MARK PLAN AND EXAMINER'S COMMENTARY - Corporate Reporting November 2018

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 manager working for Dealy and Brant (DB), a firm of ICAEW Chartered Accountants. DB has audited Zmant plc and its subsidiaries for some years.

Zmant plc supplies specialist audio equipment and has several 100%-owned subsidiaries. Zmant and its subsidiaries have a 30 September year end. During the year ended 30 September 2018, Zmant acquired an investment in a company called KJL which operates in Otherland. KJL is audited by a local firm called Welzun.

DB is not the auditor for KJL and has identified KJL as a significant component. The audit plan included an assessment of Welzun's professional qualifications and independence and no issues were noted.

Following a review of KJL's financial statements, DB asked for further information regarding certain transactions and balances which may impact on the group audit opinion. The report received from Welzun casts doubt on the integrity of the management and the quality of the financial reporting at KJL. It also raises concerns that DB's original assessment of Welzun may be incorrect and further audit procedures will be required to ensure that a misstatement does not arise in the group financial statements because of the consolidation of KJL with the Zmant group. The matters giving rise to concern are the recognition of development expenditure in the statement of profit or loss which is required to be capitalised under IAS 38 and the incorrect presentation of entertainment costs as research costs. The result of the recording of these transactions in this way enables KJL to take advantage of a tax relief to claim a significant refund of tax which is has recorded as a current tax receivable.

The assurance element of the question requires the candidate to identify that Welzun has not applied the concept of materiality appropriately to these transactions and hence identify that insufficient audit procedures have been carried out. Those procedures which have been completed do not cover all auditing assertions - particularly accuracy and presentation. From a higher perspective, the candidate should recognise that these issues require a reassessment of the original audit plan and DB may be required to complete a full audit of KJL using component materiality.

Further technical issues are raised by Zmant's newly appointed finance director who asks for assistance with consolidation adjustments for KJL. These include the financial reporting treatment of a foreign currency loan which represents a net investment in a foreign operation; the revaluation surplus and deferred tax adjustment in KJL's financial statements; and intercompany trading adjustments for inventory.

A newspaper article is supplied which highlights that some of the research and development costs are at best entertaining costs and hence incorrectly form part of the claim for a tax refund and at worst potentially bribes. The ethical requirement links therefore the audit and financial reporting aspects of the question.

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Requirements	Marks	Skills assessed
(1) For each matter in Exhibit 1: • set out and explain the appropriate financial reporting treatment and recommend adjustments to KJL's financial statements for the year ended 30 September 2018; and • identify and explain any weaknesses in the audit procedures completed by Welzun. • set out any additional audit procedures that should be performed by DB and by Welzun to provide assurance for the group audit opinion.	20	• Demonstrate understanding of the business context by relating nature of project expenditure to the business context. • Identify risks within a scenario by linking incorrect financial reporting treatment with the potential fraudulent claim for R&D tax refund • Identify elements of uncertainty within a scenario by appreciating that more information and procedures required to ensure appropriate financial reporting treatment • Appreciate that Welzun has not applied technical knowledge of materiality correctly • Appreciate that reassessment of Welzun in original audit plan is required by seeing an overview of the whole scenario and identify a range of outcomes • Make appropriate recommendations for financial reporting and additional audit procedures
(2) Set out and explain the appropriate adjustments for the financial reporting queries raised by Janet (Exhibit 2) for the year ended 30 September 2018 for: • the individual financial statements of Zmant and KJL • the consolidated financial statements of Zmant.	10	• Identify the client's requirements by clearly setting out which adjustments impact the group or individual financial statements • Identify the relevance of the information presented to the financial reporting treatment • Set out the adjustments and explanations in a format suitable for presentation to the finance director
(3) Calculate goodwill to be recognised for KJL in Zmant's consolidated financial statements for the year ended 30 September 2018. Assume Zmant uses the proportion of net assets method to value the non-controlling interest in KJL.	4	• Assimilate and apply technical knowledge by linking information from the introduction and the exhibits to calculate goodwill

(4) Explain the ethical issues for DB arising from the newspaper article (Exhibit 3) and any related matters. Set out and explain how DB should respond. Advise Janet on any actions she should take.	8	Link information from Exhibits 1, 2 and 3 to identify and structure the ethical issues for different parties involved. Appreciate that tax evasion is a public interest matter and has legal implications and risks for the different parties.
Total	42	

Question 1

1.1 For each matter in Exhibit 1:

- set out and explain the appropriate financial reporting treatment for KJL's financial statements for the year ended 30 September 2018; and
- identify and explain any weaknesses in the audit procedures completed by Welzun.
- Set out any additional procedures that should be performed by DB and by Welzun.

1.1 Appropriate Financial reporting treatment

Research and development (R&D) expenditure $10,700,000

- Project: Sound

Financial reporting implications

The project appears to meet the definition of development expenditure and the costs that meet the criteria for capitalisation under para 57 should be capitalised under IAS 38 as an intangible asset. The project involves adapting existing technology for the car industry. Provided that the technology satisfies the general recognition criteria that there are expected future economic benefits attributable to the technology and that the costs can be reliably measured, an intangible asset shall be recognised (IAS 38 (21)).

There is judgement involved in this initial assessment but there is clear external evidence in the initiation from an external customer for the product and significant orders have been received from the same customer.

The judgement involved here is not just about whether this expenditure is deemed to be research or whether it is development expenditure. The project does involve the design and preproduction of a prototype which is a specific example of development expenditure given in the standard. The judgement also involves deciding when the criteria are met.

IAS 38 para 65 makes clear that development costs can only be capitalized from the date when the criteria are first met. Because the customer placed a large order on 1 April This would seem to be the appropriate date – however the auditors have not carried out audit procedures to confirm this – see below. Thus, assuming 1 April is the appropriate date, any of the costs incurred between 1 January and 1 April (other than capital/PPE costs) should not be capitalised.

Points to indicate capitalisation from 1 April 2018

Recognition criteria per IAS 38	Points to indicate cost should be capitalised
Technical feasibility?	Question says – adapting an existing speaker
Intention to complete and sell? Ability to use or sell intangible asset? Generate probable future markets? Adequate technical - financial resources?	Specific request from an existing customer Company using the development cost to make a product to sell for which they have a firm order from a customer
Measure reliably?	Nothing in question to say the company can't measure reliably – further information is required.

IAS 38 states that the development costs comprise all directly attributable costs. These include materials for the prototype O$1,725,000, The salary costs of the development staff O$1,270,000 and the fees to secure the legal right to the design O$910,000. If the costs meet the recognition criteria for development expenditure the standard says the costs must be capitalised.

We should be sceptical about the motivation for expensing which has significant tax benefits for the company.

Amortisation of these costs should commence once the product is ready for sale. To advise on an adjustment, more information will be needed on amortisation rates.

The allocated general overhead potentially should be written off unless these are specific to the development of the technology. It is however questionable whether this expenditure would meet the criteria of research expenditure.

Further information should be obtained to determine how this cost has been calculated and whether they are specific to the development asset.

With respect to the computer equipment and the car, both these assets meet the definition of an asset and should be capitalised. Management comment is unacceptable regarding the hiding of the cost of the car from the tax authorities to prevent personal tax liability for CEO.

The computer costs of O$1,700,000 should be capitalised as part of PPE and depreciation over two years. Assuming that this was purchased on 1 January 2018 depreciation of 9/24 x O$1,700,000 = O$637,500 should be recognised in the statement of profit or loss – it is possible to include depreciation within the research and development costs and more information should be obtained.

The car too should be capitalised and the cost less residual value depreciated over its useful economic life. Further information is required.

Summary of costs to be capitalised

	O$'000	Recommended FR treatment
Materials for prototype model	1,725	Capitalise as development expenditure
New computer equipment - bought on 1 January 2018	1,700	Capitalise and depreciate
Salary costs of development staff		
• incurred after 1 April 2018	1,270	Capitalise as development expenditure
• incurred before 1 April 2018	790	Expense to profit or loss

Registration fees for design	910	Capitalise as development expenditure
Car used for speaker testing - bought on 1 January 2018	555	Capitalise as asset
Allocated general overheads	950	Expense to profit or loss
	7,900	

As all the costs have been expensed an adjustment is required to capitalise the items identified above.

- Project: Entertain

Financial reporting implications

The recognition of this cost in the profit or loss account is correct because it appears to represent selling and marketing costs from which the entity will not derive a future economic benefit. The report will also not satisfy the general recognition criteria of being capable of future economic benefits and being separable identifiable. The newspaper article in Exhibit 3 further suggests that the costs are no more than entertainment costs and are largely for the benefit of KJL's directors and there is limited invitation to customers.

These costs do not meet the criteria for research costs and have therefore been presented incorrectly in the profit or loss account.

Including these costs as research costs has resulted in the company benefiting from additional tax relief and potentially fraudulently obtained a tax refund.

Income tax receivable balance $8,025,000

The calculation of this balance assumes that all costs recorded as research costs in the statement of profit or loss qualify under Otherland tax rules for the tax refund. Clearly if these costs have been misstated then this balance too is misstated, and further audit procedures are required to substantiate the accuracy of this balance and whether the amounts are recoverable from the Otherland tax authorities.

Weakness in audit procedures

Materiality

The materiality level used is the component materiality which has been determined by DB, the group auditor. For group reporting purposes this is acceptable. However, Welzun's explanation shows a lack of understanding of materiality.

ISA (UK) 320 Materiality in Planning and Performing an Audit states that the auditor's frame of reference for materiality should be based on the relevant reporting framework. KJL reports under IFRS and IAS 1 gives the following definition of materiality. Omissions or misstatements are material if they could individually or collectively influence the decisions of that the users make based on the financial statements.

Welzun should have made their own assessment of materiality based on nature, value and impact and set a performance materiality to reduce the possibility that an aggregate of uncorrected misstatements exceeds materiality for the financial statements.

Given the profit for the year recorded in retained earnings (See Exhibit 2) is $15 million a cost of $10.7 million is material by value and as it includes the cost of a car used by the CEO also material by nature.

Furthermore, grouping the costs together results in the balance which exceeds component materiality level regardless of whether performance level materiality has been set by Welzun.

R&D

Project Sound

The clear weakness here is that Welzun has not carried out any audit procedures to determine the audit assertions as per ISA 315.

Project Entertain

The auditors have not carried out audit procedures to determine the nature of these costs as research costs– Incorrect classification of the costs could result in tax evasion since the impact is a larger claim for tax to be refunded. The assertion of classification therefore has not been substantiated.

It also seems extremely questionable that the report has not been received and yet KJL has accepted the obligations to pay for this service.

Confirmation to invoice and bank statement confirms the audit assertion of occurrence but does not confirm completeness. Are there any further costs to be recorded?

As the report has not been received, there is no confirmation that the cut off assertion has been satisfied.

The auditors have accepted management statements without challenge and corroboration.

Income tax receivable

Accepting the work of Welzun's own tax department for the income receivable balance is also not sufficient. This does not challenge management assumptions about the nature of the costs included in the claim.

The tax department may not have oversight of the nature and classification of these costs.

Additional procedures

Group auditor responsibilities

The group auditor cannot discharge their responsibility to report on the group financial statements by unquestioning acceptance of the component's financial statements (ISA 600.11).

The initial assessment of Welzun performed at the audit planning stage should be reviewed to ensure that DB believes that sufficient audit evidence on which to base a group audit opinion can be obtained from the work performed on KJL by Welzun. We should question whether DB's involvement at the planning stage was appropriate.

If the group auditor does not consider that sufficient appropriate audit evidence has been obtained then the group auditor or the component auditor should perform one or more of the following:

- a full audit using component materiality,
- an audit of one or more account balances, classes of transactions or disclosures,
- a review using component materiality or
- specified procedures.

DB should consider the evidence and determine whether a revision of the audit plan and its assessment of Welzun's ability to complete audit procedures of sufficient standard to enable an opinion on the group financial statements to be made. Depending on this assessment additional procedures should be identified. These could be completed by the group auditor or by the component auditor.

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Project Sound

Specific procedures would be:

Confirm existence of computer equipment and car by physical inspection and agree the cost to purchase invoice to confirm occurrence.
Evaluate depreciation and amortisation policies to ensure appropriate to the asset and consistent with accounting policies.
Agree costs recorded for other expenditure to supporting documentation such as invoices, payroll records to confirm accuracy and cut off.

Project Entertain

Whist it is possible that the report has been delayed, completeness of the costs can be ascertained by agreeing to a contract between KJL and GetGo - this will also enable confirmation of the appropriate classification of the costs.
.
Obtain direct confirmation of costs with GetGo to ensure appropriate cut off

Income tax receivable

Although it is reasonable to consult Welzun's tax department, the audit team should also make their own assessment of the claim agreeing to relevant tax legislation and re performing the calculations to ensure accuracy.

Welzun should challenge the assumptions management have made regarding the classification of the costs as research costs considering their knowledge gained on the audit.
Consider the appointment of an auditor's expert to review the research and development claim.

There are potentially deferred tax adjustments if the tax and accounting treatment of these adjustments which require further information.

1.2 Set out and explain the appropriate adjustments for the financial reporting queries raised by Zmant's accountant for the year ended 30 September 2018 for:

- The individual financial statements of Zmant; and
- The consolidated financial statements

Loan to KJL

The loan to KJL is a monetary item and because it is denominated in the functional currency of the subsidiary an exchange difference should be recognised in Zmant's profit or loss account.

Therefore, an adjustment is required in Zmant's own financial statements to record the exchange gain as follows:

	£'000
O$21 million @ 6.0 (1 January 2018)	3,500
O$21 million @ 4.8 (30 September 2018)	4,375
Exchange gain	875

Deferred tax and current tax implications

Because for income tax purposes, tax is not payable on exchange differences, there is no current tax liability implications. However, because tax liabilities will be higher in the future when the gain is taxed, a temporary taxable difference will arise.
In the financial statements for Zmant the deferred tax adjustment for the temporary taxable difference would be taken to the tax charge. This is because IAS 12 requires current tax and deferred tax adjustments to be recognised in profit or loss except if they arise from a transaction which is recognised outside of profit or loss.

Temporary taxable difference

£875,000 x 20% = £175,000

Journals

Zmant's financial statements:

	£'000
Dr Loan to KJL	875
Cr Profit and loss	875
Dr Income tax- PorL	175
Cr Deferred tax liability	175

On consolidation, the exchange difference will be removed from the consolidated profit or loss and it will be recognised as other comprehensive income and recorded in equity in the combined statement of financial position.
Consolidation adjustments:

	£'000
Dr Retained earnings £875,000 – £175,000	700
Cr Foreign exchange reserve	700

The loan should be presented as a receivable in Zmant's financial statements and it will cancel on consolidation. As the loans will cancel on consolidation, the following consolidation adjustment will be required:

	£'000
Dr Non-current liabilities	4,375
Cr Loan to KJL	4,375

Janet's query was in relation to the receivable balance of £3,500,000 - she also needs to investigate the treatment of the interest. The loan has an annual interest rate of 6%. She needs to ensure that 9 months of interest have been accrued or charged in KJL and credited in Zmant's individual financial statements. If the interest is outstanding at the year end there would be implications for the forex gain and depending on the tax treatment, a deferred tax implication.

On consolidation the interest would require translation at the average rate.

There will also be a consolidation adjustment to cancel the finance cost and income.

Tutorial note:
Answers which made reasonable assumptions regarding the interest were accepted.

Inventory adjustment – PURP adjustment and deferred tax adjustment on consolidation only

The accountant's calculation is incorrect – for example the accountant has adjusted for profit on goods bought from KJL not on the goods held in inventory.

An adjustment is required for the profit on goods in Zmant's inventory. This is because in the consolidated income statement this profit is not realised and therefore should not be reflected in the combined results of the two entities. Once the inventories are sold to a third party, this adjustment will no longer be required.

This is an adjustment to the consolidated financial statements and not the individual company accounts.

The unrealised profit is calculated as follows:

£2,500,000 x 35% / 135% = £648,148

The temporary difference results in a deferred tax asset as in the group accounts there is a tax charge for a non-existent asset which needs to be removed.

Although no adjustment is required to the individual financial statements, a deferred tax asset would be included in the consolidated financial statements as follows:

	£'000
Carrying amount of inventory in the consolidated financial statements £2,500,000 – £648,148	1,852
Tax base	2,500
Difference	648
Deferred tax asset at 20%	130

Journal required on consolidation:

	£'000
Dr Cost of sales	648
Cr Inventory	648
Dr Deferred tax asset	130
Cr tax charge	130

This is a consolidation adjustment and will impact the consolidated reserves; NCI and inventory.

Assuming goods are purchased evenly over the year, an adjustment will also be required to remove intra group trading

Dr Revenue £5,500,000 x 9/12 = £4,125,000
Cr COS £5,500000 x 9/12 = £4,125,000

1.3 Calculate goodwill on consolidation of KJL assuming Zmant uses the net assets method to value non-controlling interest in KJL

To calculate goodwill on acquisition, need to first establish the net assets at 1 January 2018.

The fair value of the net assets acquired at 1 January 2018 were:

	O$000
Share capital	25,000
Retained earnings at 1 October 2017	45,000
3 months profit 1 January 2018	3,750
Net assets at acquisition	73,750

Goodwill

		O$000			**£000**
Consideration transferred		52,800			
Non-controlling interest					
	73,750,000 x 40%	29,500			
		82,300			
Fair value of net assets acquired		73,750			
Goodwill		8,550	at HR	6.0	1, 425
Exchange gain - balancing figure					**356**
Carrying amount goodwill at 30 September 2018		8,550	at CR	4.8	1,781

Explain the ethical implications for DB arising from the newspaper article

DB are not the auditor but is responsible for the group audit report on the consolidated financial statements which will include the results of KJL. The issues may result in a material misstatement of the financial statements.

The evidence however is presented in a newspaper and therefore the source should be questioned. It is important that the facts are established.

The claims are also made by a former employee and we have no knowledge of the circumstances or credibility of this individual and the position regarding their departure from the company.

The article appears to confirm that KJL has been engaged in tax evasion by making a fraudulent claim a tax refund for expenditure which was not related to R&D. The treatment of the car used by the CEO would appear to support the presence of fraud.

There is evidence from the review of the financial statements that there is some credence to this story and further audit procedures will be requested to be performed.

Actions for DB

DB needs to establish whether there are any obligations to report the potential tax evasion in an overseas jurisdiction under the money laundering regulations and should seek legal advice.

However, the presence of a long-standing customer does indicate that there is a potential for bribery which would be reportable under the bribery act if any allegations are proven to be true that the parties are a means of bribing customers for their business.

On completion of audit procedures, DB should discuss the matter with those charged with governance at KJL and Zmant to establish facts; the DB ethics partner should be contacted and involved in the resolution. Legal advice and the ICAEW helpline should be contacted.

The integrity of management is also questionable and therefore DB should consider carefully any reliance on evidence from KJL's management which supports the audit opinion in the group financial statements.

Actions for Janet

As the finance director of Zmant, and an ICAEW member Janet must not allow herself to be associated with fraudulent claims for tax refunds. She should discuss the matter with her board colleagues.

Janet should be advised to consider her position and whether she wants to continue to work for Zmant – she should contact ICAEW for advice on how she should proceed.

Examiner's comments

(1) Financial reporting

For Project Sound there was good discussion of IAS 38. A surprising proportion of candidates made no comment about the strong motivation provided by the tax system to overstate expenditure. A few superimposed actual UK tax law (e.g. R&D allowances, rules on entertaining expenditure) on to the facts of the question. There was not enough scepticism as to why the expenditure was being expensed rather than capitalised. A significant minority of candidates did not identify the car and the computer as PPE, rather stated they were just 'capitalised'.

For Project Entertain most candidates appreciated that the cost should be expensed but did not clearly state that the classification was wrong so had less to discuss on the audit issues.

For the tax receivable issue, most identified that the calculation was wrong and that the audit approach was not appropriate.

Audit weaknesses and procedures

Only the better candidates attempted to identify a clear distinction between the audit issues to be performed by Welzun and those by DB. Most however identified that Welzun's application of materiality was incorrect

Weaknesses in the procedures were identified well. Better candidates produced additional procedures which linked back to the audit assertions.

Weaker candidates produced generic audit procedures using vague terms such as 'review' 'obtain' – without explaining what and why they are reviewing and what they are going to do with the information that they obtain.

Weaker candidates failed to apply concepts of reliability of audit evidence (no attempts to obtain 3rd party evidence) and a lack of appreciation that "checking that the transaction has been accounted for properly" has no actual practical credibility. Candidates should illustrate an appreciation of why they are performing certain tests and inspecting certain documents.

(2) Financial reporting in respect of Janet's queries

This section of the question was usually done well. Candidates gained high marks for appreciating, and clearly illustrating, the differences between the accounting treatments in individual and consolidated financial statements. The description of the accounting treatment of the loan was good with many students picking up all the relevant points. The main issue missed was the deferred tax on the exchange gain. Some candidates lost easy marks through not explaining that the gain went to profit or loss in the individual accounts, with some even explaining that it went through OCI. Better candidates identified that the gain would then be recognised through OCI in the group accounts.

Many candidates could identify that the client's PURP calculation was incorrect but fewer could discuss why. The client's calculation included many of the errors we see in candidate's answers and although some candidates came up with some more errors in their 'corrected' calculations, many candidates did calculate the correct figures including the deferred tax.

(3) Goodwill

Goodwill was generally calculated correctly. The most common mistake was not pro-rating the profit correctly to arrive at the pre-acquisition reserves. Most scored full marks on this section. Some candidates incorrectly adjusted for their findings in the previous section, which was incorrect as the adjustments had arisen at the reporting date and not the acquisition date.

(4) Ethics

There were plenty of good answers discussing tax evasion and bribery and not enough time was devoted to the discussion of actions. Some candidates thought, incorrectly, that Janet worked for the auditors and so did not identify appropriate actions for her. Those who scored well identified the points about the money laundering and taking legal advice and followed a clear structure.

Question 2

Scenario

The candidate is an ICAEW Chartered Accountant who has just been appointed as financial controller of Chelle plc, a listed company which imports delicatessen products. The company has been struggling and has not paid a dividend in the current financial year.

The candidate is supplied with information extracted from the draft financial statements of the company for the year ended 30 October 2018. This information has been prepared by the former financial controller, who has also supplied a list of outstanding matters.

The candidate is required to explain the appropriate financial reporting treatment for each outstanding issue: a convertible bond, and an AFS asset, adjust the financial statements and prepare a report analysing the performance and position and cash flow of the company.

The candidate is required to:

Requirements	**Marks**	**Skills assessed**
(1) Set out and explain any adjustments required to the draft financial statements for the year ended 31 October 2018, in respect of the outstanding matters (Exhibit 2). Provide supporting journal entries.	8	• Assimilate and demonstrate understanding of a large amount of complex information. • Identify appropriate accounting treatments for complex transactions including convertible bond and an AFS investment • Recommend appropriate accounting adjustments in the form of journal entries
(2) Prepare a revised statement of profit or loss for the year ended 31 October 2018 and a revised statement of financial position at that date. Include calculations of earnings per share and diluted earnings per share.	9	• Apply technical knowledge to calculate EPS and diluted EPS. • Assimilate information and use own accounting adjustments to prepare revised financial statements.
(3) Prepare a report to the board, analysing the key elements of the financial position, performance and cash flow for the year ended 31 October 2018, in comparison with the two previous financial years. Use your revised financial statements and other information provided.	10	• Use financial statement analysis to prepare relevant analysis in an appropriate format • Identify potential funding gap in 2020 • Assimilate knowledge, drawing upon question content and own procedures to provide a reasoned conclusion on performance and position and cash flow of the entity

(4) Calculate the amount of Chelle's legally distributable reserves at 31 October 2018, providing explanations to support your calculations	3	• Assimilate information and apply technical knowledge to determine distributable reserves
	30	

(1)

Convertible bond instrument

Although interest of £500,000 has been recognised in the draft financial statements, an adjustment is required to increase finance costs to reflect the effective interest rate and to increase the amount of the bond to present value.

Bond present value at 31 October 2017: £9,603,000

Finance cost on £9,603,000 at 6.5% = £624,195, rounded to £624,000

Bond present value at 31 October 2018: (£9,603 + £624 - £500 interest paid): £9,727,000
Journal entry required:

	£'000	£'000
DR Finance costs (£624 - £500)	124	
CR Bond		124

Available-for-sale financial asset

The financial controller has not recognised a gain or loss in respect of the available-for-sale asset. The value of the holding in Spence plc at 31 October 2018 is £18.50 x 100,000 = £1.85 million. This is an increase of (£1,850 - £1,503) = £347,000.

The journal entry required to recognise this gain is as follows:

	£'000	£'000
DR Financial asset	347	
CR AFS reserve		347

Current tax effects of adjustments

The adjustments made above increase the loss before tax:

	£'000
Loss as stated in draft financial statements	(938)
Additional finance costs	(124)
	(1,062)

The tax credit to be recognised is: £1,062 x 19% = £202,000 (rounded). £178,000 has already been recognised, so an additional amount of (£202 - £178) £24,000 should be recognised.

The journal entry required is as follows:

	£'000	£'000
DR Tax asset	24	
CR Profit or loss		24

(2)

Revised draft statement of profit or loss and other comprehensive income for the year ended 31 October 2018

	2018 £'000 Draft	Adjust £'000	2018 £'000 Revised
Revenue	30,600		30,600
Cost of sales	(22,803)		22,803
Gross profit	7,797		7,797
Operating costs	(8,235)		(8,235)
Finance costs	(500)	(124)	(624)
(Loss)/profit before tax	(938)	(124)	(1,062)
Tax	178	24	202
(Loss)/profit for the year	(760)	(100)	(860)
Other comprehensive income	–	347	347

Revised draft statement of financial position at 31 October 2018

	2018 £'000 Draft	Adjust £'000	2018 £'000 Revised
Non-current assets			
Property, plant and equipment	53,675		53,675
Financial asset	1,503	347	1,850
	55,178	347	55,525
Current assets			
Inventories	2,770		2,770
Trade receivables	7,710		7,710
Tax asset	178	24	202
	10,658		10,682
TOTAL ASSETS	65,836	371	66,207
Equity			
Share capital (£1 shares)	10,000		10,000
Other components of equity	913		913
AFS reserve	503	347	850
Retained earnings	37,294	(100)	37,194
	48,710	247	48,957
Long-term liabilities (5% bonds)	9,603	124	9,727
Current liabilities			
Trade payables	6,304		6,304
Tax payable	–		
Bank overdraft (limit £5 million)	1,219		1,219
	7,523		7,523
TOTAL EQUITY AND LIABILITIES	65,836	371	66,207

Note: the extract from the statement of cash flows does not change.

Earnings per share and diluted earnings per share

Chelle is loss-making therefore a loss per share is reported in respect of the year ended 31 October 2018.

	£'000
Loss before tax (as calculated above)	(1,062)
Tax credit	202
Loss after tax	(860)

Basic EPS is calculated as:

Profit/(loss) attributable to ordinary equity holders of the parent

Weighted average number of ordinary shares outstanding during the period

Basic loss per share = (860) = (8.6) p per share
10,000

As there are bonds which are convertible into ordinary shares at a future date, a diluted earnings/(loss) per share must be calculated. If the effect of the additional shares would be dilutive, diluted earnings per share must be disclosed.

Upon maturity of the bond, the bondholders can opt to receive one ordinary share for every £10 of bond held. The maximum number of shares that could be issued is £10,000,000/10 = 1,000,000. The total number of shares in the denominator of the calculation is therefore 11 million.

Computation of the diluted earnings involves adding back the after-tax effect of the finance cost saved. In the year ended 31 October 2018 interest at the effective rate is £624,000 (calculated earlier). The after-tax effect is (£624 x 81%) £505,000.

Diluted loss per share =

(860) + 505 = (3.22)p per share
11,000

The diluted loss per share is reduced, and therefore antidilutive, and does not require disclosure.

(3)
Report
To: The Chelle Board
From: Aiden, Financial Controller

Analysis of key elements of the financial statements

Position

Liquidity and efficiency

The current and quick ratios confirm that the business is not facing any immediate liquidity crisis, although they have worsened significantly over the three-year period. The £5 million overdraft limit helps to cushion any shortage of working capital funds. However, there are some worrying signs in the efficiency ratios. Inventory seems to be well under control, but both receivables and payables provide cause for concern. Receivables days are at an even higher level by the year end compared with the previous years. Chelle's customers include supermarket chains which are notoriously slow in paying, but even taking this into account, 90 days is a very long element of the working capital cycle. The trade payables collection period has worsened, too, and suppliers may be inclined to put pressure on Chelle for payment when the average outstanding period is 101 days.

Long-term liabilities: bonds

The bonds are due for redemption or conversion in slightly under two years' time. The share price at the 2016 year-end must have suggested to the board that bondholders would opt for conversion on 31 October 2020. A holder of a £10 bond at that date would be entitled to convert to a share worth £17.11p. However, by 31 October 2018, the conversion option has become much less attractive. At a share price of only £9.80 a bondholder would quite probably want repayment of the bonds.

If the share price does not recover over the next two years, Chelle may be faced with the need to raise further finance to repay the bondholders. However, if this does happen, raising further long-term finance may not be too difficult. The strong cash flow performance would help to encourage lenders, and Chelle's gearing level is not particularly high at around 22% (at the end of October 2018). Borrowing seems the most likely solution to the problem of redemption. In current conditions, it seems unlikely that shareholders would wish to contribute further funds.

Equity investors

Chelle's investors have seen their share price reduced at 31 October 2018 to only 57% of what it was two years' previously. In the meantime, they have received a dividend of only 1p per share and 2p in 2016 (0p in the 2018 financial year). Chelle's performance, at least as far as profitability is concerned, has not been encouraging. It is arguable that the payment of a dividend, which would currently have to be paid out of overdraft, would make little difference. However, please see the separate document [section 4 of answer] which addresses the extent to which a distribution could be made.

Performance

The trend in business performance, as evidenced by the statement of profit or loss, has clearly been disappointing over the last three years. Gross, operating and net profit margins have fallen, and the increased cost of supplies from other countries has no doubt had a part to play in the disappointing performance. However, adverse exchange rates are only one element.

One striking factor is the downturn in sales revenue. Revenue fell by almost 11% between 2016 and 2017, and by almost 4% between 2017 and 2018. This is, according to the MD, the result of increased competition. However, it would be worth investigating this further to confirm that this is the reason and/or to identify other factors. For example, if Chelle and the retailers it supplies have attempted to pass on increased product costs to customers in higher prices there may have been a consequent volume reduction in sales. There is a fall in GP% which presumably relates to the change in exchange rates.

Operating costs have risen by 17.7% over the period 2016 to 2018. Presumably, most of these costs are incurred in the UK, and therefore there would be no adverse exchange rate effects. This is an area that would require detailed further investigation.

At its best level over the three-year period the return on capital employed in 2016 was only 5.7%, with return on shareholders' funds in 2016 even lower at 4.27%. This performance has worsened in 2017 and 2018. The poor return on investment from a shareholder point of view may help to account for the fall in share price and the evident lack of shareholder confidence in the company

Cash flow

Chelle's performance from a cash flow point of view is much better than the profitability ratios suggest. The cash return on capital employed at around 19% has varied very little over the three-year period. The extracts from the draft statement of cash flows show that the cash generated has been utilised almost entirely in investing activities. As financial assets have remained stable over the three-year period, it is evident that the investment activity has been in respect of property, plant and equipment (PPE). The statement of financial position confirms that PPE has risen each year. However, the PPE does not appear to have been utilised as intensively in recent periods. The non-current asset turnover ratio has worsened significantly over the period. It may be that the non-current assets have not been fully functional over the period, or that the nature of the investment has changed, but further investigation is needed.

If revenue and profitability continue to decline the company's share price is likely to continue its downward trajectory. Any distribution threatens the company's cash position, so it is unlikely to be able to make a significant difference to shareholder attitudes by means of dividend. A continuing weakening of £ sterling would make a bad situation worse as Chelle would become less competitive. If strong competition in the market continues to be a factor Chelle's downward slide could be very difficult to arrest.

If the company's cash position worsens then its status as a going concern could ultimately be threatened. However, as noted above Chelle's gearing level is relatively low and it may not be too difficult to obtain further borrowings, to repay the bonds in two years' time and to finance working capital.

Conclusion

Chelle continues to produce strong positive cash flows, although its profitability has suffered. The fall in sales is a matter of concern, especially when compared to the significant investments that have been made over the last three years in property, plant and equipment. Chelle's long-term borrowings mature in two years' time and it currently seems likely that bondholders will opt for redemption. This would put Chelle into the position of having to fund a £10 million cash outflow. Directors should start planning for this eventuality now.

Appendix: ratio calculations

(4)

Distributable profit at 31 October 2018

For most companies, distributable profits is the total of accumulated realised profits less accumulated realised losses. However, for public limited companies such as Chelle, there is a potential further restriction. A public company may only make a distribution if its net assets are not less than the aggregate of its called up share capital and undistributable reserves. Undistributable reserves include share premium account, capital redemption reserve, any surplus of accumulated unrealised profits over accumulated unrealised losses (known as a revaluation reserve) and any other reserve which the company is prohibited from distributing by its constitution or any law.

Chelle has realised profits in the form of retained earnings, and also in the form of the AFS reserve, totalling (£850,000 + £37,194,000 revised) £38,044,000. This can be confirmed as follows for Chelle as a public company. The company's net assets (revised) are £48,957,000. The net assets cannot be reduced below the total of its aggregate of called up share capital and undistributable reserves of (£10,000,000 + £913,000) £10,913,000. So, the distributable amount is £38,044,000 (£48,957,000 - £10,913,000).

Distributable profits is the total of accumulated realised profits less accumulated realised losses.
The amount distributable is calculated and explained in the following table:

Item of reserves	**Distributable**	Explanation
£'000	**£'000**	
Other components of equity	–	This is likely to be the element of equity calculated under the 'split accounting' rules for hybrid financial instruments in IAS 32: *Financial Instruments: Presentation and Disclosure.* It is not distributable
AFS reserve	850	This is treated as a realised profit and so would be distributable
Retained earnings	37,294	Provided that this item comprises only realised profits (which is likely to be the case) then it is fully distributable
TOTAL	38,144	

Chelle's directors should bear in mind that the table above shows amounts that are legally distributable. The constraint for Chelle in paying dividends is not the amount that is distributable, but rather the absence of cash.

Examiner comments

(1) Financial reporting adjustments

Most (although not all) candidates made a good attempt at working out the effect of the change in valuation of the AFS instrument. It was common to find errors in accounting for the bond. The question stated that the bond issue had taken place in 2012 but despite this, some candidates accounted for the bond as a new issue in the financial statements for the year ended 31 October 2018. Following this through, they then commented in the next part of the question about the high gearing level and the influx of cash from the 2018 bond issue. Even where candidates recognised that the bond had been issued in 2012, some still tried to account for the bond as if for the first time. The size of the company makes it clear that it is audited. It is unlikely that the auditors of the listed company had completely overlooked a bond issue for a period of 6 years since 2012. A common mistake was to calculate the gain as £850,000 because the existing gain in the reserves was ignored.

For the tax section - the question specifically asked for deferred tax to be ignored and yet many candidates discussed the deferred tax issues of having a loss that may not be recovered.

(2) Revised Profit or Loss and SOFP and EPS

Most candidates made a reasonable attempt at this section. Sometimes the redrafting of the financial statements was incomplete. The weaker candidates stated that there was therefore no EPS, or incorrectly used PBT or total comprehensive income as opposed to the loss for the year.

(3) Financial statement analysis

Weak candidates produced very short and superficial answers which simply calculated some ratios and then worked through them listing why they may have changed. This approach meant that they did not link important areas of the financial statements together. However, in some cases the analysis was done well and all the pertinent points were picked up including the fact that the bond was due for repayment in two years. – a great achievement under exam conditions.

(4) Distributable profits

A fairly common error was to ignore the legality of the dividend payment, to concentrate only upon what the business could afford to pay (i.e. not very much). However, most gained some marks for understanding the basic rule for legally distributable reserves and for demonstrating some knowledge of the further restrictions applied to public companies.

Question 3

Scenario

The candidate is an audit senior working for Kanes LLP, a firm of ICAEW Chartered Accountants assigned to the audit of Solvit plc for the year ending 31 March 2019. Solvit plc is a listed company supplying software and related services. Some of Solvit's customers purchase only software but others enter into multiple element contracts, purchasing software together with customisation, integration services and maintenance. Solvit is a new audit client for Kanes LLP.

The candidate is presented with extracts from last year's audit report (**Exhibit 1**) which includes the key audit matters identified by Solvit's previous auditor, Fenn Yo LLP. These matters are in respect of revenue recognition and a provision for an onerous contract. Also provided are notes from my meeting with the Fenn Yo LLP audit partner and manager (**Exhibit 2**) with additional information concerning these matters and a summary of points from the audit manager's initial meeting with the Solvit Finance Director, Sam Browne (**Exhibit 3**) which includes financial reporting issues relating to the current financial year ending 31 March 2019.

The question involves the skills of assimilation, and structuring by identifying critical factors in the scenario which lead to the selection of issues for Key Audit Matters which ultimately require disclosure in the audit report. The candidate also is required to advise on the implications of a new accounting standard IFRS 16 on the leasing transactions of the entity.

Requirements	**Marks**	**Skills assessed**
(1) In respect of the key audit matters to be included in our plan for the Solvit audit for the year ending 31 March 2019: a. Explain why the key audit matters identified by Fenn Yo LLP (Exhibit 1) continue to be relevant and explain how each of these has changed this year. b. Identify additional key audit matters for this year's audit and explain the factors which have led you to select each of them as a key audit matter.	10	• Relate different parts of the question to identify critical factors • Interpret information provided in various formats and different sources • Present the analysis in accordance with the instructions of the manager • Appreciate when expert help is required to confirm fair values • Recognise potential for bias and manipulation in management's judgement to achieve bonus targets

(2) For **each** of the key audit matters identified in (1) above: a. Identify the relevant financial reporting standard and explain how it should be applied to the key audit matter in Solvit's financial statements for the year ending 31 March 2019. b. Explain the specific audit objectives of our audit procedures to provide assurance in respect of the key audit matter.	15	• 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.
(3) Draft a brief response to the Finance Director's question (Exhibit 3) about the likely impact of IFRS16, *Leases*, on Solvit's financial statements for the year ending 31 March 2020	3	Apply technical knowledge to describe alternative financial reporting treatment of complex transactions under IFRS 16
Total	28	

In respect of the key audit matters to be included in our plan for the Solvit audit for the year ending 31 March 2019:

a. Explain why the key audit matters identified by Fenn Yo LLP (Exhibit 1) continue to be relevant and explain how each of these has changed this year.

Revenue recognition

Why key audit matter is still relevant

- It is a presumed key risk under auditing standards and there appears to be no good reason to challenge this in Solvit's case
- It was identified as a key audit matter in the prior year and there is no reason to believe that the level of audit effort this year will be lower.
- Revenue is a very material balance in the financial statements
- Some of the revenue transactions made by the company are complex, involving multiple elements.
- There is judgement involved in allocating revenue to elements and this will affect the timing of revenue recognition where not all elements have been delivered at year end.
- An audit adjustment was identified in this area in the prior year.
- There is a relatively new revenue accountant and it is this individual who made an error in the prior year. The previous auditors raised doubts about his level of experience.

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Changes this year

- There is a new accounting standard – IFRS15 – and early indications are that the company has struggled to apply this. There also appears to have been reliance on the revenue accountant whose expertise has been called into question.
- There is a new education sector product which may be sold on different terms to other products and for which additional discounts for future maintenance have been given.
- The new product has had issues, including problems in the software which means there is a heightened risk of returns and credit notes and reputational damage.

Onerous lease

Why key audit matter still relevant

- The provision brought forward is material.

Changes this year

- The provision has been released this year however discussion with the client has revealed that the sub-lease entered into is not for the entire term of the underlying lease and so there remains judgement as to what will happen when that lease ends. Annual rentals are £700,000 (£1.4 million is for 2 years) so the total rental for the period after the end of the sublease could be material.
- The release of the whole of the provision appears incorrect as there were rentals incurred in the period before the property was let and there is also a rent-free period.

b) Identify additional key audit matters for this year's audit and explain the factors which have led you to select each of them as a key audit matter.

Allowance for aged receivables

Factors leading to selection of the matter as a key audit matter

- There was an identified mis-statement in the prior year which was not material –this was an over-provision
- There is a new type of customer this year – the educational sector customers and Solvit has far less history of dealing with such customers and therefore less evidence to support any provision or lack thereof.
- Days sales outstanding have increased significantly at 30 September 2018

Accounting for sale and lease back

Factors leading to selection of the matter as a key audit matter

- This is a material one-off transaction
- The accounting for it is not straightforward and not routine for the accounting team

Management bonus – incentive to manipulate results

Factors leading to selection of the matter as a key audit matter

- Last year management incentive was not identified as a key audit matter but the facts have changed as this year Solvit is struggling to meet its plan and is not currently on target to meet the performance targets necessary to trigger the maximum management bonus. The results for the first half are lower than plan despite the release of the onerous lease provision and no increase in the aged debtor allowance.

- Management therefore has a much greater incentive to manipulate results and judgemental areas (such as bad debt allowance and onerous lease provision) and one-off items such as sale and lease back provide potential opportunities for them to do so.

(2) For each of the key audit matters identified in (1) above:

a. Identify the relevant financial reporting standard and explain how it should be applied to the key audit matter in Solvit's financial statements for the year ending 31 March 2019.
b. Explain the specific audit objectives of our audit procedures to provide assurance in respect of the key audit matter**.**

Revenue recognition

a) Relevant financial reporting standard

The relevant financial reporting standard is IFRS 15 which came into force for accounting periods from 1 January 2018.

- Under IFRS15 there is a 5-step model for revenue recognition. This requires:

    - identification of the contract with the client (unlikely to be an issue in the case of Solvit as we would expect contracts with each customer)

    - identification of the separate performance obligations in the contract - in Solvit's case there appear to be contracts with 3 separate elements, all of which are also supplied separately – software, services, maintenance. Software can be sold separately but other integration services and maintenance will introduce complexity here as these would not be sold separately but it does provide the customer with a separate right.

    - determine the price – that will be the total payable for all elements included in the initial contractual arrangement and may become more complex where, for example, discounts are offered for future years.

    - Allocate the transaction price between the elements – software, services and maintenance – this will be done in relation to the stand-alone prices for each element – the price for software sold on its own; the day rates for services sold on their own; the renewal rate for maintenance per the standard price list.

    - Recognise revenue as and when the service is provided – for standard software that is likely to be when it is delivered. For customised software the question is more complex and it is necessary to consider whether there is an obligation to deliver the customised product and recognise revenue on delivery or separate obligations to deliver standard product and then services. For maintenance, the obligation is likely to be satisfied over time and so the revenue will be spread over the maintenance period.

It is not clear how any transitional arrangements to IFRS 15 have been applied.

Tutorial note:
Answers which identified IAS 18 were also accepted in marking this section.

Specific audit objectives of our audit procedures to provide assurance in respect Revenue recognition

The application of the new standard, IFRS15, is the key focus of the revenue recognition risk for the 2018/19 audit, although the risk is also enhanced by the operational factors.

In particular the audit objectives of our audit procedures on this key audit matter are:

- to ensure that any prior period adjustment has been accurately calculated and that all relevant contracts have been considered.
- to examine if software and services are separate performance obligations where Solvit is delivering a customised software product.

- to ensure that the allocation of the total price between the elements of larger, multi-element contracts is performed accurately using prices which are those applied when the elements are sold separately. This work is likely to be similar to that performed in the past but with reference to the new accounting standard.
- to identify if sales to customers who have been given the rights to future discounts
- to identify revenues where there appears to be delay in customer payment and consider whether this is indicative of any early revenue recognition. In particular there is a risk that revenue may be recognised for faulty software which the customer has not accepted and which is not fit for purpose.

Our audit procedures should:

- Identify contracts where not all elements have been delivered at the year end, as such contracts are the ones where revenue recognition will be affected by allocation between delivered and undelivered elements. Agree that revenue has been recognised appropriately for these contracts
- Perform analytical procedures on the pattern of revenue recognition over the year for each type of revenue and investigate unusual items – these might include variations in maintenance revenues which might be expected to be spread evenly over the year or peaks in the recognition of software or services revenues which might be indicative of cut-off issues or manipulation of the results.
- Identify revenue postings not generated by cash, trade receivables or a release from deferred income as these are inherently unexpected transactions worthy of follow up.

Onerous lease

a) Relevant financial reporting standard

The relevant financial reporting standard is IAS 37

- The lease for a property no longer used by the company is an onerous lease for which provision needs to be made under IAS37.
- The amount to be provided is the directors' best estimate of the net cash outflows they will incur under the contract, having taken account of the income from the present and any future sub-tenant.
- Discounting needs to be applied if the time value of money is material – it is likely to be so if the anticipated net cash outflows are sometime in the future – i.e. after the initial 5-year rental period.
- The brought forward provision should not have been released completely as the rent for the 4 months to 31 July should have been charged against it along with the first 2 months of the initial rent-free period, meaning that £350,000 of the brought forward provision has been utilised at 30 September 2018 and that a further provision for 4 months rental (£233,333) is needed to cover the remaining rent-free period.

b) Specific audit objectives of our audit procedures to provide assurance in respect the onerous lease

The objectives of our audit procedures should be to eliminate the following risks:

- The movement on the provision in the year ending 31 March 2019 is not correctly recorded and disclosed within the financial statements.
- The provision is not adequate to cover a future shortfall in rentals received when the sub lease ends in 5 years' time at which point the property may remain empty for some time or a lease be negotiated which does not cover the rentals payable under the head lease.

Our audit procedures should

- Confirm that the head lease permits sub-letting and that any conditions have been complied with and obligations recorded.
- Evaluate the need for discounting to be applied at an appropriate rate
- Agree the terms of the sublease to ensure correct accounting for the rent free period

Aged receivables allowance

a) Relevant financial reporting standard

The relevant financial reporting standard is IAS 39

Trade receivables qualify as financial assets and would be considered impaired if the carrying amount exceeds the recoverable amount. The trade receivable allowance is an estimate and it is both correct and legitimate to reconsider the basis for an allowance to be made based on the increase in time taken to pay and the issues over the acceptability of the services supplied by Solvit to its educational customers.

The principle of impairment is the same for both standards IAS 36 and IAS 39. However, the procedures in assessing the asset for impairment are quite different. IAS 39 requires all financial assets, except for those measured at FVTPL, to be assessed for impairment. IAS 39 adopts different approaches to assessing and calculating impairment for different classification categories but the two most notable characteristics of the IAS 39 impairment model are that:

1. Impairment losses should be recognised when they are incurred, rather than as expected; and
2. An impairment loss should be regarded as incurred if, and only if, there is objective evidence of impairment because of one or more events that occurred after initial recognition (a 'loss event').

IAS 39 requires an assessment, at the end of each reporting period, as to whether there is any objective evidence that a financial asset or group of financial assets is impaired. An asset is considered impaired, and an impairment loss recognised only if such evidence exists.

IAS 39 does not require that an entity be able to identify a single distinct past causal event to conclude that an impairment loss on a financial asset has incurred - rather the combination of several events may have caused the impairment.

Hence the additional information regarding customers taking longer to pay together with information concerning the problems with the software would be indications that an increase in the receivables allowance should be examined.

(Note: IFRS 9 will introduce changes to the calculation of trade receivables allowances. IFRS 9 impairment model is based on the premise of providing for expected losses. It adopts a simplified approach to the expected loss model in respect of trade receivables which do not have an IFRS 15 financing element. The loss allowance is measured at the lifetime expected credit losses from initial recognition. Should a receivable exceed the credit limit it is likely that the allowance established based on expected credit losses at initial recognition should be increased – credit will be given to candidates who discuss this standard as it is adopted from 1 January 2018 but is at level C in the syllabus for 2018).

b) Specific audit objectives of our audit procedures to provide assurance in respect the trade receivables allowance

The objectives of our audit procedures are to address the following risks:

- To ensure that adequate allowance is made for receivables from educational sector clients
- To ensure that the allowance is based on the best information available or reassessed fully to consider the balances and circumstances at 31 March 2019.

Our audit procedures should:

- Perform analytical procedures to identify trade receivables with a deterioration in ageing.
- Identify factors which might be distorting the ageing reported such as unmatched credit notes or cash receipts
- Identify any amounts on the receivables ledger which relate to the prior financial year so that the adequacy of the prior year allowance can be fully assessed

Sale and lease back

a) Relevant financial reporting standard

The relevant financial reporting standard is IAS 17

The first consideration is whether the lease is an operating or finance lease. It is an operating lease as it is relatively short term for a building and total rentals are well below the fair value of the asset even without discounting.

The second consideration is whether the sale is at fair value – in this case it is above fair value as the fair value is £15 million and the sale proceeds £18 million.

As the lease is an operating lease, the amount by which the fair value (£15m) exceeds the carrying amount (£11m) = £4m is recognised as a profit within the statement or profit or loss. The asset will be derecognised and shown as a disposal within the financial statements.

The remaining gain of £18m-£15m = £3m is deferred and amortised over the period for which the asset is expected to be used. In this case that may be the 20-year life or the 10-year lease term depending on whether there is intention to renew the lease. This will result in an additional gain of 6/12 x £3m / 20years or 10 years (£75,000 or £150,000) in the statement of profit or loss for the year ending 31 March 2019.

The rentals of £600,000 per annum are recognised over the lease term, £300,000 will be included in the statement of profit or loss for the year ending 31 March 2019.

b) Specific audit objectives of our audit procedures to provide assurance in respect the onerous lease

The objectives of our audit procedures are to address the following risks:

- To eliminate the risk of a material misstatement arising from the incorrect financial reporting treatment of this complex transaction

Our audit procedures should:

Determine how the transaction has been recorded in the financial statements
Obtain third party confirmation of the fair values
Challenge management over the useful life of the property
Examine the contract with the leasing company and agree terms
Obtain further evidence from an independent source about the likely renewal of the lease after 10 years
Evaluate the need to appoint an auditor’s expert to agree fair value.

Management bonus – incentive to manipulate results

a) Relevant financial reporting standard

IAS 19 sets out the measurement basis for the employee bonus. This is based on whether Solvit has a legal or constructive obligation to pay the bonus based on achieving targets – an expense will be recognised in the year ending 31 March 2019 if the targets are judged to be met

b) Specific audit objectives of our audit procedures to provide assurance in respect the management bonus

The objectives of our audit procedures are to address the following risks:

- Management understates judgemental provisions or consistently sets provisions at the lowest acceptable point in a range meaning that the position overall is aggressive and does not truly represent the best estimate.

- Management makes accounting entries with the sole purpose of boosting results
- Risk that the bonus is inappropriately recognised.

Our audit procedures should:

- Review closing and other journal entries to identify items of audit interest. These will include journals booked by senior management who do not normally make detailed accounting entries; round sum amounts which might be indicative of estimates of overall adjustments; journals booked outside of normal working hours to conceal them; journals which are unusual in some way such as an entry in DR non-current assets and CR revenue which would not normally be expected.
- Reperform the calculation of the management bonus at the year end – agree to contracts of employment to ensure that the calculation is in line with the contract.

3) Response to query about IFRS16

Under IFRS16, there will be a single accounting model applicable for all leases to lessees with no requirement to distinguish between operating and finance leases. As a result, Solvit will need to recognise on its balance sheet for each lease, a right to use asset and a lease liability, effectively grossing up the balance sheet. In most cases, the initial amount to be recognised as an asset will be equal to the obligation to make future lease payments (discounted as appropriate) but the asset value will also be adjusted for payments in advance, lease incentives and costs. This treatment will apply to the car and equipment leases and to the property leases, meaning large increases to both the assets and liabilities shown in the statement of financial position.

After initial recognition, the asset will be depreciated over the shorter of its useful life and the lease term and it is this depreciation charge, rather than the operating lease rentals which will be the cost reflected in the profit or loss account. There may also be impairment charges where a leased asset is impaired.

For the London offices, Solvit is now lessor as well as lessee – the lessor accounting is largely unchanged and rental income will be accounted for as it falls due.

For the Northern office property, the sale and lease back transaction will need to be reconsidered under the specific accounting guidance of IFRS16. The first consideration is whether a sale has been made under IFRS15 – It seems likely that it is in which case Solvit will need to calculate the asset value of the rights retained and recognise a gain only on the rights transferred. As the sale was at greater than fair value, the additional proceeds received will be treated as financing from the buyer.

Examiner comments

General points

Generally, this question was done very well and quite a lot of candidates scored high marks. The most common reason for a candidate not scoring well was producing an unstructured answer - mixing up the different sub-requirements of the question. So, for example, the answer would start with a description of the key audit matters relating to revenue, but then would wander off into a description of the financial accounting elements, with some vague audit procedures. The answer might then develop into a description of other accounting and auditing issues, without identifying why an area or transaction type might be regarded as a KAM. The questions are structured to help candidates think through the issues.

IFRS 15 is at Level C for this sitting and this was reflected in the marking – this question has a greater emphasis on audit and FR is the springboard for identifying audit issues. Most candidates spotted that a new standard would be an issue to consider in determining the KAM –markers were instructed to accept either IAS 18 or IFRS 15.

(1) Key audit matters

The majority of candidates answered this requirement very well. Many candidates identified the numerous factors making revenue a KAM as well as the separate issues arising during the period.

(2) FR issues with KAM and audit objectives and procedures

Weaker candidates missed out either the financial reporting or the audit requirement. Weaker candidates had problems describing adequate audit procedures and objectives. Problems included failures to identifying the relevant assertions being tested and why certain documents would be inspected.

From a FR perspective, the lease back, onerous lease and revenue recognition rules (mainly via IAS 18) were well discussed. The receivable and bonus issues were less confidently attempted. Some failed to identify the relevant financial reporting standard as required in the question. Some made errors, the most egregious and common of which was to identify IAS 37 (and/or IAS 36) as relevant to allowances for bad and doubtful debts. A receivable is a financial instrument and it is therefore subject to financial instrument standards and scoped out of IAS 36 and IAS 37.

(3) IFRS 16

Knowledge of the IFRS rules was demonstrated but specific application to the scenario was attempted by fewer candidates.