forecast provided (Exhibit 2).

(2) In respect of HZ's audit of Thetaron's financial statements for the year ending 31 December 2021:

- explain the key audit risks to be addressed; and
- set out the audit procedures for research and development costs.

Assume the completion date is 31 December 2021.

(3) Explain the ethical issues for both HZ and Sam that arise from the information in the email I have received (Exhibit 3). Set out any actions that HZ should take.

	Total Marks	
(1) Explain the financial reporting treatment for the year ending 31 December 2021 of the disposal of shares in Thetaron (Exhibit 1) for each of: c) Offer 1; and d) Offer 2, in both • the separate company financial statements of Circeon plc; and • the consolidated financial statements of the Circeon Group. For both (a) and (b), include relevant calculations and assume that the disposal of the shares takes place on 31 December 2021 and that Thetaron's results are in line with the forecast provided (Exhibit 2).	12	• Using the data & information given analyse the data and information to support requirement • Use technical & professional knowledge to analyse the data • Perform relevant calculations; explaining or stating the issues • Assimilate complex information to produce appropriate accounting adjustments
(2) In respect of HZ's audit of Thetaron's financial statements for the year ending 31 December 2021: a) explain the key audit risks to be addressed; and b) set out the procedures for the audit of the research and development costs.	10	• Use technical knowledge and judgement to determine appropriate audit approach of substantive analytical procedures or tests of detail • Explain the additional procedures required • Relate different parts of the question to identify critical factors
(3) Explain the ethical issues for both HZ and Sam that arise from the information in the email I have received (Exhibit 3). Set out any actions that HZ should take	8	• Identify the threats in the scenario to the ethical principles of professional behaviour and objectivity arising from the information obtained • Identify the conflict of interest for HZ from the and explain how HZ should respond • Explain the actions for you including consult with ethics partner and ICAEW • Explain the scenario from different perspectives. • Demonstrate understanding of the importance of contributing to the profession & appreciating the ethos & culture of the accountancy profession
Total	30	

(1) Explain the financial reporting treatment for the year ending 31 December 2021 of the disposal of shares in Thetaron (Exhibit 1) for each of:

e) Offer 1; and
f) Offer 2,

in both

- the separate company financial statements of Circeon plc; and
- the consolidated financial statements of the Circeon Group.

a) OFFER 1

In individual financial statements of Circeon plc

Offer 1 is the disposal of Circeon's entire shareholding in Thetaron. The shares were all acquired at par and have a carrying amount in Circeon plc equal to their cost of £1 million.

The additional consideration of 1% of revenues from 1 January 2022 is based on revenues being generated and represents for Circeon contingent consideration which, under IFRS 3 and IFRS 10 is measured at FVTPL determined as per IFRS 9 and IFRS 13. The treatment in the seller's accounts will mirror that in the buyer's accounts. Therefore, the right to receive the 1% of revenues is a financial asset to be recognised at if fair value of £400,000.

The additional consideration clearly compensates for the low upfront initial consideration and is therefore part of the purchase price and therefore impacts the amount of the gain in disposal.

The cash proceeds received under Offer 1 will be £1.7 million, which together with the additional consideration is £2.1 million. This results in a gain of £1.1 million which will be recognised in Circeon plc's individual statement of profit or loss.

The fair value calculation includes consideration of the expected sales (which cannot be estimated with certainty for such a new device), probabilities of outcomes and discounting. It is a judgemental figure which needs to be challenged and is likely to change.

As Circeon's loan to Thetaron is repaid in full as part of this offer, there is no need to consider whether any provision for impairment is required. Interest income for the year of £165,000 will be included in the Circeon plc statement of profit or loss.

In consolidated financial statements of Circeon Group

In the group accounts, Thetaron's results will have been consolidated. It is a 100% subsidiary and so, at 31 December 2021, the net liabilities included in the Group accounts immediately prior to the disposal transaction will be those forecast by the Thetaron Finance Director of £1.8 million.

Thetaron's loss for the year of £1.9 million will be included in the group consolidated profit and loss account as Thetaron was owned for the year. The interest of £165,000 will be eliminated on consolidation.

The loan from Circeon to Thetaron will be repaid on completion so there will be no balances to be eliminated. Repaying the loan will not affect the net assets of Thetaron.

When net liabilities of £1.8 million are compared to proceeds of £2.1 million (1.7 million + £400,000), there is a gain of £3.9 million. This will be reflected in the group statement of profit or loss. The gain included in the individual financial statements of Circeon plc will be eliminated on consolidation.

There is no goodwill balance to be taken into account because no goodwill arose on the acquisition of Thetaron as it was incorporated by Circeon and would have had cash equal to share capital on incorporation.

b) OFFER 2

In individual financial statements of Circeon plc

Circeon plc has now disposed of only 40% of its shareholding in Thetaron. The cost of 40% was £400,000 and this is compared to the proceeds of £700,000 giving rise to a gain of £300,000 which is recognised in Circeon plc's statement of profit or loss.

Circeon retains a 60% interest in Thetaron which will be carried at its cost of £600,000 and must be reviewed for impairment.

The loan to Thetaron remains and will also need to be considered for impairment given the losses incurred by Thetaron, although the offers made for the company and information available suggests that the company's long-term prospects are good. It will also be important to consider what security has been given for the bank borrowing and whether this weakens the likelihood of repayment for Circeon's loan.

In consolidated financial statements of Circeon Group

If Offer 2 is accepted, Circeon retains 60% ownership and Thetaron is still a subsidiary with its results consolidated for the whole year. Because there is no loss of control, no gain or loss on disposal is calculated or reflected in the consolidated statement of profit or loss account. Instead the difference between the proceeds received (£700,000) and the change in non-controlling interest is accounted for in shareholders' equity. Goodwill is calculated as at the original acquisition date and therefore remains as nil – there is no recalculation of goodwill.

Before the transaction, there was no NCI. After the transaction the NCI is 40% of Thetaron's net liabilities of £1.8 million = £720,000 DR. Hence there is a net decrease of £720,000 in NCI to be added to the proceeds, resulting in a credit of £1.42 million to equity.

The loan between Circeon and Thetaron will be eliminated on consolidation.

(2) In respect of HZ's audit of the completion accounts of Thetaron at 31 December 2021:

a) Explain the key audit risks our audit planning and procedures should address

Management over-ride

The most significant over-riding risk is one of management override of controls. The CEO of Thetaron and 3 other directors are on the MBO team which will pay less for the company if the net assets (before loan) in the company's financial statements are reduced. There is therefore a huge incentive to manipulate the results to the MBO team's advantage. There is therefore a risk of understatement of assets and overstatement of liabilities.

First time through audit

Although HZ will have knowledge of Thetaron from the review procedures it will have performed in the past as group auditor, 2021 is the first year it will have audited the entity. It will therefore need to ensure that adequate procedures are performed on opening balances and additional work to gain a full understanding of the entity.

Materiality / significance of each adjustment

The other over-riding risk is that, because there is a £ for £ adjustment for the difference in net asset value, there may be unrealistic expectations of the audit process which can only ever be expected to identify material adjustments and difficulty in assessing an appropriate materiality level to apply. Audit work is aimed at a true and fair view not a single pinpointed result.

From this over-riding risk, a number of other key risks arise:

Capitalisation of development costs

The risk that development expenditure is being expensed rather than capitalised. Under IAS38, development expenditure must be capitalised once certain tightly defined criteria are met. Development costs are capitalised only after technical and commercial feasibility of the asset for sale or use have been established. This means that the entity must intend and be able to complete the intangible asset and either use it or sell it and be able to demonstrate how the asset will generate future economic benefits.

The point at which this stage is reached for a particular product is always judgemental but there are a number of factors which suggest this point was reached during 2021 for the BSM49 – the Circeon Board is of the view that the product is commercially viable and the email reporting Sam's views reports that there has been marketing activity and suggests that the company may be close to a deal with a customer. The offer which includes contingent consideration also makes it clear that sales are expected within the next year which is a reasonably short time period and may suggest that the development phase, rather than the research phase has been reached.

Development costs are very significant and capitalising even a proportion of them could materially affect the net assets and thus the purchase price. The MBO team have an incentive not to capitalise the expenditure and there is therefore a risk that they may seek to emphasise only that evidence which supports expensing the costs.

Overstatement of liabilities

As the Thetaron management team have an incentive to reduce net assets, it is possible that they will seek to include accruals and provisions for items which are future costs, rather than valid expenses for the year ending 31 December 2021. Cut-off is therefore a risk but this should be focussed on over-statement of liabilities rather than the more common risk that liabilities are understated.

Taxation

The other balance which has a significant effect on net assets is the recognition of tax receivable. The note to the financial statements suggests that this has been prudently estimated and represents group relief receivable for the surrender of some of Thetaron's tax losses to other group companies. It is possible that the treatment of research and development costs for tax purposes will lead to significant tax allowances and possibly have deferred tax implications. It also seems odd that only part of the losses can be surrendered although this may be due to the capacity of other group companies to use them. There is a significant risk that this balance is mis-stated and that the actual tax which can be recovered is either higher or lower.

Tangible fixed assets

The PPE balance looks low as the company must have premises it operates from and laboratories for development work. There is a risk that expenditure on tangible fixed assets has been expensed as part of development costs.

In addition, rent for leased premises may be being expensed through the statement of profit or loss rather than the lease being capitalised appropriately under IFRS16.

b) Set out procedures for the audit of the research and development costs.

- Perform enquiries to understand fully the status of the project to develop BSM49 and whether it does or does not meet the criteria for capitalisation under IAS38. Steps to reach a full understanding will include
    - Discussions with the development team, including, if at all possible, those who are not involved in the management buyout team
    - Review of minutes of management and board meetings
    - Review of the results of any trials completed to date and gaining a full understanding of what trials are required for a medical device of this type and what stage has so far been reached.
    - Consideration of any relevant articles in the medical press, opinions from experts or claims in the media that other companies have made advances in developing similar or competing technologies or devices
    - Review of up to date budgets for future costs and revenues to assess commercial viability and also the stage of completion
    - Review of correspondence or agreements with potential suppliers or customers to assess the stage which the project has reached.
- Test the costs that have been included in expenditure for the year:
    - For payroll costs incurred, consider the roles of those charging time to the project and ensure that there is evidence they have spent their time working on the device. Agree costs to payslips, payroll summaries etc
    - For consumables, agree costs to invoices and ensure by discussion and review that the items purchased have reasonably been treated as costs of the project.
    - For allocated overheads, review the basis for allocation and ensure that it is reasonable.
- To test completeness of costs
    - Review operating costs and test a sample to determine whether they should be allocated to research and development costs
    - Review post year end invoices and costs incurred to determine whether cut-off is correct and all costs for the period correctly accounted for.

(3) Explain the ethical issues for both HZ and Sam that arise from the information in the email I have received (Exhibit 3). Set out any actions that HZ should take.

<u>Issues for HZ</u>

HZ is in possession of information which suggests that Sam as the CEO of a subsidiary has not been entirely open with his shareholder (Circeon) and that he may be manipulating results and the timing of commercial deals for his own personal advantage. Whether he has an obligation to share prospective information with the shareholder proactively is debatable but he should certainly not deliberately lie when asked for information.

The information about marketing and prospective sales would clearly be of interest to Circeon, HZ's customer but Circeon is aware that it is negotiating with the MBO team and have an obligation to ensure that appropriate due diligence is performed before agreeing the sale price. HZ can only share the information it now has with care as it was arguably received by the audit manager in a personal capacity rather than as part of her work.

HZ also has information which may well contradict evidence presented during the course of the audit but from an unsubstantiated source which it may not be possible to name.

<u>Issues for Sam Heran</u>

Sam is an ICAEW Chartered Accountant and is thus required to act with integrity, objectivity and confidentiality.

He is facing a situation where there is a conflict of interest between his position as CEO of a wholly owned subsidiary of Circeon and his role as a member of an MBO team trying to buy the Thetaron shares from Circeon. That makes it very difficult for him to act objectively. This conflict will be well understood by all concerned as it will always arise in an MBO bid.

However, there will still be an expectation that Sam will act with integrity and the fact that he appears to be failing to share information which might inform the value of the Circeon shares is evidence that he may not be doing this.

Sam has also reportedly made comments about Thetaron's trials and potential revenues to a personal acquaintance and has thus breached the requirement that he maintains confidentiality.

A 'benchmark' for Sam's own ethics under the ICAEW Code should be that any conduct that might discredit the profession, would breach the principle of professional behaviour as well as the specific principles mentioned here as being at risk.

<u>Actions for HZ</u>

- The HZ audit team should maintain professional scepticism throughout the audit, remaining mindful of the conflict of interest which exists and seeking corroborative evidence from external sources wherever possible.
- The HZ team should seek to corroborate (or otherwise) the information provided in the friend's email concerning the results from trials and the interest from potential customers. It will be much easier to share this openly with Circeon if evidence has come from audit procedures rather than an unsubstantiated email.
- HZ should ask specifically for representations from the Thetaron Board in connection with the audit of Thetaron that all information relevant in assessing the status of the BSM49 has been shared with the audit team. This means that Sam and his team will have deliberately concealed it if it is not shared.
- If evidence cannot be found which either confirms or refutes the information provided that it may be necessary to challenge Sam and his team about what the team has heard, without revealing the source. HZ too has to respect confidentiality.
- The situation should be discussed with the audit partner on the Circeon audit and with the firm's ethics partner.

- The information and breach of confidentiality should then be reported to those charged with

Examiner's comments on candidates' performance

3.1 Explain the financial reporting treatment of two disposals in the individual accounts of the parent and the group financial statements.

Answers to this question were a mixed. Strong candidates were able to identify and distinguish between the disposal where control was lost, and the control to control disposal. Weaker candidates were unable to distinguish between the impact of the disposal on the individual company financial statements and the consolidated financial statements. The technical knowledge of some candidates shown here in a core area of the syllabus was very disappointing.

Despite the question clearly stating that candidates should assume results were in line with the forecasts given, many wasted time calculating unnecessary figures for net assets and/or adjustments to sale proceeds. Some candidates did not seem to realise that there would be no goodwill and were thrown by the impact of having negative net assets.

Subsequently, answers for the implications to the group accounts for both offers were well answered.

3.2 Key audit risks for Thetaron and audit procedures for research and development

This was the best performed requirement with many candidates scoring maximum marks.

Weaknesses included an insistence on describing audit procedures in relation to all the audit risks identified rather than focussing on the audit of research and development and the repeating problem of only offering unreliable audit evidence e.g., board minutes, discuss with directors, management representations. Candidates need to consider the quality of audit evidence in their answers. The most common mistake was to assume development costs had been capitalised incorrectly despite the extracts to the FS clearly showing that they had all been expensed.

Weaker candidates spent too long explaining the impact of the disposal on the parent company and the group and failed to notice that this was about the subsidiary. In addition, some candidates noted that the main risk was that the assets would be overstated when here that is not the case.

3.3 Ethics for HZ and Sam. Actions for HZ

Some good attempts were made on this requirement. Many candidates appreciated the confidentiality issues and self-interest issues for Sam. Most identified that Sam was an ICAEW member and discussed the principles of the code that applied to him. Fewer candidates noted that there was a conflict between his roles as CEO and MBO buyer.

The more intricate issues faced by HZ were less well acknowledged. Despite this, marks for the actions of HZ provided marks for most candidates who attempted the question.

Weak answers focussed only on Sam's ethical issues and talked around the issue from the narrative details provided without directly applying the ethical principles to the scenario.

- Advice could also be sought from the ICAEW helpline.

governance of Circeon – the Audit Committee / Board.