MARK PLAN AND EXAMINER'S COMMENTARY – CR November 2017

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

Scenario
The candidate is an audit senior working on the audit of EF Ltd. The initial audit planning was performed earlier in the year. After the audit plan had been completed, EF Ltd was acquired by a large multinational company, MegaB. The management of EF are under pressure to process financial reporting adjustments in respect of four matters relating to a brand, goodwill, PPE and a receivable allowance which are set out in the attachment to an email from the EF CFO.

The candidate must also assimilate information to identify changes in key elements of audit approach which includes, for example, the impact of the acquisition on the control environment and materiality, management incentives to manipulate the financial statements, and complex financial reporting issues. Also following the acquisition responsibility for routine accounting work was moved to a shared MegaB service centre which the candidate was required consider as part of the changes to the audit approach.

The candidate's firm is facing a potential conflict of interest regarding its ability to obtain further consultancy work from MegaB and the fact that the EF audit will be performed next year by MegaB's auditors puts additional pressure on the candidate's firm. The candidate is required to identify the ethical matters in the scenario for the audit firm and to explain the appropriate actions.

Requirements	Marks	Skills assessed
1. Explain, for each of the adjustments required by MegaB (Exhibit 2), the appropriate financial reporting treatment in the financial statements of EF for the year ending 31 December 2017. Identify any additional information you need to finalise the accounting entries required. Ignore any adjustments for current and deferred taxation	18	• Assimilate and demonstrate understanding of a large amount of complex information. • Identify appropriate accounting treatments for complex transactions including recognition of intangible assets, the difference between recognition of intangibles on consolidation and in the subsidiary financial statements, investment properties and IAS 40, and allowances for bad debt • Recommend appropriate accounting adjustments
2. Identify and explain the changes that we need to make to each element of the planned audit approach summarised in the file note (Exhibit 1). You should also consider any additional key areas of audit focus and risk using all the information available.	14	• Appreciate and demonstrate technical understanding of the role of component auditors • Relate different parts of the question to identify critical factors • Be able to respond to changes in the audit plan due to changes in the business environment • Identify key judgement areas from a complex scenario and different sources in a changing time frame

		• Identify gaps and where more information is required to develop a revised plan • Appreciate the impact on materiality level due to changes in the business operations • Understand the difference between component and planning materiality • Identify the risk of management override of controls and the potential for manipulation of judgement areas
3. Explain any ethical matters which MKM now needs to consider in respect of the 2017 EF audit and any actions that MKM should take."	8	• Demonstrate understanding of the importance of contributing to the culture of the profession • Discuss appropriate responses and actions for the firm in respect of the potential ethical issues. • Appreciate the public interest and role of an ICAEW Chartered Accountant • Demonstrate the principle of objectivity and the threat derived from external time and fee pressure imposed by other audit firms and management • Identify and recommend actions for a self-interest and intimidation threats
Total	40	

(1) Financial reporting matters relating to the acquisition of EF by MegaB

1. Valuation of EF brand at £20 million

The brand is an intangible asset and the relevant accounting guidance is set out in IAS38. For it to be recognised within the separate financial statements of EF, it would need to be identifiable, that is capable of being sold separately from the business or arising from contractual or other legal rights. It is debatable whether this is the case and clear that EF has not historically recognised the asset as an intangible within its financial statements.

In addition, to recognise an intangible, EF would need to be able to measure its cost reliably. It could subsequently choose to adopt a revaluation model for intangibles but only if the requirements for initial recognition were met and an active market can be demonstrated. The "cost" to MegaB has been determined as part of the overall acquisition cost but this is not the cost to EF and the CFO's email makes it clear that he is unsure what costs were incurred. Indeed, it seems likely that the value of the brand has built up over time through reputation rather than because of direct expenditure.

Unless it can clearly be demonstrated that there has been an error and the brand could and should have been recognised in the past, it would not be correct to do so now just because a valuation has been obtained. Additional information is required. Clear evidence of an error seems unlikely as the costs will have been considered at the time.

Hence the brand should not be reflected in the separate financial statements of EF as it does not meet the requirements for recognition within those financial statements. No entry should be made. The brand will be recognised on consolidation only as part of the acquisition accounting entries.

2. Goodwill of £1.2 million

This is goodwill generated internally by EF and it is clear from IAS38 that internally generated goodwill should not be reflected within an entity's financial statements.
No entry should be made. The goodwill will be recognised on consolidation only as part of the acquisition accounting entries in the consolidated financial statements.

3. Revaluation of PPE

PPE, including the head office building, has historically been recognised within the EF financial statements at depreciated cost - and the company can choose to change its accounting policy and move to a revaluation model, providing the fair value of the asset can be measured reliably (which does appear to be the case). It does however have to apply this model consistently to a class of assets. In this case, MegaB has specified that the revaluation model is to be used both for investment properties and all other land and buildings.

The only asset with an uplift if the revaluation model is used will be the Head Office Building. In the fair value exercise conducted by MegaB this has been treated as an investment property and we therefore need to consider whether this is the correct classification. The relevant accounting guidance is set out in IAS40.

For the whole property to qualify as an investment property, only an insignificant portion should be owner-occupied. That is clearly not the case for the head office property as EF still occupies two floors out of three. However, it is still possible that the portion which is rented out could be regarded as an investment property if it were capable of being sold separately or leased separately under a finance lease. Further information is needed to determine whether this is the case.

If the rented-out floor is regarded as an investment property, then the carrying value will need to be apportioned between the two portions and the valuation of the rented floor determined separately from the value of the remaining owner-occupied portion. It is clear from the information that historically the whole property was owner–occupied and therefore we need to follow the guidance on "change in use" within IAS40. The change in use date could be 1 September 2017 when the rental agreement commenced. A valuation should be obtained at that date and the uplift over carrying value (for the rented floor) recognised under IAS16 as a credit to revaluation reserve (within other comprehensive income). The valuation of the investment property element is then re-measured at fair value at each period end with subsequent gains and losses going to the profit or loss account.

The remaining two floors of the property which are still owner occupied will also need to be valued as the fair value model is to be adopted. Any uplift will be taken to reserves thorough other comprehensive income and to revaluation surplus and will need to be apportioned between land and buildings so that depreciation can be based on the fair value.

Depreciation will need to be charged on the owner-occupied building element based on the revalued amount and this will reduce operating profit.

The revaluation would increase reserves by £2.4 million. However, this depends on whether the valuation method used is appropriate. For both elements of the valuation, accounting guidance on the determination of fair value within IFRS13 needs to be followed and the income-based approach used by MegaB is not necessarily correct. It should be a market value considering the ability of a market participant to generate value by using the asset in its highest and best use. Further input from an expert will be necessary to ensure that both elements of the valuation are on the correct basis before accounting entries are made.

There is also a lease to the new tenant to account for. Rental income of £13,333 should therefore be accrued in the statement of profit or loss for the 4 months to 31 December 2017.

4. Trade receivable allowance

The trade receivable allowance is an estimate and it is both correct and legitimate to reconsider the basis for that estimate if the new basis provides a more accurate assessment. That is a judgement for the EF directors. Trade receivables qualify as financial assets and would be considered impaired if the carrying amount exceeds the recoverable amount.

Although the amount which would have been booked at 31 December 2016 is material, there will be no prior year adjustment as the change in the allowance is a change in estimate and not an error (unless allowances were missed which should have been made at the time). Hence, if you conclude that you can support the higher level of allowance, the entire charge of £1.35m will be shown as irrecoverable debt expense within the 2017 statement of profit or loss. However, more information is required concerning the justification for the allowance.

(2) Changes to overall audit plan and areas of audit focus because of information received

Audit timing

The timing of the audit will need to change as final audit work was planned for March and Lewis Morson require sign off by the middle of February. Whether EF can be ready by this date is debatable as its October results will not be ready until early December implying that it takes it more than a month for it to close its books. A difficult year end is likely to take even longer, leaving little if any time for audit.

This issue needs to be discussed with the client as soon as possible to determine when it is possible for audit work to start, what work can be done before the year end and rolled forward and what can be left until after the group reporting date on the basis that is will not be material given the higher level of component materiality. Leaving work until later may however not work as more staff are due to leave at the end of February and it may be difficult to get answers to enquiries about 2017 after that date.

A realistic timetable needs to be agreed with the client and Lewis Morson, especially as the new issues and approach mean that the audit is likely to take more time than in the past.

Controls reliance

In the past, the audit approach has relied on testing the operating effectiveness of controls over revenue and trade receivables. The controls were operating effectively until June 2017. Since that date there have been significant redundancies among finance and other staff and day to day accounting has moved to a shared service centre. It is therefore highly likely that both the controls and those responsible for carrying them out have changed. We know that the CFO is now responsible for both reviewing the financial statements and posting journal entries for the more complex and judgemental items which may be indicative of a lack of review and segregation of duties.

In addition, there is a new and very significant revenue stream relating to sales to overseas distributors which will not have been covered by the controls work done to date.

More information is needed on when processes changed, what the new processes are and what assurance, if any, can be given by Lewis Morson on the controls operating at the shared service centre. Additional audit work will be required to assess the design and implementation of controls in the post-acquisition period and to determine whether operating effectiveness should be tested and relied on. It seems likely that in at least some areas, design and implementation testing will identify weaknesses in control (due to staff or other changes) and that additional substantive work will be required either on the whole balance or, for income statement balances, for transactions processed under the new and potentially weaker control environment. Where the old controls are relied on for 10 months of the year, we will still need to update the interim testing to cover the 2 months from 1 November 2017.

Urgent work on the control environment is needed to re-assess the audit approach and determine what additional substantive procedures are required. This should include discussion with Lewis-Morson.

Materiality

The forecast result for the year has changed significantly because of the additional revenue following the acquisition. Planning materiality of £800,000 was based on a profit after tax of £16 million whereas the expected profit is now £26 million which might imply a rise in materiality to £1.3 million on the same basis.

However, there are other factors to consider:

- Lewis-Morson have asked us to use component materiality of £3 million both for reporting to them and for the statutory audit. We cannot simply accept this but need to form our own view on what materiality should be.

- That view should be based, not only on the financial results, but on factors such as the ownership structure (which has clearly changed) and the focus of the users of the accounts. Given that EF is now a wholly owned subsidiary of MegaB rather than a standalone entity reliant on external financing, it might be appropriate to increase materiality.

- We also need to consider the key focus for users of the financial statements. For management, the key focus will clearly be operating profit as they each earn a significant bonus based on achieving the forecast profit of £34 million. If actual results are close to this level, then a small change could make the difference between achieving and not achieving profit. That will need to be considered in determination of the materiality level we use.

The EF board have said that they intended to retain the same level of fees. This puts MKM under pressure to cut audit time and costs to retain margin and we need to make sure that this is not unduly influencing the work proposed or the materiality level adopted.

Management incentive to mis-state the results

There is clearly an enhanced risk of management override of controls following the acquisition. The remaining management will want to please the new owners and to deliver the anticipated results as there is clearly significant emphasis on this in judging their performance and potentially their future with the company / group.

In addition, they have significant personal bonuses contingent on achieving the forecast operating profit.

We therefore need to think carefully about areas where they could manipulate results and to focus our audit on all areas of judgement. This will include areas already identified as key areas of audit interest but also some of the new areas identified below. Attention will need to be paid to balances where analytical review procedures reveal changes in the post-acquisition period and we should ensure that we look at this as soon as possible to identify any additional risk areas.

The forecast gross profit looks challenging compared to prior year as there is an overall increase of £12 million. However, the forecast operating profit assumes that there will be small decline in operating costs from 42.8 million to 42.2 million. There would be additional depreciation on the property, the additional irrecoverable debt expense and reorganisation costs, none of which appear to have been considered. Further details on the forecast figures are required to assess what level of risk there is to achieve the forecast and therefore the degree of pressure there will be on management.

Last year of audit / group reporting

The last year in which an audit firm audits an entity increases the audit risk as the work will be subject to the scrutiny of a new auditor. This is perhaps mitigated here as the new auditor is most likely to be auditing the entity only as part of a much larger entity.

However, the MegaB group is a new stakeholder and may raise additional questions and issues and reporting to the group auditor brings additional responsibility and therefore inherent risk.

Changes / additions to areas of audit focus

- Revenue recognition risk is increased by the new overseas sales channels. These are intercompany sales and so will eliminate in the MegaB consolidation. They are therefore of limited interest for group reporting. However, in the stand-alone financial statements of EF they represent a new and material revenue stream and the contractual terms will need to be understood fully.
- The new sales also appear to be EF's first overseas transactions so there is a risk that foreign currency transactions have not been accounted for correctly.
- Selling to other group companies at a lower margin than to external distributors may raise transfer pricing questions in respect of tax and potentially increase the risk of an incorrect tax charge.

- The pension obligation risk remains a key judgement but has been enhanced both by the changes in assumptions applied by a new valuer and by the fact that the valuation to be used will be that performed at an interim date rolled forward, thus increasing the risk that it does not represent the best estimate of the position at the year end.
- In addition, the extensive redundancies are likely to give rise to a past service cost / benefit which will need to be considered with appropriate actuarial input, so a simple roll-forward is unlikely to be appropriate.
- While the work done by the group auditors will be a useful starting point, it may not have been based on an appropriate level of materiality so additional work may well be necessary.

- The valuation of the head office building is inherently judgemental. The complexity of accounting for the head office property also gives rise to additional risk both in terms of the classification and disclosure of the property and accounting correctly for depreciation and lease income. As for the pension fund, this will require assessment of a new valuer.

- There appears to be an increased risk of unpaid trade receivables. A general allowance calculated on the same basis as prior year is much higher at 31 August 2017 than at 31 December 2016 and this was before any increase in revenue arising from the new sales channel. This implies that the ageing has deteriorated and that there may be underlying issues either with the customers' ability to pay or with revenue recognition arising too early. Although the additional provision will cover some of this risk, the amounts involved are material and the judgements in this area both in respect of potential under and over provisioning give rise to an area on which the audit should focus.

- The measurement, classification and timing of recognition of the reorganisation and bonus payments gives rise to an additional area of audit focus as these are one off transactions where the finance team may be unfamiliar with accounting guidance. The CFO has already demonstrated that he does not understand the need to accrue for estimated bonus payments relating to the period.

- Going concern basis of preparation - If there is a definite plan to wind up the company and transfer its trade to the parent in place by year end then it may be inappropriate to continue to prepare the financial statements on a going concern basis – this should be reviewed at the year end.

(3) Ethical considerations for MKM

There are pressures associated with the audit of EF this year around materiality, fees and timing.

We need to be mindful of the responsibility of all ICAEW Chartered Accountants to act in the public interest and the collective interest of the community of those we serve. This community does include clients and investors such as MegaB but also other users of the financial statements such as Government, employees, creditors and lenders.

One of the fundamental principles of the ICAEW ethics code is objectivity and a requirement not to be influenced by others to override professional judgement. This is relevant when considering our response to the pressure to increase materiality and so cut work. While it may well be entirely reasonable for MegaB and indeed EF to determine that they need assurance only to a higher level of materiality, that may not be the case for other users of the financial statements and we need to ensure that the firm makes its own independent judgement as to the materiality to be used based on that the collective users might consider to be a material mis-statement.

The code identifies several threats to acting in accordance with the basic principles and the most relevant of these to the EF audit are:

- Self-interest as it is clear the firm will only retain the audit work for this year (and potentially the opportunity for significant non-audit work in future) if we act in the way that the client wants and fit in with their unrealistic proposals on timing and fees. Their desire to retain the same level of fees puts the firm under pressure to cut audit time and costs to retain margin and we need to make sure that this is not unduly influencing the work proposed or the materiality level adopted.

- Intimidation – there is implied intimidation both in the CFO's comments about fees and the manager's view that MegaB may not give the firm non-audit work if it does not meet their expectations on the audit work. This does give rise to the threat that the firm may be deterred from acting objectively and we need to be very sure that appropriate safeguards are put in place.

In addition, we need more information about the proposed non-audit services to MegaB and whether these affects either our independence in respect of the EF audit or our ability to provide an independent audit opinion to Lewis-Morson in respect of their audit of MegaB. Different rules may well apply for MegaB as a listed entity and we need to discuss the proposed work not only within MKM but also with Lewis Morson.

We also need to understand the proposed consultancy contract in much more detail both in terms of its timing and the nature and extent of the work, the likely level of fees and the fee basis.

It may be that MKM decides it will perform the more extensive audit procedures for the quoted fee in which case there will need to be more focus to ensure that this "low-balling" does not lead to any short-cuts on the audit work and that the staffing is appropriate, and all necessary procedures undertaken.

It also seems that the CFO is being instructed what entries to make and may be tempted to make these without question and without bringing his own professional judgement to bear. If he is an ICAEW member, then we would have a duty to report any deliberate manipulation / fraudulent reporting although there is no real indication that has happened here, and he has asked for advice.

Further actions

We would need to discuss the above issues with MKM's ethics partner at an early stage, and arrange for additional partner file review. Advice from ICAEW ethics helpline should be obtained. Full documentation of any audit based decisions on level of work, contentious audit/ethical issues, need to be fully documented. Consideration should be given to make changes to ensure appropriate level and resilience of audit team.

<u>Examiner's comments</u>

<u>General comments</u>
The corporate reporting issues examined in this question were mostly straightforward, but the question required advanced level skills in the understanding, collating and ordering of pieces of information embedded in various parts of the question. Better-prepared candidates could demonstrate their skills in this respect.

There were some very good answers to this question, producing clear, rational discussions and conclusions.

Part a) Explain the financial reporting treatment of four matters in the email attachment.

This part of the question was not generally well answered. A small minority of candidates misread the requirement and provided accounting treatment of items in Exhibit 2, in addition to the attachment to Exhibit 2. EF brand - Most candidates correctly stated that the brand could not be recognised in EF's financial statements but could be recognised on consolidation. They were less skilled at explaining the reasons why. Few identified the possibility that the brand may have been purchased by EF and therefore could potentially have been recognised in its financial statements.

Goodwill – As with the brand, candidates could state that goodwill is not recognised in individual financial statements but will be recognised on consolidation. However, the explanation of why goodwill could not be recognised in EF's accounts was often lacking or inaccurate.

Revaluation of PPE – Answers to this part of the question were very mixed and generally lacked structure. Many candidates correctly recognised that the rented-out portion could be classified as an investment property, but then lost marks by not explaining the correct accounting treatment for an IP adopting a fair value model.

A common error was to state that the change in classification should be dealt with under IAS 8 when the correct treatment under IAS40 is to apply IAS 16 with a change of use requiring revaluation gains to be taken to Reserves.

The owner-occupied portion was in most cases correctly identified as being treated as PPE. Only the best candidates questioned the validity of the income based approach to the valuation obtained by MegaB.

In respect of the proposed receivables allowance – many candidates applied inappropriate standards e.g. IAS 8, 37 and 36. IAS 37 was a particularly popular choice – an allowance for irrecoverable debts is not a provision. Few candidates accurately identified that the movement was a change in estimate, rather than a correction of an error or change in policy, and therefore should be accounted for through profit or loss.

Part b) Identify and explain the changes needed to each element of the planned audit approach – consider key areas of audit focus and risk.

Part b focussed on the impacts of several factors within the scenario upon the proposed audit plan for the EF audit. This requirement was well answered, with a significant number of candidates scoring maximum marks. This scenario was set from the perspective of a subsidiary auditor under pressure from group audit requirements. Pleasingly, a lot of candidates considered the higher-level issues such as the implication of the need to change proposed subsidiary audit timings to meet group reporting requirements and subsidiary materiality requirements being separate from group materiality. Even without these higher-level points students could still (and did) score well due to the number of different contributing factors presented within the scenario.

A common weakness in unsuccessful candidates was the repetition of points e.g. Looking at the change in controls, applying this to revenue and then to pensions, redundancy, bonus, then looking at incentives to manipulate applying this to revenues and then to pensions, redundancy, bonus. These answers were laboured and sometimes led to candidates losing the focus of the question. The better answers were produced by candidates who spent time planning and organising focussed answers rather than rushing headlong into an unstructured answer.

Part (c) Explain the ethical matters and actions for the audit firm

Answers to this part of the question were disappointing. Almost all candidates identified a self-interest threat from the consultancy work. A smaller number of candidates identified the intimidation threat. Fewer candidates than usual put their answer into an audit context, such as reporting to the ethics partner or suggesting an additional partner review.

The structure of answers was mixed with some candidates failing to break down their answers into the different areas of ethics. Issues identified were generally not backed up with appropriate actions to address the ethical challenges.
A significant minority failed to look at ethical issues from the auditor’s perspective, instead focusing on client-focused ethical problems.

Question 2

Scenario

The candidate is working in industry for a manufacturing company called Wayte Ltd. Returning from sick leave, the candidate is required to redraft information schedules to support an application for a £10 million loan from the bank. The schedules have been prepared by an unqualified accountant and require adjustment for: an AFS asset which has increased in value but because of the impact of exchange rate, has suffered a loss which is taken to OCI; a FVTPL investment where the increase, a profit, goes to PorL; revenue incorrectly recognised which requires an understanding of the similarities between IAS 18 and IFRS 15 and the current or deferred taxation implications of the adjustments. The skills tested in this question require the candidate to identify errors in the financial reporting treatment.

The question requires candidates to demonstrate understanding by revising extracts and specified ratios of a schedule of information prepared by the client to support a bank loan application. Because the adjustments involve movements to the statements of profit or loss and financial position, the statement of cash flow is only minimally impacted.

The candidate is required to analyse and interpret the financial position and performance of the company using the revised schedule of information and the statement of cash flows and provide a reasoned conclusion of whether the bank will extend the loan. In this scenario, there are plenty of positive points to identify. For example, there is a very positive cash from operations/profit from operations ratio. However, the candidate should also question why £4 million has left the company in dividends and bank loan repayment when the company is applying for a £10 million loan.

Requirements	Marks	Skills assessed
a) Explain the financial reporting adjustments required in respect of the issues identified in Jenny's handover notes (Exhibit 3). Include journal entries.	15	• Assimilate complex information to recommend appropriate accounting adjustments • Apply technical knowledge to the information in the scenario to determine the appropriate accounting for the AFS investments and revenue • Understand the similarities of accounting treatment between IAS 18 remains and IFRS 15 • Identify the different treatment in deferred tax adjustments arising from the classification of the AFS investments and the accounting treatment of revenue • Identify further information required to recommend appropriate financial reporting treatment • Clearly set out and explain appropriate accounting journals
b) Prepare a revised information schedule for the bank (Exhibit 1) including all relevant adjustments.	8	• Assimilate and use adjustments identified in drafting the schedules requested

c) Prepare a report for the board in which you analyse and interpret the financial position and performance of Wayte using the revised information schedule and other available information. Provide a reasoned conclusion on whether the bank is likely to advance the £10 million loan	7	• Use financial statement analysis to prepare relevant analysis • Apply skepticism to the payment of a dividend of £4 million when the directors are seeking further bank finance • Assimilate knowledge, drawing upon question content and own procedures to provide a reasoned conclusion on the loan
Total	**30**	

Adjustments to information prepared by Jenny

1. Foreign exchange

(i) The investment in PSN, held as available-for-sale, has increased its fair value, and the increase should be recognised through OCI. The asset is measured at 30 September 2017 at:

2,000 shares x AS$310 per share = AS$620,000
Translated at spot rate on 30 September 2017:
AS$620,000/1.6 = £387,500.

Although the value of the shares has increased, the exchange rate movement results in an overall loss: £430,000 - £387,500 = £43,000 (rounded up)

The journal entry required is:

	£'000
DR AFS reserve	43
CR AFS financial asset	43

(ii) The investment in LXP is classified as fair value through profit or loss (FVTPL) and so any change in fair value is recognised in profit or loss.

50,000 shares at AS$7 = AS$350,000
Translated at spot rate on 30 September 2017:
AS$350,000/1.6 = £218,750

The increase in fair value is therefore: £219,000 (rounding up) - £192,000 = £27,000. The journal entry required is:

	£'000
DR FVTPL financial asset	27
CR Profit or loss	27

This transaction affects profit before tax, and therefore the opening item in the reconciliation of profit before tax to cash generated from operations.

2. Service contract

It is true that IFRS 15, Revenue from Contracts with Customers, is not yet mandatory. IFRS 15 clearly sets out the steps that must be taken in recognising and measuring revenue, one of which is to identify separate performance obligations. In this case, the sale of goods is separate from the performance obligation to provide services in future. IFRS 15 represents a significant improvement over IAS 18, but it is not true to say that separation of performance obligations is therefore not recognised under IAS 18. IAS 18 requires that revenue recognition criteria should be applied to separate identifiable components of a transaction.

In this case, it seems clear that there are separate components, and that the components are capable of being measured by reference to the price of the goods. The service component should therefore be treated as deferred revenue, to be recognised in the future in the period(s) in which the service is carried out. The value of the service element to be deferred is £750,000.

The journal entry required is:

	£'000
DR Revenue	750
CR Deferred revenue	750

This transaction affects profit before tax, and therefore the opening item in the reconciliation of profit before tax to cash generated from operations. Because no costs have been incurred in respect of the service revenue, no adjustment is required to cost of sales.

3. Deferred tax

Adjustments are required as follows in respect of deferred tax.

(i) Land and buildings.
When the land and buildings are eventually disposed of, tax will arise on the gain calculated as the difference between sale proceeds and original cost. At 30 September 2017, therefore, the deferred tax balance in this respect is: (£19,200,000 - £11,400,000) x 20% = £7,800,000 x 20% = £1,560,000. The balance brought forward was £1,200,000, and so the deferred tax balance is increased by (£1,560,000 - £1,200,000) £360,000. The deferred tax charge is recognised as an increase in the deferred tax liability, and a decrease in the amount recognised through other comprehensive income and reserves in respect of the revaluation.

(ii) Temporary differences arising in respect of gains/losses on financial assets.
Wayte has sustained a fair value loss in respect of the investment in PSN, held as available-for-sale. This is recognised in other comprehensive income in the year ended 30 September 2017. As the movement in value is not brought into the charge to tax until the investment is sold and the reserve recycled to profit and loss, there will be a deferred tax effect. The tax base of the asset is £430,000, but the carrying amount is £387,000. The deductible temporary difference is therefore £43,000. At an income tax rate of 20% this creates a deferred tax asset of (£43,000 x 20%) £8,600, rounded to £9,000. This amount is recognised as a deferred tax asset and is credited to the available-for-sale reserve.

The treatment of the increase in fair value of the investment in LXP is different however. This is recognised in profit or loss in the year ended 30 September 2017, and a current tax charge is increased in respect of the gain. This is because, in this jurisdiction, tax treatment follows accounting treatment in respect of recognition of gains and losses through profit or loss. At an income tax rate of 20% this increases the current tax charge by (£27,000 x 20%) £5,400.

(iii) Temporary differences arising in respect of deferred income.
The service income has been received. But, because it is now being treated as deferred income, it is not subject to immediate taxation (because tax treatment follows accounting treatment in respect of income recognition). The current tax charge and current tax liability are therefore reduced by an amount of £750,000 x 20%: £150,000.

Journal entries required are as follows:

	£'000	£'000
DR Revaluation reserve (i) (Head office revaluation)	360	
CR AFS reserve (ii PSN)		9
DR Current tax charge (ii LXP)	5	
CR Current tax liability (ii LXP)		5
CR Current tax charge (iii) (deferred revenue)		150
DR Current tax liability (iii)	150	
CR Deferred tax ((i) 360 – (ii PSN) 9)-		351
	515	515

Note: The deferred tax asset and liability have been offset. This is recommended presentation where the entity has a legally enforceable right to set off current tax assets against current liabilities and where the income taxes are levied by the same taxation authority. Both conditions are assumed and are likely to be the case here.

(b)

Revised information schedule for the bank (Exhibit 1)

Amendments shown in bold

Performance information for the year ended 30 September 2017

	2017 £'000	2016 £'000
Revenue (£35,400 - £750)	**34,650**	34,500
Gross profit (£10,020 - £750)	**9,270**	9,660
Cash generated from operations	6,320	3,990

Extracts from statement of financial position at 30 September 2017

	2017 £'000	2016 £'000
Total assets (£35,670+£27-£43)	**35,654**	33,560
Total liabilities (£8,490 + £750 + £351 - £145)	**9,446**	8,730
Equity	**26,208**	24,830
Net debt	**450**	

Non-current assets available as security at 30 September 2017

	2017 £'000
Land	1,000
Buildings	18,200
Financial assets: available for sale	**387**
Financial assets: fair value through profit or loss	**219**
Plant and equipment	8,678
	28,484

Key ratios

	2017 £'000
Gearing (Net debt/equity) x 100	
2017 (450/**26,208**) x 100	1.7%

Gross profit margin **(9,270/34,650) x 100**	**26.8%**
Return on capital employed (operating profit/net debt + equity) x 100	
2017 (**3,660**/ [450 + **26,208**]) x 100	**13.7%**
(Operating profit: 4,440 – 30 – 750)	

Working 1

Summary of amendments required in journal entries above:

	As stated	**JNL 1**	**JNL 2**	**JNL 3**	**Total**
	£'000	**£'000**	**£'000**	**£'000**	**£'000**
Revenue	35,400		(750)		34,650
Gross profit	10,020		(750)		9,270
Operating profit	4,410		(750)		3,660
Profit before tax	4,440	27	(750)		3,717
Total assets	35,670	(43) 27			35,654
Total liabilities	8,490		750	5 351 (150)	9,446

The adjusted figure for equity is (£35,654 - £9,446): £26,208

(c)

Report to the board of Wayte
Prepared by: Damian Field, Financial Controller

Analysis of the schedule of information prepared as part of the application for a long-term loan of £10 million.

The revised statement of cash flows is very little different from the draft – because the accounting adjustments that are required do not involve cash flows.

Cash generated from operations is at a very healthy level in the 2017 financial year compared to the previous year. The key differences are in the non-cash items of depreciation and in the working capital movements. Depreciation has increased by £410,000. This is partly attributable to the purchase of new items of plant and machinery. The movements in working capital between the 2016 and 2017 year ends all show either decreases in current assets or increases in current liabilities. While the direction of these movements can signal prudent management of working capital, it can also be interpreted as a likely effect of cash shortages. A shortage of cash, as indicated by the existence of an overdraft at the 2017 year end compared with a positive cash balance a year earlier, tends to put management under pressure to keep inventories to a minimum, to accelerate receipts from debtors and to extend credit taken from creditors. These can indicate sound management but there are risks in taking this type of working capital management too far. Wayte may experience stock-outs and could lose credibility and goodwill with debtors and creditors.

Gearing is extremely low and interest-bearing debt is limited to the bank overdraft. Therefore, Wayte is in a very good position to make a credible case to a lender for substantial borrowings. However, the borrowings proposed are £10 million for investment in non-current assets. The implication is that the scale of operations of the business will be significantly larger in future. It is important that cash flow forecasts take full account of the consequent increased requirement for working capital, which does not appear to be envisaged in the plans.

Turning to performance issues, Wayte is profitable, although the figures do show declining profitability. After deferring service income, revenue has increased only slightly and gross profit has reduced. The gross profit margin has deteriorated from 28.0% to 26.7% which is quite a significant fall. Return on capital employed has also fallen between the two years, once the adjustments are considered.

The issues that are likely to emerge in discussion with the bank are as follows:

1. The level of dividend payment. No dividend was paid in the 2016 financial year, but a very significant amount of £3,000,000 was paid in the 2017 financial year. The bank may well wish to question why the directors chose to return so much cash to themselves. Had they not done so, or had the dividend been at a low level, Wayte would have had a substantial balance at bank at the 30 September 2017.

2. A similar question is likely to arise over the repayment of loans to directors of £1,000,000. In total £4 million has left the company in the year. The bank may wonder if the directors/shareholders lack confidence in the expansion plans for the business. If they were confident, then it would surely make sense to leave the £4 million in the business on the basis that it can generate higher returns than is likely to be the case elsewhere.

The bank's schedule does not require the presentation of cash flow ratios. Cash interest cover is not an issue because there is so little interest-bearing debt in the business. However, cash return can be expressed as a percentage of capital employed, as follows:

	2017 **£'000**
Cash return (cash generated from operations + dividends received)/ capital employed) x 100	
2017: ([6,320 + 30])/26,208) x 100	24.2%

Capital employed = £26,208 + £450 = £26,658 - but left as equity above to enable comparative

This accounting ratio clearly shows the company in a good light. Another cash flow ratio, cash from operations/profit from operations is also impressive:

	2017 **£'000**
(Cash from operations/profit from operations) x 100	
2017: (6,320/3,660) x 100	
	172.7%

<u>Conclusion</u>

The value of assets available as security is significantly higher than the borrowings sought. The bank is likely to be reassured by the recent valuation of land and buildings. While the bank may have specific questions about certain aspects of the historical information shown in the schedule, Wayte's performance on both a profitability and cash-generating level is impressive, and the board could be cautiously optimistic that finance will be obtainable.

Examiner's comments

Part a) Explain the financial reporting adjustments.

The financial reporting implications of the various adjustments were generally well answered and most candidates identified the key elements of the treatment of the PSN and LXP instruments and the adjustment required in respect of the service element of the contract, together with some basic principles in relation to the tax accounting.

Regarding the revenue recognition issue, most candidates recognised that the revenue for the service component needed to be separated out and deferred. However, a significant minority of candidates thought that some revenue needed to be recognised in the current year even though the question clearly stated that no service visits were due until the following year.

In relation to the tax accounting, most were able to calculate the appropriate tax charge or credit.
Many candidates recognised that the revaluation of land and buildings resulted in a deferred tax liability that was to be adjusted.

A recurring mistake was to not recognise the movement of £360,000 and not to take this movement to reserves.

Candidates illustrated a firm understanding of the treatment of AFS and the matching deferred tax treatment within reserves. Weaker students often failed to appreciate the current tax implications caused by the FVPL financial asset.

A reasonable number of candidates discussed the impact on current tax of the adjustment to revenue.

Part b) Revised information schedule for the bank including all relevant adjustments.

Most candidates prepared well-presented draft financial statements and ratios, incorporating the effects of their proposed adjustments. Many candidates achieved maximum marks for this requirement. Credit was given for own figures.

Common errors were:

- Lack of workings, particularly for the ratios
- Adjusting cash from operations
- Incorrect calculation of ROCE based on cash from operations.

Part c) A report for the board to analyse and interpret the financial position and performance of Wayte using the revised information schedule and other available information. Provide a reasoned conclusion on whether the bank is likely to advance the £10 million loan.

This was mostly done very well. Weaker candidates could not unpack the cash flow issues to reconcile the positive operating cash flows with the end of year overdraft.
Better candidates were able to analyse the statement of cash flows, highlighting the core strength of the business and commenting on the high dividend payment and the repayment of the directors' loans. Many candidates were able to take a step back and comment on the low gearing and high asset values as security for the loan although few attempted to calculate additional ratios to support their arguments.

Weaker candidates simply focused on a decrease in revenue and the presence of an overdraft, showing poorer analytical skills as they concentrated on two figures rather than understanding the context of the situation.
Some candidates failed to draw any conclusion on the likelihood of bank finance and thus missed easy marks.

Question 3

Scenario

The candidate is in the role of an audit senior who is required to evaluate whether an AFS investment of the client, SB plc should be accounted for as an associate or a subsidiary. The shareholding acquired does not meet the 50% control threshold, however the call option, the involvement of SB in the operation of the company and the share options in SB for the two remaining shareholders provide strong indications that SB has control and the investment should be accounted for as a step acquisition.

The candidate is also required to review the work of an audit associate who has gone on leave. The audit associate had identified weaknesses in control procedures and requested data analytics of the client's purchases and payables. The candidate should identify that the audit assertion of valuation and accuracy have not been substantiated. The audit associate's testing of just 10 GRN is insufficient and she has not performed any appropriate post year procedures nor obtained third party evidence. The data analytics indicates that although the number of unmatched GRN's would indicate an under recording of purchases and payables, the client has made two adjustments; a large GRNI accrual and an adjustment for a debit balance on its largest supplier's account. Comparing the analytics with this information indicates that purchases and payables are overstated rather than understated.

Requirements	**Marks**	**Skills assessed**
(1) Explain, for each of the two matters identified in Geri's email (Exhibit 1), the appropriate financial reporting treatment in SB's consolidated financial statements for the year ended 30 September 2017. Set out appropriate adjustments. Ignore any potential adjustments for current and deferred taxation.	12	• 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.
(2) Review the file note prepared by Ann (Exhibit 2) and the dashboard (Exhibit 3) and: • identify any weaknesses in the audit procedures completed by the audit team on the two issues identified; • analyse the information provided in the dashboard to identify the audit risks; and • set out any additional audit procedures that we will need to perform.	18	• Identify weaknesses in the audit procedures performed • Critically review the work of the junior and prioritise key issues • Distinguish and explain the additional procedures required • Appreciate and apply the concept of materiality • Relate different parts of the question to identify critical factors
Total	30	

(1) Explain, for each of the two matters identified in Geri's email (Exhibit 1), the appropriate financial reporting treatment in SB's consolidated financial statements for the year ended 30 September 2017. Set out appropriate adjustments. Ignore any potential adjustments for current and deferred taxation.

Investment in CG

The issue here is whether the purchase of 40% of John's shares by SB on 1 January 2017 and the call option on 1 January 2018 establishes control by SB over CG and whether the investment is treated as an associate or a subsidiary in the consolidated financial statements.

Associate?

SB holds 10% + (40% x 60%) 24% = 34% of the shares of CG at 30 September 2017. This would indicate that SB has significant influence as this is presumed if an investor holds 20% or more of the voting power. Further evidence of significant influence is that CG has a representative on the board of directors and is effectively 2 of the 4 board members. There are other indicators too – for example:

- CG is a key supplier of SB so there are material transactions between the investor and the investee
- Ken and Sharon have roles as directors with SB so there is an interchange of management personnel between CG and SB.

Significant influence would require SB to account for CG as an associate and to equity account for the investment under IAS 28.

Is CG a subsidiary?

SB has signed a call option which means that they will own 70% of the shares in CG on 1 January 2018. IFRS 10 requires an investor to consider potential voting rights in considering whether it has control and whether it has the practical ability to exercise the voting rights.

Although SB does not have the majority of the voting rights, it seems likely that it may still have control at 30 September 2017 as SB has 2 out of 4 members of the board.

Recommended financial reporting treatment

It would therefore seem likely that control is established. SB should be accounted as a subsidiary which means that 100% of the net assets and liabilities will be consolidated within the group financial statements. The profit or loss account is consolidated from the date of control.
The acquisition represents a step acquisition which crosses the control boundary as a previously held investment is increased to a controlling holding.

A profit on the disposal of the previously held shareholding is recognised in the statement of profit or loss. This is calculated by comparing the FV of the previously held equity with the carrying amount. The profit on disposal also includes recycling the gain previously taken to OCI.
Goodwill is calculated by comparing the net assets at the date control is established (1 January 2017) with the consideration plus non-controlling interests, and the fair value of the previously held equity.

Share based payment

IFRS 2 requires an entity to recognise share based payments in its financial statements. Therefore, the fact that no cash is involved is not a reason for not recognising an expense.
This transaction involves a choice of settlement and results in a compound financial instrument.
The fair value of the cash route is:
28,000 x £22 = 616,000
The fair value of the share route is:
32,000 x £20 = 640,000
The fair value of the equity component is therefore:
£24,000 (£640,000 - £616,000)

The share based payment is recognised as follows:

Year ended 30 September 2017	Liability	Equity	Expense
9/24 x 28,000 x £24	252,000		252,000
9/24 x £24,000		9,000	9,000

Disclosure implications of share based payments:

SB will need to disclose the nature and extent of the share based payments in the period to help users of the financial statements to understand how the fair value is measured and the impact on the earnings per share.
Share based payments are also disclosed in accordance with IAS 24 Related parties.
Share based payments will also impact on the earnings per share (EPS).

(3) Review the file note prepared by Ann (Exhibit 2) and the dashboard (Exhibit 3) and:

- identify any weaknesses in the audit procedures completed by the audit team on the two issues identified;
- analyse the information provided in the dashboard to identify the audit risks; and
- set out any additional audit procedures that we will need to perform.

Weaknesses in audit procedures

The weaknesses in audit procedures performed by Ann have resulted in the audit assertions of accuracy and valuation not being appropriately tested.

GRNI accrual

The audit team has identified a control weakness which revealed that the incorrect goods had been matched to the purchase invoice - No tests of detail have been performed by Ann in respect of this weakness.

Sample sizes should have been increased in response to the control weakness being identified.

It is not clear whether Ann has agreed the GRNI list to GRN or linked this to work on supplier statement reconciliations. Therefore, she has not tested accuracy of the GRNI accrual.

Ann has selected just 10 GRNI from the list to make sure they are pre- year end, but she has not linked this to purchase invoices and the payables ledger to ensure appropriate valuation and cut off. Audit procedures (tests of detail) are required to match invoices to GRNs pre-and post-year end and vice versa to ensure completeness and accuracy.

There is no justification for the sample size of 10.

Ann has only agreed to bank payments and confirmed that no invoices have been received - she has not tested accuracy and authorisation by agreeing to GRN.

No work has been completed on supplier statement reconciliations to obtain third party evidence of completeness, valuation and accuracy.

Examining key supplier statements may identify that a significant proportion of the accrual can either be substantiated or confirmed as not required.

Audit procedures have not been focussed on older and material items in the list of unmatched GRNs.

£290,000 for debit balance on MAK

The audit procedures on the £290,000 allowance for the debit balance are inadequate and lead to inaccurate recording of cost of sales.

There has been no cross check to the accuracy of the accrual and to identify whether the adjustment for the debit balance is double counted with the GRNI accrual – the results of the data analytics would suggest that this is the case (see below).

No testing has been carried out on the timing of these payments to ensure that they are not paying against earlier invoices.

Analysis of information in the dash board to identify audit risks:

Dashboard data:	**Data**	**Analysis of data**
Number of purchase orders Number of GRNs raised and matched to purchase orders	7,246 6,884	6,884/7,246 x 100 = 95% 95% of purchase orders raised are matched to GRN. The difference could be a timing difference. However, as liabilities are not recognised based on a purchase order but are recognised when the risks and rewards are transferred to SB, no accounting adjustment is required. This percentage does however provide some comfort that goods received are authorised by a purchase order and reduces the audit risk of misstatement due to authorisation.
Average time from GRN to receipt of purchase invoice	10 days	The audit team reported that controls in the agreeing of GRN to purchase invoices are ineffective. The data analytics graph suggests that the problem is related mainly to one outlier supplier MAK Ltd. The average time to match the GRN to an invoice is 10 days and only MAK is exceeding the average time and by 11 days at 21 days.
Number of GRNs not invoiced	311	This number represents the GRNs which have been matched to purchase orders evidencing that goods received are authorised, but the liability has not been recorded in the financial statements as the suppliers' invoices have not been received and hence are not yet been recorded on the system. 311/6,884 x 100 = 4.5% This means that 4.5% of total GRNs matched to purchase orders are not matched to a suppliers' invoice and should be accrued as a liability and a cost. (SB has established an accrual for GRNI based on the GRNI list at 30.9.2017 (see below).) Of the 311 unmatched GRN 142 relate to MAK. Of the 156 unmatched GRNs over 2 months, 122 relate to MAK.
Number of GRN unmatched to invoice over 2 months	156	156/6,884 x 100 = 22.7% 22.7% of GRN unmatched are over 2 months old.
Average order	£1,900	
Total		

Test for MAK Ltd	**Data**	
Number of purchase orders Number of purchase orders matched with GRN	771 732	732/771 x 100 = 95% 95% of MAK purchases orders are matched to GRN. This is equal to the general population. This provides some assurance that purchases are authorised. MAK is SB's large supplier.
Average time from GRN to receipt of purchase invoice	21 days	The analytics supports the information received elsewhere on controls testing that a specific problem regarding invoicing at MAK is one of the reasons for the large GRNI accrual.
Number of GRNs not invoiced at 30 September 2017	142	142/732 x 100 = 19% This represents 19% of total GRNs matched to purchase orders compared to 4.5% for the total population.
Number of GRNs unmatched to invoice over 2-months old	122	122/732 x 100 16.6% of MAK GRNI are over 2 months old – 142/307 x 100 = 46% 46% of all GRNI relate to MAK GRNs
Average order value	£2,040	

Audit risks

Delay in invoicing – accuracy and completeness

As there is a delay of 10 days between GRN and recording of invoices, there is an audit risk that delays in invoicing could lead to inaccurate recording of inventory valuations and purchases. This is increased for MAK where the delay is up to 21 days.

Unmatched GRN over 2 months - overstatement

GRN unmatched over 2 months increase the risk that purchases and payables are overstated and not accurately recognised. The analytics supports the information received elsewhere on controls testing that a specific problem regarding invoicing at MAK is one of the reasons for the large GRNI accrual. Procedures performed by Ann are inadequate and do not confirm the accuracy and completeness of the GRNI accrual and the adjustment for the debit balance on MAK.

There is a risk that the purchases and payables (accruals) have been overstated by £290,000 because the accrual for the debit balance and the GRNI accrual both include the costs of goods supplied by MAK Ltd.

Using the above analysis, the expected GRNI accrual can be calculated approximately as follows:

	£
MAK GRNI 142 x £2,040	289,680
Other unmatched GRNI 311 – 142 = 169 x £1,900	321,100
	610,780
GRNI accrual	610,000

Control weakness – measurement and accuracy

Control testing identified weakness in controls by staff matching the GRN to the correct purchase invoice. The risk therefore exists that invoices have been recorded for goods not received or more likely that the GRNI accrual is overstated.

SB has recorded an adjustment for payments made to MAK without invoices of £290,000 which would represent 142 MAK orders based on the average order value of £2,040. There is a total of 732 MAK purchased orders matched to GRN.

An expected number of unmatched GRN based on the whole population would be 732 x 10 days/365 days = 20. As the total of unmatched GRN for MAK is 142, it suggests that the adjustment for unmatched payments has been double counted in the GRNI accrual and the accrual for the debit balance should be reversed:

Additional audit procedures

- Further controls testing should be undertaken on the matching of GRN to invoice to confirm whether the control weakness applied to other suppliers.
- MAK GRNs included in the GRNI should be tested 100% to ensure that they are appropriately accrued. In addition, audit procedures should be focused on older and material items from other suppliers in the list of GRNI. Any unmatched GRN's should be removed from the GRNI accrual and an audit adjustment calculated
- Obtain the MAK supplier statement and agree invoices received post year end to the GRNI accrual.
- Other key supplier statements should be agreed to invoices and GRN pre-and post-year end.
- Agree a sample of purchases invoices to purchases orders to ensure accuracy and valuation
- Review supplier terms for each large supplier and assess whether the time delay is normal for each suppliers' invoice terms.
- Ensure appropriate valuation procedures are performed on inventory to record the correct cost of inventory.
- Perform invoice cut off procedures by agreeing invoices pre-and post year end to inventory records and payables accounts to ensure correct recognition of payable and accruals and inventory.

Examiner's comments

Part a) Explain the financial reporting of the share acquisition and the share options.

The explanation of the two financial reporting issues was handled well by most candidates. They were able to identify the implications of control arising from the call option and the board representation. There were many good discussions around the principle of control and step acquisitions. However weaker candidates failed to expand on control and how it was achieved and concluded that CG was an associate (although marks were awarded for appropriate accounting treatments).
The choice of settlement share based payment was also answered well – common weaknesses were to fail to notice the choice of settlement and incorrect or lack of time apportioning. Overall, this section was attempted well.

Part b)

- Review the file note prepared by Ann (Exhibit 2) and the dashboard (Exhibit 3) and:
  identify any weaknesses in the audit procedures completed by the audit team on the two issues identified;

  Whilst many candidates were able to correctly identify where the procedures performed by Ann could be improved, many expressed these improvements as additional audit procedures rather than the specific deficiencies in the procedures performed.

  A significant majority of candidates focussed only on completeness issues and failed to detect the potential overstatement caused by the adjustment for the debit balance on Mak's account.

  Some candidates discussed at length the shortcomings and weaknesses of the system and/or what the auditor should do about it rather than discussing the weaknesses of Ann's procedures.

- analyse the information provided in the dashboard to identify the audit risks

  In general, many candidates performed a good level of analysis, identifying the fact that the terms of business with MAK are significantly different to other customers. Good answers produced analysis from the dashboard to identify risks

  Weaker answers simply involved repeating facts from the question rather than developing them and linking them to specific audit risks.

- set out any additional audit procedures that we will need to perform

  Most were able to identify additional procedures to be performed on the payables and purchases balances. Weaker candidates would often resort to a “knowledge dump” approach- simply listing generic risks and procedures surrounding payable.