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 manager and ICAEW Chartered Accountant, working for Harris and Henshaw (HH), a firm of ICAEW Chartered Accountants assigned to the audit of SSD plc (SSD) for the year ended 30 September 2020.

SSD is a UK listed company which designs and develops electronic technologies for a range of industries. A colleague, Sheena Green, the former audit manager on the SSD audit, has been moved to another audit assignment. Sheena identified three audit risk areas which are likely to be key audit matters and the candidate is provided with the working papers for these risk areas as follows:

- Intangible assets (**Exhibit 1**)
- Issue of bond **(Exhibit 2)**
- Sale and leaseback transaction (Exhibit 2)

The working paper for intangibles includes extracts from the draft financial statements and the accounting policy; Sheena's assessment of audit risk in which she identifies (not entirely correctly) that the main focus is on the additions to intangibles; and her workings to date on these additions to intangible assets.

The candidate is required to evaluate the appropriateness and completeness of SSD's accounting policy note for intangibles; explain the correct financial reporting treatment for the additions to intangible assets; evaluate the adequacy of Sheena's assessment of audit risk; and set out the key audit procedures that HH should perform.

From the audit work on intangibles, the candidate discovers that a company called GMed plc, an international pharmaceutical company, has expressed interest in SSD's Textel product which therefore becomes commercially viable. The product appears also to be financially viable due to the finance raised during the year. The second working paper includes details of this finance; a bond issue issued to GMed and a sale and leaseback transaction. The candidate is required to explain the correct financial reporting treatment in SSD's financial statements for the year ended 30 September 2020; and recommend appropriate journal adjustments

Ethics

The candidate is the training supervisor and mentor for Chris Yang, who works for HH and is in his first year as an ICAEW trainee Chartered Accountant. Chris is currently assigned to the audit for GMed, an HH audit client. The inexperienced junior sends the candidate an email with information about SSD and Textel which he has come across during the GMed audit. The provision of the information creates a confidentiality issue and also highlights business trust issues. GMed stands to gain significantly from over prescribing of its best-selling heart drug resulting from patients wearing SSD's Textel product. A press report highlights the dangers of over prescribing to patients' long-term health.

Requirements	Marks	Skills assessed
For intangible assets • evaluate the appropriateness and completeness of SSD's accounting policy note; • explain the correct financial reporting treatment for the additions to intangible assets;	12	• Assimilate and demonstrate understanding of a large amount of complex information. • Identify any information gaps • Evaluate corporate reporting policies, estimates and disclosures in a scenario in order to be able to assess whether they are in compliance with accounting standards and are appropriate in the context of audit objectives. • Formulate, implement and evaluate corporate reporting policies • Formulate the appropriate financial reporting treatment for intangibles • Evaluate and apply technical knowledge from several accounting standards are simultaneously applicable and interact • Recommend appropriate accounting adjustments
• evaluate the adequacy of Sheena's assessment of audit risk; and • set out the key audit procedures that HH should perform.	12	• Identify any information gaps • Use multiple information sources • Interpret information provided in various formats • Identify relevant key audit risks • Describe appropriate audit procedures required to provide verification evidence for each risk.
For the issue of a bond and the sale and leaseback transaction: • explain the correct financial reporting treatment in SSD's financial statements for the year ended 30 September 2020; and • recommend appropriate journal adjustments."	10	• Identify inappropriate accounting treatments for the bond and the sale and lease back transaction • Explain complex transactions for the bond and lease back transaction • Recommend appropriate accounting adjustments • Filter information provided to identify critical facts

• Identify and explain the ethical issues for HH, Chris Yang and you, the audit manager arising from Chris Yang's email (Exhibit 3). Set out the actions that you should take.	8	• Identify and explain ethical issues. recommend and justify and determine • appropriate actions and ethical safeguards to mitigate threats. • Identify the solution which is the best fit with criteria and objectives
	42	

Evaluate the accounting policy for intangibles

Assessment of the adequacy of accounting policy note

Recognition
In terms of recognition, the accounting policy note appears to be in accordance with IAS 38. The purchased intangibles are recognised at cost less amortisation. It is also appropriate to recognise internally developed intangibles which meet tightly defined criteria.

Amortisation

The cost less residual value of an intangible asset with a finite useful life should be amortised on a systematic basis over that life and this should reflect the pattern of benefits. If the pattern cannot be determined reliably, amortise by the straight-line method is appropriate. The amortisation method for purchased intangibles therefore appears appropriate. However, the 40-year life is very long for technology and therefore should be challenged as to its appropriateness.

The note should also refer to the fact that the residual value is assumed to be zero and it is incomplete in this respect.

The accounting policy refers to databases having indefinite lives and therefore not subject to amortisation - although theoretically possible that there is no foreseeable limit to the period over which the asset is expected to generate net cash inflows for the entity, we would need to confirm that the data base has applications outside of the current research project. This is highly unlikely given the specific nature of the database.

SSD uses a revenue-based method for development costs and this is not considered to be an appropriate method since revenue represents the generation of expected economic benefits rather than the consumption of economic benefits. Therefore, the policy for internally generated assets is not compliant with IAS 38 and the directors should be challenged on this too.

Impairment

IAS 38 also requires consideration of impairment in accordance with IAS 36. The accounting policy appears to address this and identifies the correct period for the review and an appropriate method of discounting. Although the policy specifies only development costs when this should apply to all intangible assets if there are impairment indicators.

The impairment review should compare carrying amount with recoverable amount which is higher of fair value less costs to disposal and value in use. The policy note states that the carrying amount is compared with VIU when this should state recoverable amount.

The policy does not comment on subsequent expenditure.

Explain the correct financial reporting treatment for the additions to intangible assets

- **Taste Database costs £87 million**

The initial writing off of the costs £22 million in 2019 and £65 million in the current financial year is correct as the project, as the scenario suggests, is still in the research phase.

Due to the nature of intangible assets, subsequent expenditure will only rarely meet the criteria for being recognised in the carrying amount of an asset. Subsequent expenditure should be recognised in profit or loss as incurred.

However, the adjustment made by SSD appears to reverse the previous accounting treatment and has include a 'fair value' adjustment for the database.

An entity must choose either the cost model or the revaluation model for each class of intangible asset.

Intangible assets may be carried at a revalued amount (based on fair value) less any subsequent amortisation and impairment losses, only if fair value can be determined by reference to an active market. Such active markets are expected to be uncommon for intangible assets.

However, it is not clear whether there is an active market for the database technology and there is no indication of what the asking price and hence market value is likely to be.

Assuming that a change to fair value model is possible and this would require a change in the accounting policy, under the revaluation model, revaluation increases are recognised in other comprehensive income and accumulated in the "revaluation surplus" within equity and not as a credit to profit or loss as in the case of SSD's adjustment.

Recommended journal

	£m
DR Operating costs	87
CR Purchased intangible assets	87

Being reversal of adjustment to fair value

- **Project Smart £13 million**

Management calculations and assumptions with regards to the cashflow forecasts of project Smart development costs are not accurate.

The figure for the year ended 30 September 2020 is discounted by a full year (ie 7,250/1.1 = 6,590). However, there is only 10 months between the cash flow date of 30 Sept 2020 and the NPV date of 1 Dec 2019.

The discounted figure should have been $7250/1.1^{(10/12)}$ = 6,696

The projections were carried out at 1 December 2019 and the projection to 30 September 2020 is already inaccurate – actual cashflows were £4.2 million.

The technology has now been copied by a rival which would also cast doubt on the reliability of the projections

Scenario A uses a 7-year forecast, IAS 36 requires a 5-year forecast period and is also contrary to

their stated accounting policy which requires a 5-year period.

Scenario B produces a higher value in use of because it uses a perpetuity based on a constant revenue stream which is also not permitted under IAS 36.

The calculation of weighted cost of capital is over 12 months out of date and is likely to change given the increase in debt arising from the bond and the adoption of IFRS 16.

There is no indication whether the cashflows are pre-tax or post-tax.

Revising the calculation for the September 2020 cashflows and taking a 5-year period would indicate that an impairment charge of £23 - £18 = £5 million would be required.

Year ending 30 September	**£000**	DCF at 10%	**£000**
2020	**4,200**	0.909	3818
2021	8,600	0.826	7104
2022	4,250	0.751	3192
2023	3,378	0.683	2307
2024	2,400	0.621	1490
			17911

However, as the Smart has been copied by a rival after these projections were made, the figures for subsequent years should be challenged as these are likely to be significantly lower. More information is needed to propose an adjustment.

- **Project Textel £79 million**

SSD has recognised all expenditure on this project in the year ended 30 September 2020 as development costs although the point at which the project has become commercially viable and the future economic benefits certain are not clear. One point could be 1 March 2020 but as the project's success relies upon additional financing which was secured on in April 2020 there is an argument to say that 6 months and not 7 months of the costs should be capitalised.

If an entity cannot distinguish the research phase of an internal project to create an intangible asset from the development phase, the entity treats the expenditure for that project as if it were incurred in the research phase only. Further information is required but a correcting journal of Dr operating costs, Cr intangibles with at least £32 million is required.

- **evaluate the adequacy of Sheena's assessment of audit risk and set out the key audit procedures**.

Adequacy of Sheena's assessment of risk

Because of the significant amount of judgement in this area, Sheena has correctly identified the risk of incorrect capitalisation and the identification of potential financial reporting errors would support this.

After applying the recommended accounting treatment additions to intangible assets are now:

	£m
Per draft	214
Less:	
Taste database - Enhancement costs – incorrect subsequent recognition at fair value	(87)
Project Smart - impairment	(5)
Project Textel – initial recognition of costs	(32)
	90

However, of these three errors, only Project Textel related to initial recognition. SSD's incorrect subsequent recognition at fair value and impairment calculations indicate that the audit risk exists also over amortisation and subsequent valuation.

Capitalised development costs are internally generated assets. This area is inherently judgemental with respect to subsequent recognition including technical feasibility, intention and ability to complete the intangible asset and to generate future economic benefits.

It involves management's assessment of the value in use and any impairment includes judgement about the future results of the projects and the discount rates applied to cash flow forecasts.

This results in a risk that expenditures may not only be inappropriately capitalised but also amortised or subsequently valued.

Amortisation rates for purchased intangibles indicate useful lives of around 37 years (£447m / £12m) which is unrealistic in this industry.

Similarly, amortisation of development costs would indicate that project costs have been capitalised but not being amortised. An amortisation charge of £5 million would appear very low in comparison to cost of £257m.

Audit procedures

Taste database £87 million

The key risk here is that subsequent costs have been incorrectly capitalised. The original data base cost of £150 million has not been amortised and it is apparent that the project may now be impaired because key personnel have left the company.

Key procedures:

Evaluate the accounting policy and methodology for capitalisation of expenditures and ensure it complies with IAS 38.

Challenge management over the change to fair value, quantify the impact (£87 million) and propose an adjustment – this is a material amount and exceeds panning materiality.

Determine the control procedures for triggering an impairment review at the appropriate time – enquire about the state of the project and the need for impairment.

There is a high risk of disconnect between the research technical team who understand the project and the accounting team who understand the accounting but not the technical issues.

Make enquiries of key technical personnel to ensure that £150 million acquisition cost of the database is fairly stated to determine whether the conditions for amortisation have been met.

Project Smart £13 million

The key audit risk here is the risk that the costs should be impaired.

Audit procedures should include:

Reperform calculations of amortisation for both purchased intangibles and development costs
Challenge management over the amortisation method for development costs. Assess whether the method is appropriate and refer to audit partner for discussion with audit committee

Quantify the potential misstatements and evaluate the impact on the financial statements

Challenge management about the adequacy of useful lives of specific assets and projects

Use audit analytics to compare SSD amortisation rates to industry statistics for comparator companies.

Determine the appropriate after-tax discount rate for the year ended 30 September 2020 considering the impact of the additional debt raised to finance project Textel.

Test the use of the discount rate on impairment calculations performed by management

Evaluate management assumptions of cashflows for impairment reviews – agree to budgets/profit forecasts.

Determine the control procedures for triggering an impairment review at the appropriate time – management have used an outdated cashflow and do not seem to respond to impairment indicator provided by the copying of the Smart device.

Project Textel £79 million

The key risk with this project is that costs are incorrectly recognised on initial recognition.

Key procedures include:

We should identify the processes and test controls for the capitalisation of internally generated intangible assets

We should evaluate the accuracy and valuation of amounts capitalised to assess that costs are directly attributable and necessary to create, produce, and prepare the asset to be capable of operating in the manner intended by management.

Evaluate managements' criteria for determining the point at which the project becomes commercially viable.

Obtain confirmation of audit evidence from relevant technical personnel in the firm

For the issue of bond and the sale and lease back transaction (Exhibit 2):

- **explain the correct financial reporting treatment in SSD's financial statements for the year ended 30 September 2020.**
- **recommend appropriate journal adjustments.**

Issue of Bond

The bond is a 'deep discount' bond and is a financial liability of SSD. It is measured at amortised cost. Per IFRS 9, financial liabilities that are classified as amortised cost are initially measured at fair value minus any transaction costs.

Although there is no interest as such, the difference between the initial cost of the bond and the price at which it will be redeemed is a finance cost. This must be allocated over the term of the bond at a constant rate on the carrying amount.

The correct financial reporting treatment is to recognise an interest cost of £1.21 million x 6/12 = £605,000. This is calculated as follows

		Interest @6%	
	£m	**£m**	**£m**
1 April 2020 Bond issued for	20.25		
Less: transaction costs	0.10		
Year 1	20.15	1.21	21.36
Year 2	21.36	1.28	22.64
Year 3	22.64	1.36	24.00

The bond has been recorded incorrectly as the transaction costs should be deducted from the liability and not expensed to profit or loss.

Journal adjustment

	£
Dr Profit or loss	605,000
Cr Profit or loss	100,000
Cr Bond	505,000

Sale and leaseback transaction

The journal entries are incorrect and do not reflect the requirements of IFRS 16 – SSD has recognised all the gain on the asset and incorrectly recognised the right of use asset.

The transfer of the asset is a sale because it meets the requirements of IFRS 15 *Revenue from Contracts*

Correct financial reporting treatment

The lease liability has been correctly calculated at 27.8m representing the 10 annual payments discounted at 5%.

1. SSD should measure the right-of-use asset arising from the leaseback as a proportion of the previous carrying amount of the asset that relates to the right of use it has retained

This is calculated as follows:

$$\text{Carrying amount} \times \frac{\text{PV of future lease payments at transfer date}}{\text{Fair value of asset at transfer date}}$$

$$\text{£30 million} \times \frac{\text{£27.8 million}}{\text{£40.0 million}} = \text{£20.85 million}$$

2. SSD should only recognises the amount of any gain or loss on the sale that relates to the rights transferred to the buyer.

Calculating the gain or loss on sale:

WORKINGS

(1) Calculate the total gain on the sale:

	£m
Fair value	40
Carrying amount	30
Total gain	10

(2) Then determine the gain that relates to the rights retained

$$\text{Gain} \times \frac{\text{PV of future lease payments}}{\text{Fair value of asset at transfer date}} = \text{Gain related to rights retained}$$

$$\text{£10m} \times \frac{\text{£27.8m}}{\text{£40.0m}} = \text{£6.95m}$$

3. The gain relating to the rights transferred is the balancing figure:

Gain on rights transferred = total gain (W1) – gain on rights retained (W2)

£10.0 - £6.95 = £3.05

The right-of-use asset continues to be depreciated as normal, although there may be a revision

of the useful life required. The right of use asset is depreciated over the shorter of the lease term or the asset's useful life.

An estimate of the depreciation charge would be:

£20.85m/10 years = 2.085 x 6/12 = £1.04m

A finance cost for 6 months also will be charged

£27.8m x 5% = £1.39m x 6/12 = £0.70m

Therefore, the correct journal entries should have been

	£m
DR Cash	40.00
CR Non-current assets (Carrying amount)	30.00
CR Gain on rights transferred (PorL) (W2)	3.05
DR Right of use asset	20.85
CR Lease liability	27.80

The following correcting journal entry is required

	£m
CR Non-current assets (Carrying amount)	6.95
DR Gain on rights transferred (PorL) (W2)	6.95
Dr Depreciation (PorL)	1.04
Dr Finance cost	0.70
Cr Right of Use asset – accumulated depreciation	1.04
Cr Lease liability	0.70

- Identify and explain the ethical issues for HH, you and Chris Yang arising from Chris Yang's email (Exhibit 3). Set out the actions that you should take.

Ethical issues

For candidate:

Inappropriate communication between audit teams

Candidate has become aware of information about the client which may impact on the financial reporting – There is a threat therefore to candidate's professional behaviour and objectivity

- SSD may have received the loan as part payment for future sales and therefore accounted for incorrectly
- There may be incorrect disclosure in the strategic report and financial statements
- Potential impairment of intangibles and additional provisions to consider.

For HH
Two of its clients may have engaged in behaviour which may breach regulations. HH is therefore in a position where professional behaviour could be threatened if these breaches are not dealt with appropriately.

Excessive entertainment by GMed –may be considered an attempt to bribe the SSD research team and directors.

SSD is not transparent about the terms of the loan - the loan again may be a form of bribe.

The product that SSD has developed and marketed by GMed may lead to overdiagnosis and harm to patients for commercial gain by GMed and ultimately SSD – There may be a breach of regulations over drug use.

The connections between the two clients also create a potential conflict of interest for HH as the auditor of both clients. Appropriate safeguards need to be put in place in order to evaluate whether objectivity could be compromised.

Junior staff seem unaware of the need for confidentiality which indicates a lack of training and creates an audit quality issue for audit firm HH.

For Chris Yang
Chris is a trainee – he may not be aware of the need for confidentiality unless he has undergone ethics training on joining the firm.

Actions for you

1) Speak to Chris
    - Explain the confidentiality rules - the information concerning approval of the bond should not have been shared without the client's permission. The information obtained from the article is however in the public domain and can be shared with the SSD team – however again there is a potential confidentiality issue as Chris cannot disclose the GMed's board view regarding the potential increase in sales.
    - Explain, as an audit manager yourself, that although this is not your assignment, you can give the general audit review advice now that that Chris has raised it with you, that Chris should review the loan agreement because reviewing the terms of the loan agreement could lead to discussions with SSD and the adequacy of disclosures in the financial statements particularly with respect to the strategic report.
    - Be clear that on any further matters relating to the GMed audit, Chris should speak to his line manager on that audit.
    - Answer Chris's question with regard to who he should speak to with regard to the excessive entertainment expenses, telling him that he must follow this up with his line manager on GMed's audit.
    - Explain that Chris should separate out what Chris wants to talk to you about as mentor and specific issues re clients for which he should speak to the senior team on that audit

2) Similarly, you as a member of the SSD audit team
    - will review the SSD board minutes and evidence of authorisation of the bond would also be apparent there which would lead to discussion of GMed and the relationship.
    - The implications of the article for the SSD team could provide evidence for the impairment of the Textel development costs and also lead to provisions and contingent liability disclosures and should therefore be discussed with the SSD board.

- Follow up the issue that has now be drawn to your attention with regard to the SSD board members and research team's conference costs. This will involve consulting with the SSD Audit partner.

3) Ensure that Chris receives training in ethics. As Chris's mentor you should explain to Chris that whilst it is absolutely the right thing to do to bring ethical issues to the forefront, it is vital that Chris follows proper channels and respects confidentiality. You should remind Chris that there is the ICAEW Ethics helpline he can contact if he needs advice.

4) Obtain advice from the firm's ethics partner and quality assurance partner.
    - Explain the potential conflict of interest threat and objectivity threat that have arisen and discuss potential safeguards
    - Explain also the risks to professional behaviour that have now arisen for HH in you becoming aware of potential business trust issues that breach regulations as well as ethical business conduct, and seek advice as to what you should now do in this circumstance

5) If not satisfied with the above, you could contact the ICAEW Ethics helpline

Examiner's comments

1.1 For intangible assets:

- **Evaluate the appropriateness and completeness of SSD's accounting policy as disclosed in a note**

  This proved to be one of the most challenging part of this question. Most candidates wasted time regurgitating the accounting treatments of intangible assets and failed to critique the note. However, specific points re the long UEL and the inappropriate calculation of Value in use were commonplace. Less common was appreciation of the inappropriate allocation of amortisation based on revenue rather than consumption. However, candidates were able to compensate for weaker performance here by scoring well on the next requirements.

- **Explain the correct financial reporting treatment for the additions to intangible assets**

  Generally, well attempted. Maximum marks were often achieved with answers that addressed issues for each of the 3 main projects. There was a tendency by weaker candidates to just quote sections of IAS 38 rather than apply it or to provide an answer to only one of the three projects.

- **Evaluate the adequacy of Sheena's assessment of audit risk and set out the key audit procedures that HH should perform**

  Most candidates realised that simply focusing on the additions to IA was inadequate and many correctly identified amortisation and impairments as other key risks. For the procedures many simply set out very bland tests relevant to any intangible assets without focusing on the specific scenarios given in the question. Those who linked procedures to the 3 categories of additions generally produced good answers.

- **Explain the correct financial reporting treatment in SSD's financial statements for the issue of a bond and the sale and leaseback transaction**

  This requirement was well answered with many candidates able to score the maximum marks. This is pleasing as financial liabilities are a core syllabus area and sale and leaseback under the new standard being a more recent addition to the syllabus. Many calculated all the numbers correctly although a common error was failing to time apportion interest and depreciation. A small minority thought the bond was an asset and that the sale and leaseback was actually some form of secured loan. Many struggled to set out the correcting journal often just showing what the original entries should have been.

  One common disappointing mistake made by weaker candidates was to inexplicably treat the bond as a hybrid instrument.

1.2 Identify and explain the ethical issues for HH, Chris Yang and you, the audit manager arising from Chris Yang's email.

There were lots of aspects to this ethical scenario and it gave the candidate lots to think about. The good candidates performed excellently and appreciated the difficult ethical conundrum presented by Chris.

Weaker candidates did not attempt to split the issues from the three prescribed perspectives. A lot of candidates failed to identify that Chris had breached any ethical issues, failing to appreciate that disclosure between audit teams is still a confidentiality breach and wasted time and effort focussing on issues from the perspective of the two clients involved with the extravagant entertaining costs (the lavish treatment of the customer being identified as a self-interest threat to retain the contracts being a commonly made statement which was irrelevant from the auditors perspective). Those that missed the point managed to salvage marks through descriptions of the actions taken.

Question 2 solution

Scenario

The candidate works as the assistant to the finance director at Beta World plc (BW plc), an AIM-listed company based in the UK. BW plc is in the travel and leisure industry and prepares financial statements to 30 September.

BW plc decided to buy 45% of the ordinary shares in Flyline, a listed airline based in Australia. The BW auditors have advised the BW board that Flyline must be treated as a subsidiary. As this is BW plc's first acquisition, consolidated financial statements will be prepared for the year ended 30 September 2020. Flyline has a 30 September year end. The BW board wants to understand why, if BW plc only owns 45% of the ordinary shares in Flyline, Flyline should be treated as a subsidiary.

The BW plc financial accountant prepared a working paper which includes extracts from the draft statements of comprehensive income for the year ended 30 September 2020 for BW plc and Flyline. She has asked for help with the consolidation of Flyline and advice about some financial reporting issues.

The financial accountant is preparing the translation of Flyline's financial statements for the year ended 30 September 2020 from its functional currency, the A$, to the BW Group's presentation currency, £ sterling, in preparation for its consolidation. She has asked for advice regarding the recognition of the purchase of an aircraft and a hedged transaction.

Requirements	Marks	Skills assessed
2.1 In respect of the acquisition of Flyline (Exhibit 1): • Explain why Flyline should be treated as a subsidiary in the BW consolidated financial statements for the year ended 30 September 2020. • Set out and explain how the investment in Flyline should be recognised in the BW plc individual company financial statements for the year ended 30 September 2020.	6	• Identify and determine whether and how different types of investment are recognised and measured as business combinations • Demonstrate understanding of the business context • Filter information provided to identify critical facts
2.2 Set out and explain the appropriate financial reporting treatment of the issues identified by the BW plc financial accountant for the year ended 30 September 2020 (Exhibit 2). Include relevant journal adjustments.	9	• Explain and appraise how foreign exchange transactions are measured and how the financial statements of foreign operations are translated. • demonstrate, explain and appraise how foreign exchange transactions are measured and how the financial statements of foreign operations are translated. • explain how different methods of recognising and measuring assets

		and liabilities can affect reported financial performance • Identify business and financial issues from the scenario • Prioritise key issues
2.3 Calculate the goodwill on the consolidation of Flyline to be included in the BW consolidated financial statements at 30 September 2020; and	5	• Assimilate adjustments to prepare key workings for the consolidation of Flyline with BW
2.4 Prepare revised draft extracts for the BW consolidated financial statements for the year ended 30 September 2020 including your recommended adjustments for (1) (2) and (3) above. Identify separately the amount attributable to the non-controlling interest at 30 September 2020."	10	• Assimilate information and use own accounting adjustments to prepare revised extracts from the financial statements. • Present analysis and recommendations in accordance with instructions
	30	

(1) In respect of the acquisition of Flyline (Exhibit 1):

- **Explain why Flyline should be treated as a subsidiary in the BW consolidated financial statements for the year ended 30 September 2020.**
- **Set out and explain how the investment in Flyline should be recognised in the BW plc individual company financial statements for the year ended 30 September 2020.**

A subsidiary is defined by IFRS 10, *Consolidated Financial Statements* as 'an entity that is controlled by another entity'.

In accordance with IFRS 10, an investor controls an investee when "the investor is exposed, or has rights, to variable returns from its involvement with the investee and has the ability to affect those returns through its power over the investee".

Through its 45% shareholding in Flyline, it is clear that BW is exposed to variable returns dependent on the performance of Flyline. The key question is whether BW has the power to affect those returns, rather than just influence decisions.

At acquisition BW has the right to appoint all board members which gives control over the board decisions.

At the acquisition date and at the year end, BW can only vote at shareholder meetings with 45% of the ordinary shares. If it were to exercise its options it would be able to vote with 75% of the ordinary shares and exercise control.

IFRS 10 paragraph 12 states that "an investor with the current ability to direct the relevant activities has power, even if its rights have yet to be exercised". IFRS 10 paragraph B47 also requires an investor to consider potential voting rights in considering whether it has control over another entity. The potential voting rights are considered only if they are substantive i.e., if the holder has the practical ability to exercise the right.

Based on the information provided, the options appear to be 'in the money' as fair value per share has risen by 17% since acquisition (from A$5.55 to A$6.5 per share) and there is a required exercise premium of 5% per share below the price per share for the 45% shareholding.

Consequently, the options seem likely to be exercised and BW does have a 'current' ability to direct the activities of Flyline, as it only requires the options to be exercised (which it can do at any time up to the exercise date, it does not need to wait for the end of the exercise period) to take control through a majority shareholding.

Therefore, Flyline should be accounted for as a subsidiary of BW in the consolidated financial statements.

<u>Recognition of the investment in BW plc individual financial statements</u>

When BW prepares its separate financial statements, Flyline as an investment in a subsidiary can be subsequently measured at cost or in accordance with IFRS 9. Under IFRS 9 the investment would be measured at fair value including transaction costs and gains and losses are recognised in the statement of profit or loss unless an irrevocable election is made to recognise gains and losses through OCI.

Flyline can account for the investment, at 30 September 2020, in its individual company financial statements per IAS 27, para 10 using any of the following:

- At cost
- IFRS 9 valuation
- Equity accounting

Where relevant, IFRS 5 applies to valuations at cost or using equity accounting.

The cost of the investment does not appear to have been calculated correctly. IFRS 3 requires that the initial investment in the subsidiary is recognised in BW plc's statement of financial position at the fair value of the consideration transferred.

Under IFRS 3 costs relating to the acquisition must be recognised as an expense at the time of the acquisition. They are not regarded as an asset. The £9 million legal costs must therefore be expensed.

In BW plc financial statements:

Jnl 1	**£000**
DR profit or loss	9,000
CR cost of investment in Flyline	9,000

Issue of shares

The cost of the investment correctly includes the full £40,000,000 - however the difference between the nominal value of the shares of £1 and the fair value of £8 should be recorded as share premium. This adjustment has not been made correctly and a journal is required to

JNL 2	**£000**
DR BW plc share capital	35,000
CR BW plc share premium	35,000

2.2 Set out and explain the appropriate financial reporting treatment of the issues identified by the BW plc financial accountant for the year ended 30 September 2020 (Exhibit 2). Include relevant journal adjustments.

Purchase of aircraft

The purchase has been correctly recorded by Flyline using the rate of exchange ruling 1 May 2020

	A$000
DR PPE	20,000
CR Payables	20,000

Being the cost of the aircraft in $AUD56,000,000/2.8 = AUD$20m

IAS 21 requires that the asset should be recognised initially at the date of the transaction. The aircraft are non-monetary assets and the carrying amount stays at the original translated value.

Depreciation should be charged from when the asset was first brought into use and is translated in the same way as the asset at the rate when it was purchased. As the asset was only brought into use on 1 October 2020 no depreciation is required.

Therefore, the asset is correctly translated at 56,000,000 / 2.8 = AUD$ 20,000,000 and no further adjustment is required.

On 1 July 2020 a payment was made to Petang KL of A$ 8,125,000 which was the equivalent of RM 26,000,000 - an exchange rate of A$1: 3.2. This has been incorrectly recorded and Flyline should record a gain as follows:

	A$000
DR Payables 26,000,000/2.8	9,286
CR Profit or loss	1,161
CR Cash	8,125

At the year end 30 September 2020, the liability is recalculated using the year end rate. A further gain of A$ 1,623,000 has been made and will be recorded

		A$000
1 May	Purchase of aircraft	20,000
1 July	Repayment (see above)	9,286
		10,714
	Gain to profit or loss	1,623
	RM 56,000,000 – RM 26,000,000 = RM 30,000,000 / 3.3	9,091

The following working also acceptable with explanation

A$11,875,000 – (RM56 –RM26 = RM30/3.3 =) A$9,091,000 =A$ 2,784,000

Therefore, a correcting journal JNL 3:

	A$000
DR Payables 1,161 + 1,623	2,784
CR Profit or loss	2,784

Hedged transaction

This is a hedge of a firm commitment in relation to foreign currency and can therefore be treated either as a fair value hedge or as a cash flow hedge in accordance with IFRS 9.

By 30 September 2020, the hedge transaction has made a profit of AUD$ 2,000,000. Assuming it is treated as a **fair value hedge** and the IFRS 9 conditions for hedge accounting are met then:

At 1 June 2020
No entries are required at this date as the firm commitment is unrecognised.
The forward contract is potentially recognised, but it has a zero fair value and there is no related cash transaction to record.

However, the existence of the contract and associated risk would be disclosed from this date in accordance with IFRS 7.

At 30 September 2020

The profit is recognised as:

	A$000
DR Forward contract – Financial asset	2,000
CR profit or loss	2,000

To recognise the increase in the fair value of the hedge instrument (which is the forward contract, being a derivative financial asset) and to recognise the gain on the forward contract in profit or loss.

	A$000
DR Profit or loss	2,000
CR Firm commitment	2,000

To recognise the gain in fair value of the hedged item (i.e., the previously unrecognised firm commitment) in relation to changes in forward exchange rates and to recognise a debit entry in profit or loss, which offsets the profit previously recognised in respect of the gain on the derivative financial asset. The assumption made here is that it is a perfect hedge.

Any further profit or loss is similarly recognised at 10 November 2020.

If the transaction is treated as a **cash flow hedge** then the increase in the fair value of the hedged item (the firm commitment) is not recognised in the financial statements at 30 September 2020.

At 30 September 2020

To recognise the increase in the fair value of the forward contract (i.e., a derivative financial asset) and to recognise the gain on the forward contract in other comprehensive income the following entries would be made.

	A$000
DR Forward contract – financial asset	2,000
CR Reserves (through OCI)	2,000

The gain is reclassified from OCI (Other Comprehensive Income) in the next accounting period.

The directors do not want the hedged accounting method to change the profit or loss and the reserves for the year ended 30 September 2020 - in which case the hedged transaction should be treated as a fair value hedge as the net impact on profit or loss is A$ nil.

The cash flow hedge results in a credit to reserves.

(2) Calculate the consolidated goodwill arising on the acquisition of Flyline to be included in the BW group financial statements at 30 September 2020

Goodwill		**£1: A $2**	**£1: A$ 1.75**
		at 1 April 2020	**at 30 Sept 2020**
	A$000	**£000**	**£000**
Cost of the investment 45%			
Shares in BW £40000 x 2	80,000		
Cash	140,000		
Contingent consideration	50,000		
	270,000	135,000	154,286
NCI at acquisition 55%			
55,000,000 x A$5.55	305,250	152,625	174,429
	575,250	287,625	328,714
Net assets at Acquisition			
Share capital	100,000		
Retained earnings			
at 1 October 2019	173,800		
6 months to 1 April 2020 72,500 x 6/12 (Note)	36,250		
	310,050	155,025	177,171
Goodwill		132,600	151,543
Increase to OCI			18,943

Note: the exchange gain on the purchase of aircraft of A$2,784,000 occurs post- acquisition

(3)

Prepare revised draft extracts for the BW consolidated financial statements for the year ended 30 September 2020 including your recommended adjustments for (1) (2) and (3) above. Identify separately the amount attributable to the non-controlling interest at 30 September 2020."

Revised draft statement of profit or loss and OCI	**BW group**
	£000
Revenue	580,723
Cost of sales	352,670
Gross profit	228,053
Operating expenses	93,635
Finance costs	15,000
Profit/loss before tax	119,418
Tax	23,855
Profit for the year	95,563

Other comprehensive loss	
Exchange differences on translating foreign operations	
Restatement of goodwill (see above)	18,943
Exchange gain in year (W1)	23,688
Total comprehensive income for the year	138,194
Profit attributable to:	
Non-controlling interests	11,420
Owners of parent company	84,143
Profit for the year	95,563
Total comprehensive income attributable to:	
Non-controlling interests (W2)	34,867
Owners of parent company	103,327
Total comprehensive income for the year	138,194

Working 1 Calculate exchange differences on retranslation of subsidiary

	A$000			**£000**	
Net assets at acquisition	310,050	at Acq rate	2.00	155,025	
		at CR rate	1.75	177,171	
					22,146
Profit for 6 months to 30 September 2020					
A$72,500/2 + A$2,784 exchange gain	39,034	at Avg rate	1.88	20,763	
		at CR rate	1.75	22,305	
					1,542
					23,688

Working 2

Non-controlling interest (55%)	£000
Share of profit for the 6 months to 30 September 2020	
A$36,250 + A$2,784 = A$39,034 /1.88 (average rate) = £20,763 x 55%	11,420
Share of goodwill restatement £18,943 x 55%	10,419
Share of exchange gains on retranslation of net assets £23,688 x 55% (W1)	13,028
	34,867

Working 3 Translate and adjust for 6 months - and consolidate with BW

	BW	Flyline 12 months	x 6/12 months	Avg. rate	Flyline 6 months	Consol.
	£000	A$000	A$000		£000	£000
Revenue	427,000	578,000	289,000	1.88	153,723	580,723
Cost of sales	254,000	371,000	185,500	1.88	98,670	352,670
Gross profit						228,053
Operating expenses	*63,600	115,716	**56,466	1.88	30,035	(93,635)
Finance costs	15,000					(15,000)
Profit/loss before tax						119,418
Tax	(19,600)	(16,000)	(8,000)	1.88	(4,255)	(23,855)
Profit for the year						95,563

Workings
*£54,600 + £9,000 (professional fees) = £63,600
** A$118,500/2 = 59250 – 2784 (foreign currency gain) = A$56,466

Examiner's comments

2.1 In respect of the acquisition of Flyline:

- **Explain why Flyline should be treated as a subsidiary in the consolidated financial statements for the year ended September 2020.**
- **Set out and explain how the investment in Flyline should be recognised in the BW individual company financial statements**

Answers to this question were clearly divided along the lines of the 2 requirements. Most candidates performed well on the description of the treatment of the subsidiary, were able to discuss control using the standard and appreciated the impacts of the options, dispersed shareholding and board representation.

Answers to the impacts in the individual financial statements of BW (the parent) where less positive. Many candidates neglected to discuss the individual accounts at all, and a disappointing number incorrectly discussed consolidation issues e.g. goodwill recognition, 100% addition of assets and liabilities. Better answers identified the recognition of an investment at cost and discussion of IFRS9 treatments were commonplace. Few, however, outlined the varying treatments per IAS 27.

2.2 FR treatments

In the main this was well answered. The forex loan was regularly awarded maximum marks. The hedging less well answered but most candidates were able to appreciate that the highly probable future commitment could lead to both methods of hedge accounting being applied. Most chose cash flow hedges rather than the FV hedge but still scored well.

2.3 Goodwill

This requirement regularly achieved maximum marks. Those who did not would fail to calculate the goodwill in the currency used by the subsidiary, therefore missing out on any credit for translating and determining forex gains or losses on goodwill.

There were some very basic errors such as including the NCI on the proportionate basis and/or failing to include the appropriate proportion of CY profit in reserves at acquisition.

2.4 Draft consolidated statement of profit or loss and other comprehensive income.

This was one of the least well performed areas of the paper. Weaker candidates were more likely to omit the requirement. Those making attempts were able to score for appreciating the impacts of the mid-year acquisition, the translation at average rate and the OFR marks for adjustments. Only the best scripts were able to manage the forex gains or losses on translation and subsequent split between NCI and parent.

Question 3 solution

Scenario

This is an auditing, financial analysis and financial reporting question set in a scenario where the candidate is the audit manager on an audit of a catering company which is nearing completion. It uses a number of red flags associated with recent business failures and tests candidates ability to spot and deal with these.

The financial reporting covers revenue and share options. The successful candidate should consider each of these using the very specific facts given in the question. The candidate is also asked to identify specific audit risk factors for each issue.

The financial analysis element focusses on interpretation of substantive analytical review procedures performed by the audit assistant on revenue and journal entries. The candidate is asked to identify key items of audit interest from the results presented and also to identify what further analysis is required. Again, the successful candidate will focus on doing this in the context of the scenario set.

The final element of the question is an audit focussed question on going concern. The candidate is presented with a far from adequate going concern paper prepared by the client and is asked to evaluate this paper and identify any concerns. In this part of the question, a good mark can only be earned by using all of the information assessed in parts 1 and 2 of the question as it is this which allows the candidate to identify many of the shortcomings in the client's paper. When that evidence is taken into account it becomes clear that there is significant doubt about the entity's ability to continue as a going concern despite the positive headline figures presented by the client.

(a) For each of the matters of concern identified in Exhibit 1: a. Set out and explain the correct financial reporting treatment, identifying any additional information you require; and b. Explain the key audit risks which arise.	9	• Assimilate complex information to produce appropriate accounting adjustments • Apply knowledge of relevant accounting standards to the information in the scenario • Identify the need for further information • Clearly set out and explain appropriate accounting adjustments. • Use technical knowledge and judgement to identify risks
(2) Using the information in Exhibit 2: a. Identify and justify which entries should be the subject of further audit investigation; and b. Set out and explain the additional key substantive analytical procedures that GR should perform on revenue and on journal entries.	7	• Apply professional skepticism to identify potential for creative accounting • Relate different parts of the question to identify critical factors • Use technical knowledge and judgement to determine appropriate audit approach of substantive analytical procedures or tests of detail • Explain the additional procedures required

(3) For each of the elements of the GlamFood finance director's paper on going concern (Exhibit 3): a. Evaluate the finance director's comments and identify any factors you believe give rise to significant doubt about GlamFood's ability to continue as a going concern; and b. Set out any additional information you require to complete your assessment of going concern. **Note:** Take into account your findings in (1) and (2).	12	• Evaluate the relevance of information provided • Use multiple information sources • Filter information provided to identify critical facts • Structure and analyse financial and nonfinancial data to enhance understanding of business issues and their underlying causes • Present analysis in accordance with instructions
Total available	28	

3.1 For each of the matters of concern identified in Exhibit 1:
a. Set out and explain the correct financial reporting treatment, identifying any additional information you require; and
b. Explain the key audit risks which arise.

GlamFood Club
Financial reporting

The arrangements for the new club give rise to three streams of revenue to consider in light of the guidance in IFRS15:

- The membership fee of £500 per member which GlamFood has recognised in full in the year ended 30 September 2020
- The revenue for the first event booked by the member which gave them the right to join the club
- The discounted revenue for any subsequent event booked by a club member – in the year ended 30 September GlamFood has recognised £1.5 million in respect of the deposits taken on these events.

Key to determining the correct financial reporting for these three streams is to appreciate that the recognition of revenue should take place when the performance obligation has been satisfied which is when the event takes place not at the date of booking the event.

Considering first the membership fee:

- This is a fee which entitles members to future purchases at a reduced rate.
- It should not be recognised immediately (as GlamFood appears to have done) but on a basis which reflects the timing, nature and value of the benefit, as required by IFRS15.
- In this case, there is potential benefit for a period of one year so an amount representing the value of the benefit should be deferred over that period. A longer period could also be considered as the discounted events need to be booked within one year and not take place in that period.
- The discounts already earned by club members on orders placed is equivalent to £3.0 million x 0.2 / 0.8 = £750,000. As some members have at least another six months to place further orders it seems likely that the total benefit from the membership fee will exceed the amount of the fee.
- In addition, it seems unlikely that a customer will pay a £500 membership fee and not then book another event so the proportion of members who take up the benefits can be expected to be very high.
- Hence the full amount of the membership fee paid should be deferred over a period of one year. This will mean that only a proportion of the £900,000 should be recognised as revenue in the year ended 30 September 2020. Although one method could be to consider deferring this on a time basis, recognising the fee when the event takes place would reflect the satisfaction of the performance obligation.
- In order to determine the amount of the £900,000 to be recognised we would need to know how many of the events booked under the discount scheme had actually taken place during the year ended 30 September 2020. This further information would allow us to refine this estimate but it is clear that not all of the fees should have been recorded as revenue in the year ended 30 September 2020.
- A further consideration is that the Club membership entitles the customer to book more than one event at the discounted price – this would therefore need to be factored into the estimate of how much of the £900,000 to defer. Given that events can be booked up to 31 March 2021 but not actually take place until September 2022 the £900,000 may need to be deferred over two further financial years.
- We would also need to consider whether the 20% is a real discount (ie the customer really pays 20% less than they would have done) or whether in fact the prices are inflated before applying it and they pay much the same as they would have done. If there is not real discount then the analysis above might change although there would need to be very good evidence to support recording the club fee as revenue on receipt.

Moving on to the revenue from the first event booked by the member giving them the right to join the club. There is no indication that the amount paid for this was any less than the “normal” revenue and so it should be recognised when the service is performed, and catering provided.

Likewise, the discounted revenue for the second and subsequent events should be recognised when the service is performed, and the catering provided. The deferred revenue from the membership fees should offset the lower than normal revenue for each individual event.

The 50% paid in advance should be deferred and recognised only when the event takes place and the performance obligation satisfied. GlamFood has recognised £1.5 million in respect of deposits for booked events under the scheme – some of these events may have taken place in the year ended 30 September 2020 and therefore the recognition is correct – however we would need further information to determine how many of the events have taken place by 30 September 2020 to propose an adjustment.

Specific audit risks

- There is high risk of cut-off error for revenue between the order date and the delivery of the event.
- The revenue from the new membership scheme has been recognised incorrectly and there is a risk that there are other new schemes or arrangements which have also been accounted for incorrectly.
- There is a risk that the membership arrangement is more complex than currently understood and that there are other performance obligations for GlamFood which need to be considered and which may affect revenue recognition
- Management has an incentive to overstate revenue and it may be that the revenue from membership was deliberately overstated.

Share options
Financial reporting

Under IFRS2, share options issued to third parties such as suppliers are usually recorded at the fair value of the good and services received in return, unless the value of those goods / services cannot be measured reliably.

The cost should be recorded when the goods / services are received which appears to be during the year ended 30 September 2020. Hence it is incorrect to record no entry for the options issued. If the estimated value of £1.2 million is a reliable estimate, that cost should be recorded with a debit to expense and a credit to equity.

Specific audit risks

- The key risk here is accurate valuation of the goods and services as the evidence for this seems limited at present.
- Transactions such as these with suppliers also appear unusual and there is a risk that the arrangements may be more complex than they first appear with other obligations and terms which need to be considered. The reason for settling supplier accounts in this way does also need to be understood.
- There is also the risk that there may be other similar contracts which have not been identified and may have been accounted for incorrectly
- Also need to understand how the share options would affect control of the company were they all to be exercised

(2) Using the information in Exhibit 2, set out and explain:

- **Identify and justify which entries should be the subject of further audit investigation; and**
- **Set out and explain the additional key substantive analytical procedures that GR should perform on revenue and on journal entries.**

Revenue entries

- It is to be expected that most entries to revenue would come from sales invoices – hence these are not high-risk items
- Credit notes are also to be expected. However, the level of credit notes is high at over 12% of invoice value and the reasons for that need to be investigated. It maybe they are linked to the potential issues with duplicate invoicing. If more than 10% of invoices are reversed it is highly likely that some provisions for credit notes is required and the adequacy of that will need to be tested.
- Entries from cash directly into revenue are unusual and need to be investigated further to understand how these arise and why there appear to be no sales invoices. It may be that there is appropriate documentation but the invoices are paid immediately so no debtor entry is required however this needs further investigation.
- Entries between revenue and deferred revenue are to be expected for a business which typically invoices in advance. However, unless revenue is rising the net effect of revenue deferrals and reversals in the year would be expected to net out. The chart shows that 4091/30285 x 100 = 13.5% of total revenue was generated by the net reversal of income deferrals in the year. This is high and further investigation is required to ensure that there have not been cut-off errors with revenue recognised on invoice and not deferred until the date of the event. Directors may have an incentive to do this given the bonus scheme.
- Other journal entries to revenue are by nature unusual and any significant items need investigation

Duplicate entries

The duplicate entries are unexpected and material and we cannot rely on the accountant's assurance that it was not unusual to have a series of stage payments for the same amount. One invoice would be expected for

each event with multiple payment dates. If the explanation were correct, far more instances would be expected. Further investigation is needed.

Day of journal posting

Unless they are reversing journals or other automated journals, it would generally be unusual to have significant journals posted at the weekend – this needs further investigation (see suggested additional analytics below) as it could be indicative of the manipulation of the results.

In addition, the overall value of journals posted is very high. This may be justified by monthly reversing journals for deferred income, accruals etc but further work is required to confirm that.
In particular the value of journals posted at the weekend are higher than those posted during the week

Average value at weekend

Saturday 1902 / 12 = £158,500
Sunday 1615/5 = £312,000

Average value on a Friday as comparison is £38,000

Unexpected double entry

This entry is unusual and again the terms need to be fully understood. Not all of the amount advanced would be expected to be offset by revenue and the nature of the transaction appears to be a financing arrangement rather than a revenue transaction. It is also at a very high rate of interest (especially when the offset arrangements are taken into account) and we need to understand why such an arrangement was made. It seems likely that it would only have been entered into if there were a real and immediate need for cash.

Key additional analytical procedures

Revenue

- Analysis of revenue per month or even per week to see whether evidence of year end manipulation. Do this separately for regular and one-off sales as would expect different patterns,
- Revenue by customer so that the revenue for key regular customers can be compared to an expectation based on contract terms.
- Further analysis of revenue journals showing who posted them and when
- Comparable data and analysis for the deferred revenue balance at prior year end, each month end and year end to look for trends and any obvious omissions from the year end balance

Journals

- Search for the most material journals, particularly with an effect on profit or revenue as there are indicators that there might be manipulation given the other entries noted
- Analysis of who has posted journals with key focus on management with any incentive to mis-state the results, such as potentially the finance director
- Analysis of any journals to suspense accounts or other “holding accounts”
- Journals to infrequently used accounts which may reflect one-off or unusual transactions which are worthy of further analysis
- Unusual posters – starters and leavers
- Focus on year end or month end close journals where there is most likely to be manipulation

(3) For each of the elements of the GlamFood finance director’s paper on going concern (Exhibit 3):

a. Evaluate the finance director’s comments and identify any factors you believe give rise to significant doubt about GlamFood’s ability to continue as a going concern; and

b. Set out any additional information you require to complete your assessment of going concern.

Note: Take into account your findings in (1) and (2).

Revenue

- A number of matters identified in the course of the audit cast doubt over the director's statement that revenue has increased by 5% (£1.44 million). Included in this figure are the following balances which certainly need further enquiry and may well be errors:
    - Membership fees for club £900,000 and deposits under the scheme may have been recognised incorrectly
    - Other journals £1,028,000 seem unusual
    - Entries direct from cash = £3,805,000 which may be inappropriate
    - Likely under-provision for credit notes as yet unquantified
    - Duplicate invoices £476,000
    - Likely under-deferral of income as only £300,000 of deferred income other than the "financing arrangement" which seems improbably low.
- It is also important to note that the revenue reported "met market expectations" as this may mean that the directors were incentivised to manipulate the revenue reported in order to earn their bonus and maintain the share price.
- There is evidence that manipulation may have taken place in the number of journals posted at weekends, although this still needs further assessment
- Although we cannot quantify the actual adjustment it is possible that actual revenue has decreased this year.
- There would therefore have to be a significant turn around for the revenue to increase by 5% in each of the next two years. This may be an over-optimistic assumption which is based on a false starting point or one which has been deliberately manipulated. In addition, we know that significant discounts will be given to Club customers and these may not have been factored in.
- If an aggressive revenue assumption like this is needed to show that GlamFood can generate enough profit and cash to continue as a going concern then this is a concern.

Profit

- Similar concerns arise about the profit figure. The revenue comments above remain relevant and, in addition, we know that the profit for the year ended 30 September 2020 is / may be mis-stated due to the fact that no cost has been included for the good / services paid for with share options
- The profit forecasts rely on a cost-cutting programme which we are aware may be cutting the quality of produce and the level of staff input to the point where customers and staff an dis-satisfied and under pressure. It may well be therefore that the company cannot rely on its "loyal customer base".
- Again market expectations may only have been met by manipulation

Cash

- Little detail is given about the cash flow analysis but it is not very reassuring if the best that can be said is that the predicted cash balance does not go below zero.
- The year end balance of £1.9 million is less than the £2.0 million "loan" received on the last day of the year and there is therefore evidence that it would have been negative without it.
- You would expect a business like GlamFood to be cash rich as it collects half of its revenue on order and before any costs are incurred.
- Presumably the cash flow forecasts will be reduced if revenue and profit forecasts are adjusted and this may give rise to much greater concern about whether there is sufficient cash.
- It also seems likely that the level of obligations to be paid may well have been understated – see below.

Obligations

- While it may be true that there are no loans in the balance sheet, there is clearly an obligation to pay back in one year the "financing" from the customer which is included in deferred income. This needs to be taken into account.

- There may also be need to consider the availability of additional financing given that an adjusted cash flow forecast may well show the need for this.
- Cutting back pension contributions, accepting an unusual loan with a very high interest rate and paying for goods and services with share options all suggest that the company is experiencing cashflow difficulties and that the Finance Director is seeking to hide this. This is a big red flag in terms of the Company's true sustainability and performance. It is also unlikely that the regulator and Trustees will accept this.

Additional information required:

- Justification of why 2 years is an appropriate period for the directors to consider in their going concern assessment
- Detailed forecasts for the 2-year period for both profit and cash
- Assessment of what are the key judgements made, the key assumptions in the forecasts and the risk factors (both internal and external) affecting those forecasts.
- Evidence to support the forecast sales and costs
- Assessment of what sources of finance the Company could utilise were it to need additional cash and confirmation that such sources are indeed available and that the lenders do have sufficient funds.
- A full understanding of what pension contributions are payable in 2020/21 and 2021/22 and whether those have been agreed with the Trustees
- An understanding of actual performance since 30 September 2020, including the level of customer orders and how those compare to previous periods.
- Detailed terms for the financing agreement and other unusual transactions
- Minutes of Board meetings to understand what operational challenges the company is facing and its ability to meet unfulfilled customer orders

Examiner's comments on candidates' performance

General comments

3.1 For each of the matters concern identified in Exhibit 1:

a) Set out and explain the correct financial reporting treatment
b) Explain the audit risks that arise

Candidates were able to apply IFRS 15 well to the many complicated revenue streams of Glamfood and scored well. The recognition as performance obligations were satisfied pleasingly formed the basis of most answers.

Many candidates achieved maximum marks for the equity settled share-based payment Weaker candidates wasted time treating the payments as a share based payment to an employee by spreading the payment over vesting periods, others failed to appreciate that the direct method should be used and valued the payment at £1.1m.

Audit risks were well attempted overall.

3.2 Identify and justify which entries should be subject to further investigation and; set out the addition key substantive analytical procedures and other procedure to perform

This requirement proved to be rich pickings for the candidates. Most that attempted where able to achieve maximum marks. The duplicate entries, journals out of hours, credit notes and incorrectly recorded loan were all regularly discussed.

3.3 Evaluate the finance director's comments and identify factors giving rise to doubt regarding going concern. Set out additional information to compete the GC assessment.

Many candidates performed well here and were able to link the potentially damaging impacts of the issues from 2.2 to the forecast growth assessments. The pension scheme impacts were also commonly identified.