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 assisting the HC audit engagement manager, Sara Yang, with the final review points arising from the audit of HC plc and the consolidation for the HC group for the year ended 31 May 2020. The audit completion meeting is scheduled for next week.

HC plc appointed Maisie Judge, an ICAEW Chartered Accountant, as the new Head of Treasury on 1 April 2020. Maisie worked for an investment bank before joining HC and she manages HC plc's investments and financial assets with minimal monitoring.

The HC plc finance director went on long-term sick leave on 10 March, just before Maisie joined HC plc. As there is no replacement finance director, Maisie is acting in that role.

The candidate is provided you with extracts from HC's consolidated financial statements for the year ended 31 May 2020, including the accounting policy note for financial assets. The audit planning for financial assets was completed in February 2020, prior to Maisie's appointment. The planning indicated that there were no significant changes from the year ended 31 May 2019 and financial assets were assigned a low level of audit risk.

Maisie has carried out some transactions in financial assets and her recording of these transactions cast doubts on her competence. Also because of a performance related bonus based on profit for the year, there is a threat to her objectivity arising from her self-interest in achieving the bonus target. There is also a possibility that she has used insider knowledge from her former employer.

Requirements	Marks	Skills assessed
1.1 For each of the matters in Jane Smith's audit notes (Exhibit 2), set out and explain the correct financial reporting treatment in HC plc's financial statements and, where relevant, the HC group financial statements, for the year ended 31 May 2020. Show appropriate journal adjustments and explain any implications for the accounting policy note (Exhibit 1).	18	• Assimilate and demonstrate understanding of a large amount of complex information. • Identify the correct accounting treatments for financial assets • Explain and recommend appropriate accounting treatments for financial assets • Set out correcting journal adjustments

1.2 Calculate, taking into account your journal adjustments, the revised profit before tax and other comprehensive income for HC plc and for the HC group for the year ended 31 May 2020 (Exhibit 1).	4	• Assimilate adjustments to prepare revised profit before tax • Demonstrate understanding of the difference between adjustments made in the parent company and those made in the group financial statements.
1.3 Identify and explain the additional audit risks arising since the audit planning was completed in February 2020.	3	• Appreciate the significance of transactions and events which have happened after audit planning was completed. • Identify relevant key audit risks.
1.4 Set out the key audit procedures that we should perform in respect of: - Konditori Ltd's investment in Clik Ltd - HC plc's corporate loans	7	• Describe appropriate audit procedures required to provide verification evidence for each risk. • Demonstrate understanding and significance of audit scoping in the context of Konditori's investment in Clik. • Explain the materiality of the investment in terms of disclosure rather than profit.
1.5 Explain the ethical implications for Welfold and for Maisie, arising from Maisie's roles and actions and the matters highlighted by the audit assistant (Exhibit 3). Set out the actions Welfold should take.	8	• Identify the threats in the scenario to the ethical principles of integrity arising for Maisie is she users information from her former employment • Identify the threats for Maisie of professional behaviour and professional competency arising from accepting and advising in roles she is clearly not qualified to accept. • Identify the self-interest threat for Maisie from the profit related bonus scheme. • Explain the self-interest threat for Welford arising from the retendering of the audit • Explain the actions for Welford including consult with ethics partner and potential need to report ICAEW member for breach of ethical code • Explain the scenario from different perspectives. • Demonstrate understanding of the importance of contributing to the profession & appreciating the ethos & culture of the accountancy profession
	40	

1.1 For each of the matters in Jane Smith's audit notes (Exhibit 2), set out and explain the correct financial reporting treatment in HC plc's financial statements and, where relevant, the HC group financial statements, for the year ended 31 May 2020. Show appropriate journal adjustments and explain any implications for the accounting policy note (Exhibit 1).

Investments in subsidiary companies

The accounting treatment of these investments in the parent company is correct and complies with the accounting policy note and IAS 27.

Sale of shares in Alma plc

800,000 shares were initially recorded at cost of £6,000,000

The fair value (FV) at 31 May 2019 was £10,000,000, hence as per the accounting policy note £4,000,000 gains accumulated in other components of equity. As the investment was classified as being at fair value through other comprehensive income it was correct to adjust its carrying amount to fair value at each reporting date.

The fair value of the investment has been correctly removed from the statement of financial position; however, the profit has been incorrectly recorded in the statement of profit or loss.

While the gain/loss on derecognition of an equity instrument at FVTOCI is recognised in profit or loss, in practice this should normally be a nil amount, assuming the disposal is at fair value. The asset's carrying amount is remeasured to fair value at the date of derecognition (IFRS 9: para 3.2.12) immediately prior to the disposal. Any change resulting from such a remeasurement is recognised in OCI.

The accumulated gains of £4,000,000 are not reclassified to profit or loss on disposal of the investment, so the total gain for the year is (800,000 shares x £17 per share = 13,600,000 less £10,000,000) = £3,600,000 which should be recognised through OCI.

A correcting journal is required of:

	£000
Dr Retained earnings (statement of profit or loss)	3,600
Cr OCI – gain recognised immediately before disposal	3,600

Investment in VLA plc shares

Maisie's proposed accounting treatment is not in agreement with the accounting policy. The accounting policy states that an irrevocable election is made to classify investments in equity instruments at FVTOCI – this should be clarified with the directors as to whether there has been a change in accounting policy.

The investment in VLA plc has been recognised at the offer price of £56.72 at 3 April 2020 (£18,150,400/320,000 shares = £56.72), which if this investment is to be treated at FVTPL, the acquisition of 320,000 shares should have been initially recorded at bid price of £55.45 per share, a cost of £17,744,000.

The bid-offer spread of 1.27p reflects a transaction cost and if the investment is classed as at fair value through profit or loss, this cost of £406,400 should have been expensed to profit or loss for the year.

A correcting journal is required of:

	£000
Dr Retained earnings (statement of profit or loss)	406
Cr Other equity investments	406

In addition, as the investment is classed as at fair value the investment should have been re-measured to its fair value at the year end. The fair value used should be the year-end bid price is £54.45. The fair value of the investment at the year end should therefore be £17,424,000 with a loss of £320,000 being recorded through PorL.

The journal adjustment required is:

	£000
Dr Profit or loss	320
Cr Other equity investments	320

An alternative answer could be that Maisie cannot change the accounting policy and therefore the investment should be recognised at FVTOCI – in which case all £726,000 representing the transaction costs and fair value loss would be recognised in OCI. Credit given for either approach.

Investment £25 million

This is in fact a loan made by HC to its subsidiary Konditori to provide finance for and investment in Clik Ltd and therefore in HC's own financial statements the amount should appear as a loan to a subsidiary company and not as an investment.

Konditorei has then invested in a joint venture with a national supermarket to form a joint venture called Clik Ltd. In the group financial statements, Clik is a joint venture of the group. This is because as 50:50 shareholders, neither Rosen nor Konditori will have control.

Also, Clik will have its own assets and liabilities and the arrangement is therefore a joint venture rather than a joint operation. It should be accounted for using the equity method in the consolidated accounts for the HC group.

The relevant accounting guidance to consider is that concerning joint arrangements. Clik is a separate entity and will have Articles setting out the contractual arrangements between the parties.

The amount that should be recognised is as follows:

In the statement of financial position	£000
Cost	25,000
Share of post-acquisition loss	
(18,000) x 50%	(9,000)
	16,000
In Statement of profit or Loss	
Share of post-acquisition loss after tax	
(18,000) x 50%	(9,000)

I would need to ensure that transactions between Clik and Konditori have been accounted for correctly

Konditori - Start-up costs

The start-up costs relate to the new company set up with Rosen and appear to relate to an amount subscribed as initial capital. It therefore appears incorrect that this should have been treated as an operating cost.

The initial capital represents an investment in the JV and should have been shown in the statement of financial position for Konditori as an investment and not accounted for as an operating cost.

This will also impact on the group results because Konditori is a subsidiary and its results are included in the consolidated financial statements.

	£000
Dr Investments	25,000
Cr profit or loss	25,000

In Konditori's separate financial statements, the investment will be recognised in accordance with IAS 27, and will be held at cost less any impairment in value as per the group accounting policy. An impairment should be considered as Clik has made a loss.

The loan from HC plc would be recognised as a liability due to the parent company and would cancel on consolidation.

Corporate loans

£12.5 million bond in Reggs plc

HC is holding the corporate bond within a business model whose objectives are met by holding the loans to collect contractual cash flows. Therefore, the current classification of amortised cost is correct.

Maisie has not recognised the profit on the sale of half of the bonds. She has simply posted the proceeds against the value of the bonds on the statement of financial position and not recognised any gain or loss.

The amortised cost at the time of the sale was as follows:

	Amortised cost at the beginning of the year	Interest income at 10% - profit or loss	Interest received	Amortised cost at the end of the year
	£000	**£000**	**£000**	**£000**
31-May-19	10,000	1,000	(590)	10,410
31-May-20	10,410	1,040	(590)	10,860

Gains on disposal of financial assets measured by amortised cost method are recognised in the statement of profit or loss. This is calculated as follows:
£6,000,000 – (£10,860,000 x 50% = 5,430,000)

The following adjustment is recommended to record the gain on the sale:

		£000
Debit	Bond £6,000,000 – (£10,860,000 x 50% = 5,430,000)	570
Credit	Profit or loss	570

Being profit on sale of 50% of the bond.

Loan to JUP - impairment loss

The loan to JUP is held within a portfolio where the business model objective is achieved by collecting their contractual cash flows. The cash flows are straightforward interest at 8% pa and repayment of principal on 31 December 2020. Therefore, the loan to JUP should be measured at amortised cost.

On 31 May 2019, 12-month expected credit losses of £20,000 (2% x £1.00 million) were correctly recognised. Because the balance is classified as amortised cost, impairment losses are debited to profit or loss and the credit balance is set off against the balance of the loan. The loan is classified at stage 1. This adjustment has been done in the previous year.

The information from the credit rating agency implies that there has been a significant change in the credit rating, at a minimum, that there has been a significant increase in credit risk and potentially that the loan has moved into stage 2 i.e. that there has been an increase in credit risk of JUP.

The impairment loss should be calculated based on the lifetime expected credit loss = £1,000,000 less £20,000 previously recognised = £980,000.

Adjustment recommended is:

	£000
Dr Impairment loss (statement of profit or loss)	980
Cr Loan asset	980

1.2 Calculate, taking into account your journal adjustments, the revised profit before tax and other comprehensive income for HC plc and for the HC group for the year ended 31 May 2020 (Exhibit 1).

Adjusted extracts

	HC Parent financial statements	HC Group
	£000	**£000**
Profit before tax	8,500	95,600
Alma plc shares - profit has been incorrectly recorded	(3,600)	(3,600)
VLA shares - incorrect price	(400)	(400)
VLA shares - fair value adjustment (assuming FVTPL)	(320)	(320)
Konditori - write back of investment in Clik-Online		25,000
Gain on disposal of bonds in Reggs	570	570
JUP impairment loss	(980)	(980)
Share of post-acquisition loss of Konditori (18,000) x 50%		(9,000)
	3,770	106,870
Other comprehensive income		
Alma – gain immediately before disposal	3,600	3,600

1.3 Identify and explain the additional audit risks arising since the audit planning was completed in February 2020

Significant transactions have been undertaken since the initial assessment of risk for financial assets was performed in February 2020.

No separation between finance department and treasury department – Maisie has control over the performance of treasury functions and the recording of those transactions.

The bonus structure creates a significant risk because Maisie's bonus is based on HC's profit before tax.

No authorisation of the transactions – no agreement at board level?

Transactions are speculative – why has she invested in VLA on the advice of former colleague

Maisie has not made any adjustments for a significant investment within her portfolio entered into before she was appointed - £25 million loan to Konditori which has been treated incorrectly in both the financial statements of HC plc and the group – this is a material transaction and the head of treasury would have been expected to have found out about this.

1.4 Set out the key audit procedures that we should perform in respect of:

Konditori Ltd's investment in Clik Ltd

Audit procedures are required both at subsidiary and group level.

Subsidiary level - Konditori audit

The investment in Clik will be held at cost less impairment as Konditori is not required to prepare consolidated financial statements as it is a 100% subsidiary.

Therefore, the key audit procedures would be:

- to ensure that the cost is correctly stated by agreeing to bank transfer from HC.
- to ensure appropriate authorisation by agreement to board meetings and direct confirmation with the HC plc board: and
- to ensure that no impairment of the investment is required. A key impairment procedure would be to obtain forecasts of results to check recoverable amount of the £25 million investment is the higher of value in use and net selling price of the investment.

Group level

The results although in terms of profit are not significant the impact on group is likely to be material and disclosure requirements of the joint venture will also need to be audited.

The HC group auditors will need to perform a scoping exercise to determine the level of procedures required. This would include confirmation of the appointment of auditors for Clik and an assessment of the auditor's qualifications. The 3- months results are likely not to have been audited and therefore depending on the outcome of the scoping exercise, Welford would need carry out its own audit procedures on the results included within the group financial statements.

Audit procedures for HC plc corporate loans

Reggs

To ensure ownership and valuation,

- confirm the proceeds and interest rates to supporting third party documentation
- re-calculate the effective interest rate and confirm the year end balance
- evaluate the need for any impairment of the debt by examining Reggs plc financial statements and analysts reports

JUP

It is insufficient to download the credit rating document and to do nothing with it.

- Confirm that the details of the rating have been correctly reported in the FR of the loan
- Evaluate the expected recovery of the loan.
- Verify the source and content of the credit rating document using external confirmation

1.5 Explain the ethical implications for Welfold and for Maisie, arising from Maisie's roles and actions and the matters highlighted by the audit assistant (Exhibit 3). Set out the actions Welfold should take.

Issues

Maisie is an ICAEW Chartered Accountant and is bound by the ethical codes. She may be using contacts for insider information - VLA shares were a former client from her time at the investment bank. There is a threat to her integrity.

Maisie has a threat to her objectivity due to the self-interest threat created by the bonus structure. The potential therefore to be influenced in her judgement to report losses – the adjustments required have changed the profit from £8.5 million to a loss of £230,000 and the bonus target is no longer achieved.

The bonus structure, lack of segregation of duty are examples of weak corporate governance.

Maisie is breaching professional competence and due care due to her lack of experience. Her lack of financial reporting knowledge is evident from the mistakes she has made and therefore she has accepted a role for which she is clearly incompetent.

There is a self-interest threat for Welford arising from the retendering of the audit as the firm may be influenced in the actions.

Actions

Welford may have duty to report an ICAEW member – It should establish whether there are any grounds to consider that Maisie has used insider information – the value of the VLA shares has in fact fallen. Discuss

Examiner's comments

General comments

The marks for the corporate reporting paper are awarded based on the demonstrations of skills and not just for technical knowledge. This question demanded a high level of skills to be applied to the scenario. The technical topics (1.1) covered accounting standards IAS 27, 28, IFRS 11 and IFRS 9 and required candidates to appreciate the difference between group financial statements and individual parent financial statements, the accounting treatment of investments in joint ventures and financial instruments. Most candidates were able to compare the accounting treatment against the accounting policy to decide whether the treatment and or the policy were appropriate. A similar structure was used for Vacance (July 2019) which also presented candidates with an accounting policy for a different technical area (PPE) but tested similar skills.

Also tested was the ability to provide correcting journal adjustments. Key skill marks were available for assimilation (1.2) and for applying structuring skills to identify the change in audit risk by events since audit planning was carried out -i.e. the bonus structure and change in personnel (1.3) and to focus on key audit procedures (1.4). This question also contained the ethical scenario which again demanded judgement and assimilation skills to be applied to the scenario (1.5).

The question addresses the learning outcome in the syllabus

2 c) formulate and evaluate accounting and reporting policies for single entities and groups of varying sizes and in a variety of industries controls to mitigate risk and governance procedures with the client. Seek advice from Welford's Ethics partner concerning need to report ICAEW member.

1.1 Explanation each matter in Jane Smith's audit notes

Overall, candidates coped extremely well with this requirement, and were able to attempt answers to each of the five accounting issues and as a result, maximum marks were frequently awarded.

Weaker candidates struggled with some of the more basic financial asset issues covered. e.g. the use of amortised cost for financial liabilities was frequently incorrectly applied or not discussed.

Some candidates missed out on identifying that the investment in the subsidiary held at cost less impairment in the parent's financial statements was the correct treatment. Time was then wasted by detailing how to then treat the investment when preparing the group accounts, i.e. eliminating the investment and replacing the assets/liabilities line-by-line and even explaining the goodwill and NCI. This was not asked for in the requirement – candidate's need to be able to distinguish between correct and incorrect accounting treatment which is a much higher skill.

This was further examined in the joint venture section and weaker candidates struggled to see the movement of the £25 million from the parent company to the subsidiary to the JV. However, the majority of candidates coped very well with this and some excellent answers were provided.

It was good to see so many stating the journals, including the values although weaker candidates struggle to provide correcting journals when requested to do so.

1.2 Revised PBT and OCI

Another area in which candidates often achieved maximum marks. Typically, well attempted with application of own figure rule.

Weaker candidates demonstrate a lack of understanding of parent company financial statements and the difference between the individual financial statements and the group. This is a key area which is tested at in this paper as oppose to basic consolidation adjustments examined at professional level

1.3 Additional audit risks arising since audit planning was completed in February

Maximum marks were again often achieved here. Identification of the audit implications caused by the bonus and change in key staff were commonly identified. Weaker candidates often wrote extensively about the risks caused by every financial reporting issue instead of focussing on higher level issues. This could have caused time pressure later in the exam.

1.4 Key audit procedures

A very pleasing overall performance as candidates were regularly using strong verbs to describe their testing and were able to appreciate the need for 3rd party evidence across both the joint venture acquisition and the corporate bonds. Weaker candidates struggle with identifying key procedures and tend to write overall objectives instead.

1.5 Ethics

Overall, well attempted and many candidates considered the independence issues arising from the bonus and the tender.

However, the insider dealing issues and legal implications were less frequently considered as were the governance issues arising from the dual roles undertaken by Maisie and lack of board oversight. Weaker candidates tend to focus on one side of the issue inside of seeing the perspective from both Maisie and Welford's positions. Many suggested calling the ICAEW helpline for advice but did not identify advice they wanted. Few suggested reporting Maisie because she is breaching the code and potentially breaking the law with insider dealing. There was however some good application of the principles of the code to the scenario.

Question 2 solution

Scenario

The candidate is working as a financial accountant at React Chemicals plc (React), an AIM-listed company based in the UK. React manufactures and supplies chemicals to customers in the UK. It prepares financial statements to 31 July.

The board has set out two proposals for the year ending 31 July 2021 and needs to understand the financial reporting implications of these proposals.

Proposal 1 relates to the distribution of chemicals and the board is considering two alternative contracts, A and B
Proposal 2 relates to a new share option scheme which will be open to all employees

Forecast financial information, including information about tax treatments, for the year ending 31 July 2021 is provided which does not include any impact from the board's proposals.

The candidate is required to set out the financial reporting treatment of both proposals. The question covers the recognition of a right of use asset and liability under the IFRS 16, IFRS 2 share options and deferred and current tax.

Requirements	Marks	Skills assessed
(1) Set out and explain the appropriate financial reporting treatment, including the impact on current and deferred tax for: • Proposal 1 – Distribution costs (Exhibit 1). Address both Contract A and Contract B; and • Proposal 2 – Share option scheme (Exhibit 2). Include relevant journal adjustments.	18	• Assimilate and demonstrate understanding of a large amount of complex information. • Evaluate the appropriate accounting treatments for complex transactions including leases and share options. • Recommend appropriate accounting adjustments in the form of journal. • Evaluate the impact of the transactions for the financial reporting of deferred and current tax. • Interpret the impact of the recommended financial reporting treatment on the presentation of the financial statements and ratios.
2.1 Assuming that React signs Contract B with Dutton, • Calculate the tax charge to be shown in the statement of profit or loss for the year ending 31 July 2021 and the current tax and deferred tax liabilities as at 31 July 2021.	6	• Assimilate adjustments to prepare revised the figure for income tax to be reported in the statement of profit or loss and the current and deferred tax balances in the statement of financial position

2.3	Prepare revised extracts from the financial statements for the year ending 31 July 2021, including your adjustments.	6	3 Assimilate information and use own accounting adjustments to prepare revised extracts from the financial statements
		30	

2.1 For each of the proposed changes (Exhibit 1)

- explain the financial reporting implications recommend the appropriate financial reporting treatment including the impact on current and deferred tax; and
- set out briefly the impact on React's gearing ratio

Briefing paper for the React board

Subject: The financial reporting implications for each of the proposed changes (Exhibit 1) and recommendation of the appropriate financial reporting treatment including the impact on current and deferred tax.

Distribution costs

The key financial reporting implication with Contract A and B is to determine whether the contract results in a right of use asset and an associated liability under IFRS 16. Key questions to ask are as follows:

1. Is there a contract between a supplier and a customer? Can you identify an asset or group of assets or part of an asset?
2. Does the customer have 'right of use' - can the customer direct what happens to the asset? Does the customer have the economic benefits of the identified asset? Or can the supplier benefit from the asset when the customer is not using it.
3. Does the supplier have 'substitution rights? i.e. can the supplier use the asset for its other customers?

Contract A

<u>Identified assets?</u>

The first criterion to be assessed is to determine whether the contract between the customer and the supplier contains a lease and whether there is an identified asset which the customer controls.

With Contract A it could be said that there is an asset which will be explicitly identified in a contract. Either the tankers or the containers could be said to be identified assets as they are made available for use by the supplier (TrensFar) to the customer (React).

Right to direct the use?

However, even if a contract specifies a particular asset, a customer does not have the right to direct the use that asset if the supplier has a substantive right to substitute the asset throughout the period of use.

Substantive substitution rights?

TrensFar does have substantive right of use because:

- TrensFar has the practical ability to substitute alternative assets throughout the period of use - TrensFar can collect the containers from React's premises when they are not in use; and
- TrensFar would benefit economically from the exercise of its right to substitute the asset – for example by using for a different client.

Although it may be the case that because the containers are located at React's premises, the cost to collect the container may outweigh the benefit to TrensFar and this would need to be confirmed. Also, the cost to clean the containers may not make the substitution economically viable. This is an important point because IFRS 16 requires that when it is not readily determinable whether a supplier has substantive substitution rights, a lessee must presume that any substitution right is not substantive. Conclusion: No right of use asset and related liability should be recognised.

However, assuming that TrensFar has substantive substitution rights, the recommended financial reporting treatment is to treat the costs arising under the contract as a debit to profit or loss account and a credit to cash/trade payables.

Because the accounting treatment and the tax treatment are the same the impact of the cost will be to reduce the current tax charge by £5,000,000 x 25% = £1,250,000.

	£000
Dr Distribution costs	5,000
Cr Cash	5,000
Dr Tax liability	1,250
Cr profit or loss	1,250

Contract B

Supply of containers

In this contract the identified asset could be said to be the 15 containers available to React (the customer) for 9 years which have been provided by the supplier (Dutton) .

Right to direct the use?

With contract B the containers are specific to the customer, React. The containers are stored at React's premises when not in use and they have been specially constructed for the particular chemical produced by React.

Substantive substitution rights?

Apart from cleaning and repairs, it does not appear that Dutton has substitution rights from which it can benefit economically.

The above would therefore lead to the conclusion that the contract contains a lease for the 15 containers.

The recommended financial reporting treatment is that React should treat the 15 containers as a right of use asset and set up an associated liability.

Accounting entries for a right of use asset and associated liability

A 'right of use asset' is measured at the present value of the minimum lease payments.
The discount rate used to determine present value should be the rate of interest implicit in the lease. However, if this is not known the entity's incremental borrowing rate can be used.

1. The lessee recognises a right-of-use asset and a lease liability.

	£000
Dr Right of use asset (£4,000,000 x 6.802 (DCF 9 years @ 6%)	27,208
Cr Lease liabilities	27,208

Being the recognition of a right-of-use asset measured at the amount of the lease liability

2. The 'right of use asset' would also include the following amounts, where relevant:

- Any payments made to the lessor at, or before, the commencement date of the lease, less any lease incentives received.
- Any initial direct costs incurred by the lessee.
- An estimate of any costs to be incurred by the lessee in dismantling and removing the underlying asset, or restoring the site on which it is located

In relation to Contract B, the £80,000 payable by React at the start of the lease should therefore be included in the cost of the right of use asset.

	£000
Dr Right of use asset	80
Cr Cash	80

Being inclusion of any initial direct costs incurred by the lessee.

3. The lessee measures the right-of-use asset using the cost model or revaluation model if it relates to a class of PPE to which the lessee applies the revaluation model - the asset will then be depreciated. Assuming that the containers have a useful life at least equal to the lease term, they should be depreciated over 9 years.

	£000
Dr Profit or Loss – depreciation expense (£27,208+ 80 / 9 years	3,032
Cr Right of use asset – accumulated depreciation	3,032

4. Lease liability subsequent measurement

	£000
Dr Lease liability	4,000
Cr Cash	4,000

Being payment of lease rental to the lessor

5. Interest is then charged using the amortised cost method

	£000
Dr Profit or loss – finance cost £27,208 x 6%	1,632
Cr Lease liability	1,632

Being finance interest using the rate implicit in the lease.

The liability will be presented as non-current and current liability

Year	b/f	Cash	Interest	C/f	Non-current liability	Current liability
	£000	£000	£000	£000	£000	£000
1	27,208	(4,000)	1,632	24,840	22,330	2,510
2	24,840	(4,000)	1,490	22,330		

Tax implications:

The finance interest will reduce both accounting and taxable profits and tax relief will be available of 25% x 1,633,000 = £408,250

The depreciation cost will be disallowed for tax purposes and replaced by tax depreciation at 30% – therefore the impact on current tax will be tax relief of £27,208,000 x 30% = £8,162,000 x 25% = £2,040,600.

Deferred tax

Because the rate of tax relief is faster than the rate of depreciation, a deferred tax adjustment will be required as follows:

	£
Carrying amount of right of use asset £27,288 – £3,032	24,256
Tax base of the right of use asset £27,288 - (£27,288 x 30% = £8,186)	19,102
	5,154
Increase in deferred tax liability - Timing difference at 25%	1,289

Transport to React's customers

There is no specific identified asset in this element of the contract, and therefore it does not contain a lease. The cost of transporting the containers to React's customer and returning the container to React's premises should be charged to profit or loss.

Because the cost is treated the same for accounting profits and taxable profits, the cost will reduce the amount of current tax payable by £1,000 x 25% = £250,000

	£000
Dr Distribution costs - profit or loss	1,000
Cr Cash / trade payables	1,000
Dr Tax liability	250
Cr Profit or loss	250

Share options

This is an equity settled share-based payment scheme and is therefore measured at the fair value of the option on grant date in accordance with IFRS 2.

The directors predict that the non-market-based condition will be met by 31 July 2022 and their accounting treatment is incorrect to not measure an expense. Therefore, React will recognise an expense each year for the consumption of the employee services given in consideration for the share options granted as follows:

100 x 2,600 options x £3.60 = £936,000 / 2 years = £468,000

	£000
Dr Profit or loss	468
Cr Equity	468

Deferred tax asset

The company will not receive a tax deduction until the share options are exercised. Therefore, a temporary difference arises, and IAS 12 *Income Taxes* requires the recognition of deferred tax.

A deferred tax asset results from the difference between the tax base of the services received (a tax deduction in future years) and the carrying amount – which is zero. IAS 12 requires the measurement of the deductible temporary difference to be based on the intrinsic value of the options at the year end. This is the difference between the fair value of the share and the exercise price of the option.

If the amount of the estimated future tax deduction exceeds the amount of the related cumulative remuneration expense, the tax deduction relates not only to the remuneration expense but also to equity. If this is the case the excess should be recognised in equity.

The difference between exercise price and market price of the share at July 2021 is £4.80 (£8.60 - £3.80).
100 x 2600 x £4.80 = £1,248,000/2 years = £624,000

Tax at 25% = £156,000

The cumulative remuneration expense is £468,000 which is less than the estimated tax deduction of £624,000.
Therefore:

- A deferred tax asset of £156,000 is recognised in the statement of financial position.
- There is deferred tax income of £468,000 x 25% = £117,000: and
- the excess of (156,000 – 117,000) £39,000 =goes direct to equity.

	£000
Dr Deferred tax asset	156
Cr Tax charge	117
Cr Equity	39

2.2 Assuming that React signs Contract B with Dutton,

Calculate the tax charge to be shown in the statement of profit or loss for the year ending 31 July 2021 and the current tax and deferred tax liabilities as at 31 July 2021.

Calculation of current income tax liability

	£000
Profit before tax	13,135
Less:	
Dutton contract distribution cost	(1000)
Dutton contract depreciation	(3032)
Dutton contract finance cost	(1632)
Share based payment charge	(468)
Revised profit before tax	7003

	£000
Profit before tax	7003
Add: depreciation	3562
Add: share based payment	468
Less: tax depreciation (£2666 + 8186)	(10,852)
Taxable profit	181
Current tax liability at 25%	45

Alternative working

	£000
Profit before tax per question	13,135
Less finance costs (1,632) and transport costs (1,000) for Dutton contract	(2,632)
Add: depreciation	530
Less: tax depreciation (£2666 + 8186)	(10,852)
Taxable profit	181
Current tax liability at 25%	45

PPE

	£000
Carrying amount of PPE	21,247
Add: Carrying amount of right of use asset £27,288 – £3,032	24,256
	45,503
Tax base of PPE	12,147
£14,813 – (£14,813 x 18% = £2,666) £27,288 - (£27,288 x 30% = £8,186)	19,102
At 31 July 2021	31,249
Taxable timing difference	14,254
Deferred tax liability at 25%	3,564
Deferred tax liability at 1 August 2020	1,741
Movement to profit or loss	1,823

Calculation of deferred tax liability

	£000
Deferred tax liability at 1 August 2020	1,741
Movement to profit or loss arising from PE	1,823
Deferred tax income arising from share options	(117)
Deferred tax movement taken to equity - share options	(39)
Deferred tax liability at 31 July 2021	3,408

Tax charge per statement of profit or loss

	£000
Current tax	45
Deferred tax movement to profit or loss arising from PPE	1,823
Deferred tax income arising from share options	(117)

Income tax charge	1,751

Tax reconciliation

	£000	Tax rate 25%	£000
Accounting profit	7,003	x 25%	1,751
Increase in taxable temporary timing difference			
Depreciation	3,562		
Tax depreciation	(10,852)		
	-7,290	x 25%	-1,823
Increase in deductible timing difference			
Share based payment	468	x 25%	117
Taxable profit	181		45

2.3 Prepare revised extracts from the financial statements for the year ending 31 July 2021, including your adjustments;

Statement of profit or Loss

		Right of use asset	Share options	Tax	Revised
	£000	£000	£000	£000	£000
Revenue	23,731				23,731
Gross profit	20,174				20,174
Operating costs	(6,384)	(1,000)	(468)		(7,852)
Depreciation	(530)	(3,032)			(3,562)
Operating profit	13,260				8,760
Finance costs	(125)	(1,632)			(1,757)
Profit before tax	13,135				7,003
Income tax				(1,751)	(1,751)
Profit after tax	13,135				5,252

Statement of financial position

	£000	Right of use asset £000	Share options £000	Tax £000	Profit £000	£000
Non-current assets						
Property, plant and equipment	21,247	24,256				45,503
Current assets	26,567	(5,080)				21,487
TOTAL ASSETS	47,814					66,990
Equity						
Share capital (£1 shares)	11,810					11,810
Share option reserves			468	39		507
Retained earnings	17,290				(13,135) old profit 5,252 new profit	9,407
	29,100					21,724
Non-current liabilities						
Lease liability		22,330				22,330
Borrowings and other financial liabilities	4,264					4,264
Deferred tax liability at 1 August 2020	1,741		-156	1,823		3,408
	6,005					30,002
Current liabilities						
Trade payables	12,709					12,709
Lease liability		2,510				2,510
Current tax payable (to be completed)	–			45		45
	12,709					15,264
TOTAL EQUITY AND LIABILITIES	47,814					66,990

Examiner's comments

General comments

This question examined two technical areas only examined at advanced level – deferred taxation (IAS 12) and share based payments (IFRS 2). It also tested leases and IFRS 16 which is level A at advanced level, by asking candidates not just to calculate the adjustments but also to interpret the scenario – this distinguishes advanced level from professional level.

2.1 Financial reporting treatments including current and deferred tax

The lease scenarios were well attempted. Knowledge of IFRS 16 and its application to the scenario was generally of a high standard. The accounting entries and their subsequent journals were good.

Common mistakes included, failure to discuss the decision as to whether a lease existed or not, discussion of finance lease and operating leases as per the old standard and omission of any deferred or current tax issues.

Most candidates handled the share-based payment well including appreciation of the need for a deferred tax asset. The implication of the excess tax relief held in equity identified only by the stronger technical candidates.

Overall, the standard of answers was high although weaker candidates were unaware of the introduction of IFRS 16.

2.2 Tax reconciliations

This was the least well attempted requirement with candidates often neglecting to attempt it altogether. Another mistake was failing to show the actual tax charge calculation in favour of focusing on deferred tax issues only. IAS 12 is an advanced level financial reporting topic deferred tax and current tax are financial reporting issues. An ACA should understand the basics of how tax is reported by entities.

Only the exceptional few were able to put together a coherent overall tax position with proper interaction between current and deferred tax and an explainable overall tax charge. Adding back depreciation and deducting capital allowances in the current tax computation was particularly rare.

Those who attempted this question properly scored very well and picked up some easy marks.

2.3 Revised forecast information

Typically, well attempted with application of own figure rule. A plea to future candidates – if the adjustments to a SOFP or a PorL are not added across and the SOFP not balanced, - the marker cannot judge whether the adjustments are included the correct way around. Easy marks are lost here by too many candidates.

Question 3 solution

Scenario

The scenario is an audit planning scenario for a company with many divisions which has expanded by addition of new divisions in the current year. The candidate is required to analyse the divisional information given and to use it to identify possible areas of audit risk; to scope the audit, identify significant components and set out the extent of work at each division/site; and assess the extent of the segmental reporting required.

There has also been a reported fraud and the candidate is asked to suggest specific procedures which can be performed to address this and controls which the company might implement to minimize the risk of such frauds in the future. The successful candidate will use the information in the question, referring back to it for each part of the answer and keeping focused on the scenario.

Requirements	Marks	Skills assessed
3.1 Calculate relevant accounting ratios as preliminary analytical procedures on the summary information from the management accounts (Exhibit 1)	8	• 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
3.2 Use your analysis, together with the other information provided, to: (a) identify any matters that you believe Hyall and Forbes should investigate further as we plan the audit of NuTyre for the year ending 30 September 2020. (b) produce an extract from the audit plan which, for each manufacturing and retail division: • states whether that division is a significant component and why; and • outlines the extent of the audit procedures we should perform at that division. (c) provide Jud with guidance on the divisional financial reporting disclosures that should be included in the NuTyre financial statements for the year ending 30 September 2020. Explain your guidance and set out any additional information you require to reach a conclusion on the disclosures required.	14	• Appreciate and apply the concept of materiality • Use technical knowledge and judgement to identify risks • Apply knowledge of relevant accounting standards to the information in the scenario • Assimilate complex information to produce appropriate accounting adjustments • Identify the need for further information • Clearly set out and explain appropriate accounting adjustments.

3.3 Respond to Jud's request regarding the fraud allegations from the Belgium employee (Exhibit 2), setting out: (a) the specific procedures Hyall and Forbes could perform to investigate the occurrence and extent of the alleged fraud; and (b) the controls which NuTyre could introduce to minimise the likelihood of a fraud of this nature being committed by a divisional manager."	8	• 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 • Identify potential weakness in controls and the ability of management to override controls
Total	30	

3.1 Calculate relevant accounting ratios as preliminary analytical procedures on the summary information from the management accounts (Exhibit 1)

	Product	Revenue	Operating profit	Total assets	Revenue - % of Total	Revenue mix	Operating profit - % of total	Operating margin %	Assets - % of total	Return on total assets
		£000	£000	£000	%	%	%	%	%	%
Manufacturing										
- UK	Exhausts	4,061	51	2,395	24.5%		1.9%	1.3%	17.1%	2.1%
- India	Tyres	4,801	1,680	3,484	29.0%		63.4%	35.0%	24.8%	48.2%
Total manufacturing from intra-divisional sales		8,862	1,731	5,879	53.5%		65.4%		41.9%	
Retail										
- UK	Exhausts	2,051	428	2,018	25.3%	49.0%	28.2%	20.9%	14.4%	37.1%
	Tyres	2,135	320			51.0%		15.0%		
- India	Exhausts	723	291	1,539	20.6%	21.2%	41.5%	40.2%	11.0%	71.3%
	Tyres	2,692	807			78.8%		30.0%		
- France	Exhausts	626	234	410	6.5%	58.3%	13.4%	37.4%	2.9%	86.3%
	Tyres	448	120			41.7%		26.8%		
- Germany	Exhausts	253	27	781	9.0%	17.0%	-0.3%	10.7%	5.6%	-1.0%
	Tyres	1,239	-35			83.0%		-2.8%		
- Sweden	Exhausts	477	97	954	11.1%	26.1%	11.3%	20.3%	6.8%	31.4%
	Tyres	1,354	203			73.9%		15.0%		
- Other: 8 small divisions	Exhausts	1,093	208	2,182	27.5%	24.0%	27.5%	19.0%	15.6%	33.4%
	Tyres	3,466	520			76.0%		15.0%		
Total retail to external customers		16,557	3,220	7,884	100.0%		121.6%		56.2%	
Total manufacturing and retail		25,419	4,951	13,763	153.5%		187.0%	19.5%	98.1%	36.0%
Less: Inter-divisional		-8,862	0	0	-53.5%		0.0%			
Less: Head office costs		0	-2,303	263	0.0%		-87.0%		1.9%	
Total from external customers		16,557	2,648	14,026	100.0%		100.0%		100.0%	
Summary by product	Exhausts	5,223	1,336				50.5%	25.6%		
	Tyres	11,334	3,615				136.5%	31.9%		
	Head office	0	-2,303				-87.0%			
		16,557	2,648		407.0%		100.0%			

The above is one suggested analysis – any reasonable format was given credit in the marking of candidates answers.

3.2 Use your analysis, together with the other information provided, to:

a) identify any matters that you believe Hyall and Forbes should investigate further as we plan the audit of NuTyre for the year ending 30 September 2020.

Operating profit margins are relatively low in the UK both for manufacturing and for retail and relatively high in India for both. This may be because of the prices those retail divisions are able to charge but could also suggest some manipulation of transfer pricing as UK has a relatively high tax rate and India a low one. It would be an issue to charge different prices to different countries unless justified by differences in the operating model, distribution costs etc.

It is unclear how individual retail divisions benefit from the reconditioning of tyres as all the benefit appears to go to the manufacturing division in India. This needs further investigation to determine whether it is appropriate and also whether it incentivises the behaviour that the entity wants. Transfer pricing therefore needs further consideration from both an audit and company perspective. From an audit perspective there may be additional liabilities for tax or penalties which should be recognized.

The margins are also very high in France, especially given that we know that equipment has been treated as a cost rather than capitalised. This may again be due to differential pricing and needs further investigation.

The sales of tyres compared to exhausts in France seems unusual, and there is a particularly low margin in Germany (though explainable in the fact that it is new).

Return on assets is high in France (explained by fact they write off rather than capitalising costs) but also in India which needs to be fully understood.

Head office costs look very high – are there costs in here which should be allocated between the divisions?

There is no inter-divisional profit elimination which looks incorrect – would expect there to be inter-divisional profit in inventory as tyres and exhausts are supplied by the manufacturing divisions.

No information is given on gross margins, so it is impossible to assess whether the differences in profitability arise from different margins or from differences in operating costs or scale. This is important in assessing the performance of the divisions.

Comparative information for staffing, inventory levels etc. would allow Hyall and Forde to identify divisions where there appear to be inefficiencies.

In a number of countries, the operations are new, and it would therefore be useful to see month by month information, indicating whether the business is growing.

Also, helpful to know the number of sites for each country to assist in analysing performance and determining whether there are anomalies which need to be investigated.

Need information on FX rates and movements which will affect results in £

(b) produce an extract from the audit plan which, for each manufacturing and retail division:

- states whether that division is a significant component and why; and
- outlines the extent of the audit procedures we should perform at that division.

General principles

- We need to perform sufficient work to ensure that we are satisfied that we have addressed the risk of material misstatement for the Company as a whole.

- We will need to identify the divisions which are significant components by considering their contribution to revenue and profit and their assets and also any other risk factors which make it more likely that a material misstatement could occur.

- All divisions which are significant components will need full audit procedures and we will also need to ensure for those divisions that we visit sufficient sites to obtain appropriate coverage of key balances which require physical verification or other on-site work.

- The divisions all share a common accounting system, but controls differ across divisions. In addition, each division has its own finance manager. Hence, we cannot conclude that there is a common control environment.

- We will need to set a component materiality for each significant component, and this will be lower than group materiality as a whole. Overall company materiality is £130,000 and this has been used in assessing each division below:

- Taking each division in turn:

	Proposed extent of work
- UK manufacturing	Significant component based on revenue and assets. Operates from one site which we should visit and perform a full scope audit using component materiality.
- India manufacturing	Significant component based on revenue, profit, and assets. Operates from one site which we should visit and perform a full scope audit using component materiality.
Retail	
- UK	Significant component based on revenue, profit, and assets. Full scope audit using component materiality. The division operates from multiple sites so there will be a need for further assessment about the site visits required to verify assets, count inventory etc. Need more information on number and relative size of sites to be able to assess this.
- India	Significant component based on revenue, profit, and assets. Full scope audit using component materiality. The division operates from multiple sites so there will be a need for further assessment about the site visits required to verify assets, count inventory etc.

- France	Much smaller entity based on key measures so may not be considered a significant component on that basis. However, we are aware that its results are potentially incorrect in that equipment which should have been capitalised may be being written off to the profit and loss account. This could be material and may also be indicative of tax fraud and so specific procedures should be performed on this.
- Germany	Immaterial division contributing only a very small percentage of the operating result, although its revenue is more significant, and this may mean we wish to perform specific procedures on revenue and maybe certain assets. This is a new division formed in the year which means that we should visit it and perform at least some procedures at some sites.
- Sweden	New division representing more than 10% of profit and revenue and hence a significant component – full audit to component materiality. The division operates from multiple sites so there will be a need for further assessment about the site visits required to verify assets, count inventory etc.
- Other: 8 small divisions	Each of these is immaterial but together they contribute over 25% of profit and revenue so we will need to visit at least some of them (4-6 divisions seems appropriate). Others will be subject to analytical review only. Important to visit Belgium given the allegations of fraud there and therefore increased risk of misstatement. Also need to look at analysis of results by division to assess whether any other divisions look unusual or have indicators of enhanced risk
Head office	Need to assess whether there is a risk of material misstatement in costs or assets or whether analytical procedures are likely to be sufficient.
Elimination adjustments	These will need to be audited, including ensuring that any profit in inventory is eliminated along with inter-divisional sales and balances.

Need further information to determine whether the work proposed above will give sufficient coverage of each key account balance – may need to do additional procedures to obtain sufficient coverage of inventory etc.

(c) Provide Jud with guidance on the divisional financial reporting disclosures that should be included in the NuTyre financial statements for the year ending 30 September 2020. Explain your guidance and set out any additional information you require to reach a conclusion on the disclosures required.

NuTyre is a listed company and so is required to include in its financial statements segmental analysis in accordance with IFRS8 – Operating segments. Competitive disadvantage is not sufficient reason to avoid disclosure.

The standard envisages that the segmental information might be by product or geographical.

A segment is defined as a component of an entity:

- That engages in economic activity from which it may earn revenues and incur expenses (including from transactions with other components)
  It is clear that each of the divisions does this.

- Whose operating results are regularly reviewed by the entity's chief operating decision maker to make decisions about resources to be allocated and to assess performance.

  Jud has told us that the analysis in the management accounts is reviewed monthly by the executive management team and used to assess the performance of the divisions, to make decisions about any further investment and to set prices for inter-divisional sales.

- For which discrete financial information is available
  There is information available for each of the geographical divisions and also split between the two products.

It is therefore clear that NuTyre does have segments it needs to report and the key emphasis appears to be on geographical segments so that will form the basis of the primary segment analysis.

A segment is reportable if it meets the definition of an operating segment (each country division does as shown above) and its revenue, profit or assets represent 10% or more of the total.

On that basis the following divisions are segments:

		Total revenue		**<10%**	**Operating profit**		**<10%**	**Assets**	**<10%**		**IFRS 8 segment?**
UK	Manufacturing	4061	16%	Yes	51	1%	No	2395	17%	Yes	Yes
India	Manufacturing	4801	19%	Yes	1680	34%	Yes	3484	25%	Yes	Yes
UK	Retail	4186	16%	Yes	748	15%	Yes	2018	15%	Yes	Yes
India	Retail	3415	13%	Yes	1098	22%	Yes	1539	11%	Yes	Yes
France		1074	4%	No	354	7%	No	410	3%	No	No
Germany		1492	6%	No	-8	0%		781	6%	No	No
Sweden		1831	7%		300	6%		954	7%	No	No
8 others		4559	18%		728	15%		2182	16%		
		25419	*100%		4951			13763	100%		
				Profit	4959						
				Loss	-8						

Includes roundings

- UK – Both manufacturing and retail – these cannot be aggregated because they have very different customer bases – one sells to retail divisions and the other to end customers – qualifies on basis revenue and assets are greater than 10% of the total and also on profit grounds for the retail division

- India – Both manufacturing and retail – revenue profit and assets

- France – No less than 10% on all criteria
- Sweden – No less than 10% on all criteria

None of the smaller divisions is large enough to qualify as a reportable segment

Head Office incurs common costs and is not itself a segment as it does not generate any revenues.

All of the above analysis is based on data for 9 months – it might change when the year end financial information is reviewed.

Because the total of the reportable segments identified is less than 75% or revenue, additional segments must be identified even though they do not meet the definition of segments.

More information is needed to determine whether it would be acceptable to aggregate two or more of the smaller divisions to form one reportable segment. It may be possible to do so if they have similar long-term financial performance (such as similar gross margins) and are similar in the majority (but not necessarily all) of the following:

- Nature of products and services – this is the same at all retail divisions
- Nature of production process – not applicable for retail divisions
- Type / class of customer – the model is similar in all countries with depots supplying and fitting tyres and exhausts to individual car-owners.
- Methods of distribution- similar as set out above
- Regulatory environment – this is different in each country as Jud explains

Hence, providing rates of profitability are similar, it may well be possible to aggregate two or more smaller segments into one segment, possibly achieving coverage of 75% of revenue

Non-reportable segments are then combined and disclosed as “all other segments”

NuTyre will need to disclose the factors used to determine its reportable segments and the fact that all segments derive their revenues from the sale of tyres and exhausts. It will also have to disclose segment assets and liabilities and also items such as revenue which are regularly provided to the executive decision makers.

Hence would expect to see by geographical segment (with manufacturing and retail also separate):

Revenue
Operating profit
Any other profit and loss measures included in the management information
Assets
Liabilities

Although the geographical segments are the primary segments for NuTyre, the revenue for each product should be reported for the company as a whole as this is an additional disclosure requirement.

3.3 Respond to Jud's request regarding the fraud allegations from the Belgium employee (Exhibit 2), setting out:

(a) the specific procedures Hyall and Forbes could perform to investigate the occurrence and extent of the alleged fraud; and

(b) the controls which NuTyre could introduce to minimise the likelihood of a fraud of this nature being committed by a divisional manager."

(a) Procedures to evaluate extent of fraud

NuTyre is a public company so we need to be careful that any additional procedures and non-audit work, remain within fee limits, independence rules and any additional criteria set by the Audit Committee.

It is always difficult to evaluate the extent of something which is omitted from the financial accounting records – such as refurbished tyres which are not sent back for refurbishment but instead sold by the manager. Procedures which might suggest the extent to which this is happening are:

- Compare the volume of tyres sent back from Belgium for refurbishment with that from the other similar sized divisions (or pro-rata to revenue across all divisions). Such an analysis would provide an idea of the expected number of refurbishments for Belgium but would need to be to be treated with caution as regulatory or cultural differences might influence decisions about which tyres are suitable for refurbishment. However, if the number of tyres sent from Belgium is lower than expected, that would potentially support the claim that not all tyres are sent back.

The Belgium division is new to NuTyre so it is not possible to look back at historic information which may have shown the trends for numbers of tyres sent for refurbishment – a change in this would have been of interest.
Also, important to consider what is normal business practice in the country – it may be that the manager considers it a "perk" of the job and would not consider it fraud. Establishing clear company guidelines is important here.

- reconcile the total number of replacement tyres fitted with the total of tyres returned for refurbishment and records of those which have been scrapped.

  The division obtains a tyre which has potential for refurbishment whenever it replaces a tyre for a customer and therefore it should be possible to perform this reconciliation.

- Identify whether there are any lifestyle indicators – such as new car; expensive holidays; property investments etc – which suggest that the Belgium manager may have come into additional cash. Such indicators are not in themselves conclusion but can add to a pattern of evidence as to whether the fraud is occurring and to what extent.

There are also allegations that the finance manager is making payments to a company owned by his wife, Pinot Ltd. Procedures to investigate this could include:

- Obtain company searches to find out who owns Pinot Ltd and, if publicly available, its accounts

- Perform analytics to show the total amount paid to Pinot Ltd since the Belgium Division was established.
- Request invoices to support the amounts paid to Pinot and ascertain whether these are for bona fide services or goods.

- Compare the operating costs and other key ratios in Belgium to those of other similar divisions to determine whether there are any indications that profits are effectively being syphoned off or the results distorted in some way.

- Review all consultancy costs and looking at what reports or other input has been provided in return for the any amounts paid

- Performing analytics to determine whether there are any other payments being made into the bank accounts used for Henri's payroll or Pinot Ltd. This could indicate a more widespread fraud

(b) Controls

NuTyre needs to consider preventative, detective and monitoring controls which can be put in place at head office and should also impose common controls across all divisions wherever practical.

Preventative controls might include:

- Clear policies about which tyres should be returned for refurbishment and what the divisions should do with any tyres they believe cannot be refurbished. There should also be regular reporting with the total number of tyres returned and scrapped reconciled to the number of tyres replaced by the division.
- Ensuring that there are common policies across the company and that these are clearly set out and communicated to all divisions, especially new divisions.
- Reviewing authorisation procedures for payments and for adding new suppliers to the payables Masterfile such that no one person acting alone can do this and any finance manager would only be able to commit a payment fraud of this type with the collusion of another employee.
- Introducing an independent review of a supplier before any payments can be made to that supplier

Detective and monitoring controls might include:

- A company-wide review of metrics on a monthly basis so that any anomalies can be promptly identified and followed up
- Spot checks on records for inventory or scrappage of tyres – following through from an invoice for a replacement tyre to what has happened to the tyre replaced
- Spot checks on payments at head office level, asking periodically for the back up for a payment and details of the supplying entity
- Considering setting up an internal audit function which visits divisions, checks whether controls are operating properly and shares best practice

Examiner's comments

General comments

This question exams IFRS 8 which is an accounting standards which is exclusively examined at Advanced level - it is combined with financial statement analysis which is not examined in the professional level FAR paper and the identification of significant components – which from an audit perspective is very much in the advanced level syllabus.

Markers commented that all too often weaker candidates struggled with calculating percentages.

3.1 Accounting ratios

Most were able to provide ratios incorporating both the margins and the assets for each segment. If a candidate calculated the ratios this then allowed them to score well analysing them in the next section. Weaker candidates concentrated on the split of tyres and exhausts and then found it difficult to write anything sensible in 3.2. When geographic ratios were given, they often concentrated on the operating profit and sometimes revenue. Not all thought to look at the assets.

3.2 Audit issues

Candidates were able to score well on this requirement. Pleasingly, numerous answers focused on the specific issues within the scenario e.g. transfer pricing issues in the Indian segments and the incorrect accounting treatments in France. However, even if the candidates were not able to spot these points, high scores were still achieved if they answered all 3 elements of the requirement.

Details points include

- Weaker candidates demonstrated little understanding of how to scope a group audit. While many candidates made a reasonable job of identifying significant components, the concepts of "full scope audits", "specific procedures" and "analytical procedures" appeared rarely and "component materiality" very rarely indeed.
- There were some alarming comments about "auditing in UK because easier"; "not auditing a material component this year because we went there last year"; and "relying wholly on controls testing or analytical review" for a significant competent division.
- Time was often wasted listing copious specific audit procedures which were not asked for.
- There was at times some confusion between a significant audit component and a disclosable segment.

3.3 Fraud allegations – procedures and controls

This requirement was well attempted. It was pleasing that candidates were able to deal with a forensic rather than audit assignment and were comfortable identifying specific procedures focusing on the payments and theft of tyres.

Even when candidates struggled with the procedures, they were able to suggest relevant controls to minimise future similar fraudulent activity. Weaker candidates produced answers listing generic controls not applied to the scenario.