Tutor Conference February 2019 Corporate Reporting - Candidate A

1	Q1	
2	1)	
3	Project Sound	
4	Research and development expenses on project sound need to capitalised as an intengible asset from the date that the speaker produced by KJL became commericall viable. According to IAS 18 - Intangible Assets, research and development for a potential product is an internally generated intangible asset and the majority of the cost relating to Project Sound must be capitalised from the date the commericla viability of the speakers has been established. For commercial viability to be established, the following requirements need to be met: . 1. Probable future economic benefits 2. Intention to complete and sell asset 3. Resources are adequate and avaialble to complete and sell the asset and there is ability to sell the asset 4. Expenditure can be measured reliably . From the provided information we can see that on 1 April L-Motors placed a large order for the speaker. This confirms the commercial viability of the developped produc the above requirements are met as probable future economic benefits will be sold. Therefore, any costs incurred in the development process following the 1 April must l capitalised under intangible assets. . This includes the following:	
5		
6	Salary costs	790
7	Registration fees	910
8	Car used for testing	555
9		2255

Allocated general overheads should not be capitalised as intangible assets. Furthermore, the intangibvle asseets houldbe amortised from the date that it is available for sale, over its useful economic life. The date the equipment is available for sale has not been provided, therefore we would need more inforamtion to calculate the depreciation charge.

Furthermore, under IAS 16 PPE the new computer equipment should be capitalised from the date the asset was available for use and brought to its current location and condition, therefore the first of January 2018. Although the computer equipment was used for the project, it should be classified under PPE.

Thererfore, the costs for the computer should be reclassified from expenses to PPE and depreciated form the 1 January with the following depreciation charged for the year:

1700/2*(9/12)= 637,.5k

has most of the technical points and is applying to the scenario

Weaknesses in the audit procedures:
1. The component auditors have failed to identify that development costs should have been capitalised and therefore the audit testing carried out is insufficient.
2. Auditors have not carried out any detailed audit procedures because each balance was below component materiality. This is a weakness as although each cost is below component materiality, the total costs relating to the project are material and therefore a material adjustment might have been necessary.
3.The accuracy of the balances have not been confirmed and agreed to any supporting documentation and have been taken at face value.

It was rare to see candidates tackling the parent - component auditor relationship

Has the materiality point

Additional audit procedures;
1. Welzun must instruct DB ont he additional procedures they would like them to carry out on the balances relating to the new audit speakers which include the below:

1. Review correspondence with the client who made the order to confirm the date that commercial viability was established

Review used here with justification

2. Obtain all supporting documentation (invoices and payroll reports and employee contracts) and agree the costs to the information provided. Review the purchase ledger in order to ensure that the balances are completene and there are no further costs relating to the product
3. Review post year end information, to undestand when the development of the speakers was complerte and when the order were fulfilled. This will ocnfim whether any amortisation charge would need to charged in the year
4. Obtain correspondence with the lawers on the registration for the design, to confrim that it was registered and thus future economic benefits can flow to the entity
5. Calculate the potential tax effects of the CEO's personal use of the car and ascertain the need for a provision int he financial statements. Disscuss this with the client and undestand whether they are trying to avoid the payment of tax.

2. Project entertain

Under IAS 38 - Intangible assets, the company can capitalie costs if it is probable to future economic benefits attributable to the asset swill flow to the enetity and the cost can be emasured reliably.

In this case, although it is cosndiered that the even will generate sales for the company and although the costs can be measured reliabily, the cost of 2.8million $ relates to marketing and adveritising, as the fees were paid to a public relations companya and the general event is a marketing/networking event and therefore it is appropriate for all costs to be capitalised as it does not meet the definition of an intangible asset.

Therefore, the financial reporting treatment is correct.

As with candidate B - has the right FR treatment but does not hit the point about classification of the cost

Audit Weaknesses:
Although the fees have been agreed to invoices from GetGo and to bank statements,the main audit risk is that the expenses are understated in order to improve profitability and therefore the completeness of the balance must be tested.

There is a key weakness here in the inability fo the compoennt auditors to obtain third party information such as a supplier statement as obtaining third party information is key for confirming completeness.

There is a further key weakness in that the component auditros have not contacted get go direclty, but are instead depending on KJL to obtaint he reports

Further audit procedurs:
1. Review post year end bank statements and post year end invoices to ensure that there are no ommitted costs in relation to the events carried out in the year ending 30 September 208
2. Contact GetGo and obtain a supplier statement for the services provided to JKL in orde to confirm the the balance included in the statement of profit and loss is complete and accurate.

Income tax receivable

Under IAS 21 Income Taxes, any unpaid tax or tax due from the authorities needs to be calculated by the company and recognised in the statement of financial position as ar asset or a liability, depending on the position of the company.

In this case, teh company is due a tax credit from the authorities based on the R&D expenditure included in the statment of profit or loss. However, as it has been mentioned above a number of balances have been capitalised in the finanical statements therefore only the below balances have been included in the statement of profit or loss:

Row		
25	Materials	1725
26	Salary costs before 1 April	1270
27	Overheads	950
28		3945
29	GetGo fees	2800
30		6745
31	Tax credit	5059
32		

Thefore, based on he formula provided the tax credito needs to be 5.059 and a journal must be posted to reduce the tax refund recognised by 2.966.

Key Weaknesses in audit procedures:

1. The compoentn auditors have not carried out any rtesting and have relied on the tax department of Welzun which is a key weakness as the information should have been agreed to other sources and the work carried out by the tax department should have been reviewed with profesisional scepticism applied and should not have been relied upon.
2. The compoentn auditors has not considered the independence, competences and objectivity of the Welzun tax department

Additional audit procedures:

1. Ensure that the formula provided for caluclated the refund is in line with the current tax legislation
2. Ensure that the rate of 30% is in line on tax laws and iti is the enacted rate based on current law
3. Ensure that the reduction in the tax credit is appopriately reflected in Welzun's financial statements.

Nice layout with space for marks

Loan to KJL

The loan made from Zmant to KJL is denominated in the currency of KJL. Under IAS 21, the initial recognition of the loan in Zmart's financial statements should be to recognise a receivable of 21million using the spot rate on the date of the transaction i.e. on the 1 January 2018. On this date, the rate was 1=6 and therefore the £ equivalent of the loan was 21,000,000/6 = 3,5000,000 therefore the loan has been correctly recognised initially.

According to the standard, any monetary balances should be translated at the year end using the closing rate i.e. the rate of the 30 September of 4.8. Any differences should subsequenlty be included in the statmetn of profit or loss of the Zmart, as the loan is denominated in KJL's currency.

Receivable at YE	4375	21m/4.8
Current baalnce	3500	
	875	

As the pound has weakened against the O$, there is a gain on the receiable of 875.000 which should be included in Zmart's individual fianncial statements as a credit in the profit or loss. This should improve proiftability of the company.

Also, as there is no tax payable on exchange differences now, but only once the loan is repaid, this should also create a deferred tax liability as tax will be paid in the future in relation to this transaction. Therefore, a deferred tax liability of 875,000 * 0.2= 175,000 should be recognised in relation to this exchange gain by:

Dr - Income Tax (P&L) - 175,000
Cr - Deferred tax liability - 175,000

great answer

On consolidation, the loan to Zmant needs to be eliminated as it represents and intercompany loan. Instead, the loan will be recognised as a net investment and any gain or losses from the individual financial statements of Smart will also be eliminated on consolidation and will be recognised in equity and Other Comprehensive Inocme. Therefore, OCI for the yera ended 30 September for the finanicial statments should include the gain of 875,000.

Inventory

Individual financial statements of Zmant

The effect of this transaction in Zmant's indivudal financial statements is that a related party transaction disclosure needs to included. This is because under IAS 24, as Zmant has control of KJL from the 1 January 2018 and the two companies are members of the same group this means that the two companies are related parties. Therfore, a related party disclosure should be included stating the nature of this relationship, the amount of the purchases and also the amount included in inventories at the year end.

Consolidated financial statements

Under IFRS 10 - Consolidated financial statements, the first step wouuld be to eliminate the intercompany sales and purchases between Zmant and KJL for the period between 1 January 2018 and the year end.

Then, an additional adjustment would be required for the amount of 2.5million remaining in intentory. First, as correctly identified, the profit made on these sales which remain in inventory should be calculated. As KJL sells goods on a mark up of 35% then the profit will be calculated by multiplying the sales value by 35/135, therefore the calculation presented is incorrect as it uses total sales and not the balance remaining in intventory and the wrong percentage.

The correct figure for the profit made on these sales is 35/135 * 2,500,000 = 648,148.

Assuming that all the goods that remian in inventory were purchased after the 1 January 2018, as the company is liekly to use a FIFO policy for intentory, then an adjustment for the total unreliased profit calculated above is required. As the goods were sold from the subsidiary to the parent, the adjustment would be to Dr Cost of sales and Retained earnings and Credit inventory by 648,148.

Any exchange gains losses included int he P&l arising from these transactions do not coancel out, and thus should remain in the consolidated statement of profit or loss and carried to consolidatiobn.

3)

Under IAS 21, when consolidated financial statements include a foreign subsidiary, goodwill should be calculated in the foreing currency and retranslated at the year end, with any foreign exchange gains or losses on remeasurement included in the Statement of Comprehensive Income.

	O$	Rate	£	
Consideration	52800			
NCI at acquisiton	29500			40* Fair value of net assets
Less: Net assets	-73750			W1
Goodwill on acqn	8550	6	1425	historic rate
Impairments	0	0	0	
Exchange gain			356	
Goodwill at year end	8550	4.80	1781	

Nice layout - easy to mark!

W1) Net assets on 1 January		
Share capital	25000	
RE 1 October	45000	
Pre acquisitoon profits	3750	3/12*15000
	73750	

Assuming the net proportion method is used to value NCI, then goodwill to be recognised in the consolidated financial statements is £1,781,000. A foreign exchange gain arises on remeasurement of goodiwll of 356,000. This shoukld be included in the Consolidated Statement of P&L and Other Comprehensive Income as a gain on translating goodwill.

4)

It is first necessary to establish the facts of this article. The accusations on the article are serious and relate to a government official who is the husband of the KJL board member and has attended a 5 day eventat a luxuty hotel using the company's funds and also includes accusations of potential money laundering. In order to establish the facts it is first necessary to establish the relationship between the official and the KJL board member and confirm whether the official has attended the event and the way expenses were paid for this event.

.

With regards to the financial statements, the tax refunds obtained in the past should ber eviewd to understand whether expenses were incorrectly included int eh statement of profir or loss.

.

In this case, the following ethical issues arise from the article:

1. Company's funds are being used for activities which are not incurred in the rodinary course of business. This presents a conflict of interest and self interest threat, wher the KJL board member is not acting in the best interest of stakeholders but instead she is acting in her own self interst and is misusing company funds.
2. The misuse of company funds could also indicate fraudulent activity
3. There is also an ethical issue concerning money laundering. There are accusations that the company has manipulated financial statements to obtain a tax advantage and theerfore the profits arising from this tax advantage could be considered as proceeds of crime, if it is confirmed that the intention of KJL was to obtain a tax benefit.

.

DB, as the group auditor, has a responsibility to report on the group accoutns which include all subsidiaries and therefore should investiagete the above allegation. It is preferrable for DB to investigate the matters on its own rather than using the help of the compoennt auditor.

.

The allegations also raise concerns regarding the group auditors and their inability to discover any of this in previous audits. As a result,less reliance should be placed on their work and DB might need to carry out further audit procedures on thier own.

.

Janet as a manager of the audit should take the following actions:

1. Discuss the accusations and findings of her investigation with the MLRO of DB and understand whether
2. Obtain legal advice on whether the KJL director and her husband have comitted fraud
3. Contact the ICAEW helpline and discuss the matter, documenting any discussions

.

DB, asgroup auditors, should also discuss the matter with the Zmant audit committee, being careful to avoid tipping off the committee when it comes to discussions on the tax issue.

Good answers - What about Janet?

Question 2

Q2)

1)

Convertible bond instrument

Under IAS 32 - Financial Instruments, convertible bonds should be treated using split accounting, with a portion of the bond being recognised in equity and a portion being recognised as a financial liability, at amortised cost. The portion recognised as a liability is equal to the present value of future interest and capital payments, using the market rate for similar debt without conversion rights which is 6.5%. This is calculated as follows:

Time	Cash flow	DF @ 6.5%	PV
t1-t7	500	5.485	2743
t8	10500	0.604	6342
		Debt	9085
		Equity	916
			10000

It seems that debt and equity have been correctly recognised using split accounting. The equity component is included in Other components of equity as 913 (rounding differences with above calculations) and the liabilit component has been includd in long term liabilities. It seems that the liability component has also been correctly recognised at amortised cost however no adjustment has been made for the convertible bond for the year ending 31 Octobne 2018 other than including the actual interest paid within finance costs.

.

As the liability is measured at amortised cost, any interest actually paid i.e. 500,000 per annium should not be included within finance costs but isntead should be Debited to the financial liability. Instead, finance costs should include the effective interest which is 6.5% based on the market interst on similar debt instruments with no conversion rights:

B/F	Effective int.	Actual paid	
9603	624	-500	9727

Therefore, the following adjustment should be included to correct the financial statements frot he year ended 31 October 2018:

Cr - Finance costs	-500
Dr- Finance costs	624
Cr - Financial liability	-124

Uses plenty of space and a column approach - helpful for markers

Identifies that this is not the first year of the bond!

Available for sale asset.

As the investment is an avaialble for sale financial asset, then according to IAS 39 - Recognition and Measurement, then the investment in Spence should be remeasured to its fair value. Its fair value at the year end is :

.

100,000 * 18.50 = 1,850,000

.

Currently, the investment is being held at 1,503,000 in the statement of financial position, as revaluations of 503,000 have been recorded in the past. This value should be increased to 1,850,000 and the increase of 347,000 shoudl be included in the AFS Reserve.

25	Dr - AFS Investment	347000
26	Cr - AFS Reserve	-347000
27		

28 Tax

29

Under IAS 22 - Income taxes, a company can recnogise a deferred tax asset in respect of tax losses to carry forward as these will create a tax advantage in the future. An unreleived tax loss gives rise to a deferred tax asset however only where there are expected to be sufficient future taxable profits to utilise the loss.

.

Currently, there is no indication of Rhydding's future profitability althoguht the extende of the current year losses suggests that future profits may not be available. If this is the case, then no deferred tax can be recognised.

.

This is therefore an area of judgement. Assuming the loss is a one off this year and there is potential for the company to be profitable in the future,t hen the deferred tax asset may be recognised at 19% of this loss.

.

Taking into consideration the above adjustmnets, losses before tax will be 938+124 = 1,062. Assuming this is equivalent to a tax loss then a deferred tax asset of 1,062 * 0.19 = 202 can be recognisd in the financial statements. Therefore, the following adjustment is required:

30	Dr - Tax asset	24	202-178
31	Cr - Tax for year	-24	
32			
33	2)		

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

		2018
Revenue		30600
Cost of sales		-22803
GP		7797
Operating costs		-8235
Finance costs	see above	-624
Loss before tax		-1062
Tax	178+24	202
Loss for the year		-860
OCI	see above	347
Total OCI		-513

Statement of financial position as at 31 October 2018

		2018
NCA		
PPE		53675
Finanical asset		1850
		55525
CA		
Inventories		2770
Receivables		7710
Deferred tax asset		202
Cash		0
		10682
Total Assets		66207

No workings shown here - but does have journals clearly set out above

Equity		
Share capita		10000
Other compennts		913
AFS reserve		850
Retained earnings	37294-124+24+347	37541
		49304
LT Liabilities		9727
Current liabilities		6304
Trade payables		0
Bank overdraft		1219
		7523
Total eequity and		66554

EPS calculations

Loss after tax	-860
Weighted average number of shares	10000
EPS	-0.086

After taking into consideration the above changes the company is loss making, and therefore basic earnings per share are negative at -8.6p per share

A diluted earnings per share figure can also be calcuklated taking into account the worse case scenario in respect to the potential increase in the equity base of the company by assuming that the potential convertible bond could incrase share capital by 1million new shares, but the itnerest saved by conversion is asdded back to the loss. This interest is tax deductible therefore the interest to be added back is net of tax.

Loss after tax	-860
Add back: interst	624
	-236

96		-236
97		
98		
99	Shares in issue	10000
100	Convertible bond	1000
101	Total	11000
102		
103	Diluted EPS	-0.021
104		
105	Diluted EPS are -2.1p for every share.	
106		
107	4)	

A company's legally distributable reserves include the reserves which are available for dividend paymetns to the shareholers. In the case of Chelle, retained earnings at the year end are 37,541k however these include Other Comprehensive Income relating to the revaluation of the investment in Spencer. .

.

This gain has not yet been realised by the company and therefore it should not be included in legally distributable reserves for paymetns to shareholders. Therefore, legally distriubutable reserves are 37,541 - 347 = 37,194

110	3)			
111	Key rations:			
112	GPM	0.25	0.28	0.29
113	OPM	-0.03	0.01	0.07
114	EPS	-8.60	1.90	21.20
115				
116	ROCE	-0.016	0.004	0.041
117	ROE	-0.018	0.004	0.043
118				

There are no workings shown here however markers are instructed not to award marks purely for calculations - they have to be used in a meaningful context.

integrates ratios with text

119 Report to the board analysing the key elements

120 Looking at the results of Chelle for the year ended 31 Ocober 2018, the fiancial performance of the company has deteriorated due to a combination of a fall in revenues and a deterioration of the gross proift margin and also a deterioration of the total profit margin. The gross profit margin has fallen from 29% in 2016 to 25% in 2018 and revenues have also decreased by 14% from the year ending 2016. The decrease in revenues therefore coupled with a deteriorating margin has led to lower gross profits which have set the way to an operating loss, as the operating and finance costs have not decreased in line with the fall in gross profits meaning that the company has recorded a loss in the year.

.

We do not have the sufficient information, but from the information you have provided it seems that the deteriorating financial performance has been due to increasing competition and higher costs due to the deterioration of the pound. The deteriorating performance of the company has led it to be loss making in 2018 which means that return to shareholders and return on capital employed, as well as earnings per share are negative. Looking at ROE and ROCE in 2016 and 2017, there were significant decreases. ROCE and ROE both decreased from 4% to 0.4% in that period, indicating the deteriorating performance of the company. In addition to that, the earnings per share decreased by a significant amount amount 91%.

.

The above factors have led to a fall in the share price of Chelle, which has almost halved in valued since 2016 falling from 1711p to 980p. The fall in the share price reflects the deterioading performance of the company.

Uses other information than the financial statements

Uses the scenario in a relevant way

considers a trend of results

Cash flow has also been negatively affected. The company had a healthy cash position of 2,273 in 2016 however by 2016 this position had fallen to 525, representing a fall of 77%. The deteriotion was due to increase operating profits, as well as due to a fall in receivables which was less than the fall in sales and an decrease in payables which was less than the decrease in cost of sales, suggesting a longer operating cycle for the company. By the end of 2018, the decreased profitability of the company and further deterioration of the cash operating cycle mean that the company has had to rely on an overfraft and has no cash reserves in the bank.

Looking at the future of the company, the most impoartnat factor which will determine the going concern status of the company is whether the bond holders will exercise their right to convert the bond into shares or whether the company will be required to repay 10 million. If the profitability of the company does not improve significantly, in 2 years time when the convertible loan expires the company will hae no cash to repay the 10million. Therefore, unless the bond holders convert their rights into shares the company might not be a going concern a year from now. This all depends on the share price in the future.

Identifies the key point here

Question 3

Q3

1)

Key audit matters identified by Fenn

Revenue Recognition

Revenue recognition was identified as a key audit matter by Fenn Yo LLP due to the compelxity of the revenue received by Solvit which relates to component sales which might be sold together in a bundle.

.

There is therefore an audit risk of incorrect revenue recogntiion and cut-off in relation teh services provided ina budnle and therefore this increase the risk of material misstatement of revenue in the financial statement. This continues to remain a relevant risk, as Solvit continues to enter into contracts with customers which include the sale of the software and sercvices and miantenance costs. The company therefore continues to enter into these cotnracts which means that the transactions are more complex and thus tehre is a higher risk of mistatement.

.

The transactions also include judgement relating to the stage of completion of services such as maintenance and integartion services and therefore there is greater scope for manipulation and inherenthly a greater risk of mistatement in the financial statements.

.

The risk is even higher in the year ending 31 October 2018 due to the change in the standard. The new standard was applied from the start of the year and thereefore there is a greater possibility that the revenue figure is not caluclated in accordance to the new standard.

Provision for Onerous leases

Another key audit matter identified by Fenn Yo was the provision for the onerous leases. This was identified as a key audit matter due to the magnitude of the judgements applied when calculating this assumption and due to the fact that there is reliance on third party external advice for the matter.

.

The provision for onerous leases still continues to be relevant due to the level of judgement applied in its calculation. However, for the yera ended 31 March 2019, there has been a change in that the london offices were cavated at the start of the year which has resulted in a provision of the release. However, just because the offices have been vacated this does not necassrily mean that the provision should have been released.

.

8	There is a possibility that the rental paymnets from su-letting the property are insufficinet to cover the rental costs under the main elase agreement or there is a possibility that the the sub-tenant vacates the premises after 5 years and terminates the agreement. As Solvit will still have 10 yeras left of the elase this will become an onerous conctract again. . Therefore, there is still great judgement involved as to the probability of the sub tenants terminating the agreement in the 5 years and the lease becoming onerous againt herefore this remains a key audit risk. . Furthermore, it seems that at the year ending 31 March 2018 the management had made a wrong judgement that the premises would remian vacant for 2 years. The offices did not actually remain vacant at all. This suggests that managements judgements may therefore not be reliable, further increasing the risk of this balance.
9	
10	Additional key audit matters
11	1. There is an overall key audit risk hihglighted by the lack of experience and competence of the new accountant which was hired in March 2018. AN error was highlighted in the prior year financial statements arising from his lack of skills and therefore this increase the overall control risk of this audit. . 2. Allowance for receivables: There is a risk that the allowance for receivables in the year ending 31 March 2019 is understated. Although this is the same as in the prior year, there seems to have been a change in receivable days from 45 days to 75 days which either suggests a change in terms with new clients or just becauase new clients are late to pay. As a result of this change, the historic level of provisions might not be sufficient and a good basis for determining current year provisions. This is also an area of judgement and is subject to manipulation which further increases the audit risk. . 3. Management override of controls and bonus: . There is an increase incentive to report improved figures in the financial statemetns in order to achieve the maximum bonus. Although this was not a key risk in the prior year audit it is considered a key risk this year due to the fact that the company has not improved as good as expected, due to the fall in revenues to the eduation sector. As a result incentives will elad to increased audit rrisk. . 4. Sale and leaseback of property . This is a key audit risk again due to the compelxity of the transctions which leads to an icnrased risk that they have not been treated accordingly in the financial statements.

14	Revenue. . The relevant financial reporting standard is IFRS 15 - Revenue from contracts with customers. Under this standard, the separate performance oblgiations within the contract need to be identified and must be accounted for separately. In this case, the separate obligations are the installation of the software, the customisation services, the integration services, maintenance services etc. . Under IFRS 15 these performance obligatgions should be separated and a price must be determined for each oblgiation which reflects the time value of money and the estimated future consideation which is highly probable. In the case of the education market, wehere there are large dsciounts given on the agreemetns the price must be reduced by this discounts. In deciding the transction prices, the stand alone prices of customisation and integarion services should be considerred . Then the transaction price should be allocated to the performance obligations and revenue should be recognised as a performance obligation is satisfied. If it relats to services, then the revenue must be recognised over the period the services are recognised, it might be practical to do this on a month by month basis.
15	Audit objectives and audit procedures in respect of revenue: The audit objective is to ensure completeness, cut-off and accuracy of the revenue balance 1. Obtain a sample of revenue contracts (sample calculated using an appropriate sampling tool) and review the information in the cotnracts. Perform a recalculation of revenue to be recognised in the year ending 31 March 2019 by reviewing the separate obligations and compare it to the revenue recognised but he client 2. rReview the transaction prices allocated to each performance obligation and ascertain whether they are appropriate. This should include a comparison of the transction prices to the stand alone prices for the services and explanations obtained for differences 3. Ensure the cut-off of revenue by reviewing invoices raised before and after the year end and ensuring they have been recorded in the correct period, based on the contract completion.
16	

Strong verb and justifies audit procedure

Uses 'review - but has a justification of what the review intends to achieve

Specifically uses the scenario and relates to the standard

Onerous lease contract

Under IAS 37 - Provisons and Contingent liabitlies, a provision must be recognised when a contract becomes onerous. A contract becoems onerous when the future benefits arising from the contract are less than the costs. The onerous provision should be provided for is equal to the unavoidable costs from the contract which is the lower of the costs of fulfilling the contract and penalties from failure to fulfill.

.

In this case, there does not seem to be an option to cancel the cotnract therefore the provision should be equal to the costs of fulfilling the contract. Currently, the bulidng has been subletted and based on the information provided the rental received covers the costs of the contract therefore no losses arise under the contract. However, there is a possibility of termination of that cotnract in 5 yersa which would mean that the elease would become onerous and the company would need to recognise the present future of future rental costs, unless it can sublet the property again.

.

The probability of the sub let being terminated therefore needs to be considered.

Audit procedures:
1. Obtain the sub letting agreemet and the original elase agreement and review the terms. Ensure that the rent received from the sub letting agreement is enough to cover the contract costs of the initial lease
2. Ascerrtain the possibility of the sub lesses terminating the lease. Obtain correspondence and perhaps hold a discussion with the sub lessees discussing their future plans
3. Reclulcate the provison if there is a probability of more than 50% than the sub lessess will terminate the lease and recognise the costs

Sale and leaseback

Under IAS 17, the treatment of a sale and leaseback trasction depends on whether the new agreement is an opeating lease or a finance lease. Looking at the information provided the lease seems to be an operating lease because:
1. The lease term is for 10 yers which is much lower than the remaining UEL of 20 years for the office property
2. The present value of the minimum lease payments (6million withou any discounting) are much lower than the fair value of the lease of 15million

.

As this is an operating lease, the office property must be derecognised from the financial statemnets and a gain on the disposal must be recognised. As the property has been sold for more than its fair value the gain on the disposal must be recognised as follows: 1
1. Difference between proceeds and fair value i.e. 3million will be recognised in deferred income and the profit will be deferred over the life of the elase and released to the P&L
2. Difference between the fair value and the carrying amount of 4 million must be recognised immediately in the stamenf o profit or loss.

Audit procedures:
1. Obtaint henew agrement and ensure the terms agree to the information provided by the client
2. Review the sale agreement for the property and agree the proceeds to the agreement and the bank statement
3. Review the fair valuation of the property and consider the independence and competence of the valuer.

Management override: It is improtant the the incentiv schemes are ud

3)

Under IFRS 16, there is no longer a disctinction between an operatuing lease and a fiannce leases therefore the treatmnet of the sale and leaseback would be different.

.

To be a sale the transaction wouild need to meet the criteria in IFRS 15 - Revenue from contracts and if it does the asset sold is derecognised and a right of use asset is recognised in the financial statmeents together with a liability for the right of use retained and a gain or loss in relation to the rights transferred.

.

For the operating leases on cars and equipments, the intiial recognition would be to recognise a right of use asset and a liability measured at the present value of the lease payments over th elase term discounted using the implicit rate of the lease. Then the asset would need to be deprciated over the lease life and the liability would be paid off using the actuarial method and lease payments would reduce the lease liability if paid.