ADVANCED LEVEL EXAMINATION

Crocus

CORPORATE REPORTING

ANSWERS

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1 Elephant Ltd

Marking guide

Requirement	Marks	Skills
(1) Identify and explain reasons why trade receivables may be considered an area of significant audit risk.	6	Significance of year-end balance Incentives to misstate Entries indicating risk
(2) Evaluate the appropriateness of using the work of Steve, the internal auditor, with respect to reliance on Elephant's internal controls.	7	Application of ISA (UK) 610 requirements to scenario: • Competence • Objectivity • Approach to work
(3) Assuming that it is determined that you can place reliance on the work carried out by Steve, set out additional audit procedures that should be performed to enable you to place reliance on internal controls over receivables.	5	Procedures to cover the period subsequent to performance of Steve's work Procedures to cover controls over areas not covered by Steve.
(4) In relation to the contract with Spooks (Exhibit 1): – Explain the appropriate financial reporting treatment related to the deposit for the year ended 31 December 2018. Include correcting journal entries. – Identify and explain the financial reporting implications of the option to extend the contract and set out the information that would be required to determine the appropriate treatment. – Set out appropriate audit procedures that should be carried out. Include any additional information and explanations that you would require of management.	22	Identification of Frank's posting and application of IFRS 15 to contract and journals Implication of option to extend as possible additional contract obligation and information required Audit procedures and information/explanation from management

Requirement	Marks	Skills
Total marks available	**55**	
Maximum marks	**40**	

(1) **Justification for significant audit risk**

Significance of year end balance

- Trade receivables represents 34% of Elephant's total assets (excluding the credit balance for cash at bank and in hand).
- Trade receivables is a significant balance of £690,482 that has increased significantly over the prior year.
- The increase in trade receivables of £345,741 exceeds materiality of £30,000.
- Using Explore, we can identify that Trade Receivables has increased by 100% compared to only 14% increase in income, despite no apparent change in credit terms offered.

Incentives and opportunities for misstatement

- The role of the 2018 financial statements in the bank's credit analysis for its loan decision may incentivise management to boost the value of assets increasing the risk of overstatement of receivables and sales and management bias.
- The estimates required for expected credit losses to recognise impairment of trade receivables and to assess irrecoverable receivables require the exercise of judgement by management which may be biased for the reasons above.
- IFRS 9 permits the use of a simplified provision matrix to calculate expected losses as a practical expedient for trade receivables. The provision matrix is based on historical default rates over the expected life of the trade receivables, but it still requires management judgement to adjust for forward-looking estimates.

Entries indicating elevated risk

- Using the Heat Map two high risk items can be identified that are more than 3x materiality.
- Account 79000 – Bad debt expense appears to only contain a single transaction writing off an amount of £9,875 and there is no evidence of any entries related to impairment of receivables. Receivables subject to invoice financing are non-recourse, but there may be irrecoverable debts in the remaining receivables balance.

- Accounts included within trade receivables includes account 21050 – Receipts Unallocated which has a credit balance of £20,000. This amount was brought forward for 2018 and no further entries occurred during 2018. It would be expected that such a brought forward balance would be reversed in 2018 as the cash is allocated to specific receivables – perhaps with a new balance of unallocated receipts posted at the end of year. The fact that this has not happened may indicate poor controls over the allocation of cash received to customer accounts.
- A number of sales credits of £5,000 or more have been posted to receivables by individuals other than Frank or Andrea in breach of the internal control identified by Steve. For example, transaction SCR001198 for an amount of £21,920 was posted by TPOTTS on 5/10/2018.
- Account 20021 – Invoice Finance has a large credit balance. Given that CRD only allow Elephant to drawdown up to the value of invoices transferred, it suggests that transfers of invoices to CRD that have occurred may not have been recorded. Looking at Stacked Bar Charts for the Invoice finance account shows very low levels of debits posted to 20021 in December. Transfers to CRD in this period may not have been recorded. Since transfers of receivables to CRD should be derecognised this may lead to an overstatement of receivables.
- We can identify from Data Analytics Software that there are 88 transactions recorded as SCR – sales credits, which credit 21010 – Receivables Control A/c with a total value of £220,201. These entries either have a narrative suggesting that they are the component of a job that has been reversed – possibly as the result of a change to the contract or a disputed invoice. Others are described as a 'discount taken'. Suggesting these relate to early payment discounts.

  We can also see from the Data Analytics Software that only £255,320 of sales receipts were debited to 20010 – Bank, Current Account. Investigation of the composition of this balance reveals that £225,000 relates to cash from CRD not payment of receivables directly to Elephant. Given such a low value of receivables directly collected by Elephant, rather than transferred to CRD, it is difficult to see a rationale for posting sales credits totalling £220,201 to receivables and this suggests that mis-posting of sales credits to receivables may have occurred.

Tutorial note

ISA (UK) 315 (Revised) para.12(l) defines a significant risk in terms of either its positioning on the spectrum of inherent risk or as required by a specific ISA (UK); however, for the purposes of these types of questions, we are interested in students displaying sound judgement in prioritising information uncovered as they attempt to answer the question.

(2) ISA (UK) 610 *Using the Work of Internal Auditors* requires that in order for the auditor to rely on the work of internal audit, the auditor must consider the internal auditor's competence, objectivity and the approach taken to their work.

Competence

- Steve was internally recruited from within Elephant in 2018. As a consequence he is likely to have a very good understanding of the business.
- Although he has some experience as an auditor prior to joining Elephant, he did not complete his studies. This raises some doubt as to whether he has sufficient technical knowledge and skills to adequately fulfil this role.
- Steve is the only member of the internal audit function. This is not surprising given the small size of Elephant. However, it does mean that there is no-one else involved in the internal audit function to remedy any deficit or augment Steve's knowledge and skills.

Objectivity

- As someone with a history of employment at Elephant, Steve will inevitably have existing relationships with its staff. This could compromise objectivity and professional scepticism in the role of internal auditor.
- Steve also posted some transactions in January/February 2018 so there is a (limited) self-review threat in his role as internal auditor.
- Steve used to be part of the finance department and he also reports to Frank, the finance director. This sub-optimal reporting line may result from Elephant's lack of an audit committee due to its small size. Steve's close relationship with the finance function may compromise objectivity when making an assessment of its operations.
- Reporting to a board director directly suggests that internal audit has an appropriate status. However, it would be preferable for Steve to report to someone independent of the finance function, such as a non-executive director, one of the other executive directors or to the board collectively.
- A lack of objectivity is evident from the fact that Steve performed controls testing based on a sample selected by the finance department, rather than one which he independently selected. This gives scope for the sample to be manipulated by the finance department.

Approach taken to work of internal audit

- The work approach of internal audit should be systematic and disciplined. There seems to be some evidence of a systematic approach in that Steve is carrying out a review of each area of the business in turn.
- Steve also appears to have adequately documented his work.
- The scope for the work of internal audit to be supervised and reviewed is limited by the fact that Steve is the only internal auditor. These roles may be fulfilled by the finance director, but as above this is likely to adversely affect the objectivity of internal audit.

(3) If it has been determined that it is appropriate to use the work of internal audit carried out on internal controls there are two additional areas which need to be addressed by the auditors.

Procedures to cover the period subsequent to performance of the internal auditor's work

The testing of controls over income and receivables was performed by Steve in September. As such it can only have covered the operation of control in the first nine months of the year.

The auditors need to perform tests of controls to confirm that they were operating satisfactorily for the final quarter of the year. This would involve performing the same tests of controls as Steve for a sample of transactions related to the remainder of the year.

In addition, the auditor should inquire of management whether any changes were made to control procedures in the last three months of the year. If significant changes in controls have occurred these should be documented and tested.

Procedures to cover controls over sales credits and controls over the transfer of receivables to the invoice finance account

The procedures undertaken by Steve to test controls over income and receivables only focused on the initial recognition of receivables. He appears to have not carried out any further testing of controls over sales credits, the transfer of receivables to CRD or the allocation of cash received within 14 days of invoicing to receivables.

To test the operation of controls designed to ensure that invoices transferred to CRD are correctly transferred from receivables to the invoice finance account, the auditor should verify that each month Frank has reconciled the amounts transferred to the invoice finance account to CRD's confirmations of receivables accepted and that any differences are investigated.

In relation to sales credits, as described in (1), unauthorised posting of sales credits of £5,000 or more has occurred. In addition, as also noted in (1), there appears to be inconsistency between the value of sales credits posted to receivables and the amount of receivables directly collected by Elephant. These matters suggest that controls over segregation of duties, authorisation and supervision may be weak. Explanations should be sought for the apparent breaches of controls over sales credits.

The auditor should also identify and test internal controls designed to ensure correct allocation of payments received from customers to accounts receivable. The round sum credit balance of £20,000 in account 21050 – Receipts Unallocated suggests that there may also be control weaknesses here.

(4) **Financial reporting treatment for Spooks contract**

We know the entries related to the deposit were posted by Frank on December 7 as an overseas receivable of £100,000. Using this information, we can use data analytics software to identify that Elephant has accounted for the Spooks deposit by the following entries:

Debit £100,000 – 21020 – Overseas Receivable

Credit £100,000 – 51020 – Overseas Sales

This transaction was posted as an SRC – Sales Receipt rather than a SIN – Sales invoice. The reasons for this should be investigated.

This means that Elephant has recognised the entire amount of the Spooks deposit due as revenue in the year. This is inconsistent with the core principle of IFRS 15 that an entity only recognises revenue to the extent of the transfer of promised goods or services to the customer (IFRS 15. IN7).

IFRS 15 provides a five step model to achieve this outcome. We can apply this to the Spooks contract as follows.

Step 1 – Identify the contract with a customer:

There is a clear written contract agreed between Spooks and Elephant.

Step 2 – Identify the separate performance obligations in the contract:

There are three phases in the Spooks contract. We must consider whether each could be considered a distinct service and thus constitute a performance obligation. The first two phases of the contract: website design concept and preparation of artwork and graphics are unlikely to be considered distinct as Spooks would be unlikely to be able to derive benefit from these services on their own or by combining with readily available resources. Therefore, these should be combined with developing the Spooks website to form a single performance obligation. A completed website could be used to derive a benefit and can thus be considered a performance obligation. Similarly, a digital marketing campaign is a distinct service linked to, but not dependent on, the development of the website. Thus, there are two performance obligations in the contract – the first three phases concluding in completion of the Spooks website and the digital marketing campaign.

The issue of whether the option to extend the contract is a performance obligation is considered below.

Step 3 – Determine the transaction price:

This is the £300,000 agreed contract price for the 18 month contract plus the expected value of variable consideration of £25,000. However, if £25,000 does not represent the most likely outcome or the expected value of possible outcomes it may not be the most appropriate value to include.

Step 4 – Allocate the transaction price to the separate performance obligations in the contract:

We determined above that there are two performance obligations. Neither of these two performance obligations has a standalone selling price, therefore this step requires an estimate. Elephant have estimated that 40% of the transaction price relates to the digital marketing campaign from which we can infer 60% must relate to the first three contract phases making up the first performance obligation.

Step 5 – Recognise revenue when (or as) the entity satisfies a performance obligation:

Because Elephant has an enforceable right to payment for performance completed to date the performance obligations can be considered to be satisfied over time. At the year end the work to produce the website concept has all been performed and this phase has been approved by Spooks. It is only the revenue related to this proportion of the first performance obligation that should be recognised as revenue for the year to 31 December 2018. Because this milestone has been met and the website concept has been accepted by Spooks the output method can be used to measure the extent of performance. Elephant's management have estimated this at 5%.

Therefore £195,000, 60% of the total contract price of £325,000, can be allocated to the first performance obligation. We can also conclude that five 60ths of this performance obligation has been delivered to Spooks at the year end. As a result, £16,250 should be recognised as revenue for the year to 31 December 2018 in respect of the preparation of the website design concept.

Journals:

Using the data analytics software we can determine the double entry used by Frank to record the deposit becoming due was:

DEBIT Overseas receivable	£100,000	
CREDIT Overseas sales		£100,000

At this point no revenue should have been recognised and the consideration due to Elephant at this point represents a contract liability. So, to correct Frank's entry.

DEBIT Overseas sales	£100,000	
CREDIT Contract liability		£100,000

At the year end Elephant is able to recognise £16,250 of revenue.

DEBIT Contract liability	£16,250	
CREDIT Overseas sales		£16,250

Implications of option for Spooks to extend the contract for an additional six months

Under IFRS 15 an option to extend the contract for a further six months could be considered an additional performance obligation of the initial contract.

Whether this is the case is dependent upon whether the price at which the further services can be obtained by the exercise of the option is at a discount.

If this is the case, the option would be considered an additional performance obligation in the 18 month contract.

The amount of the transaction price allocated to this performance obligation would be established as the normal price for the service adjusted for the discount price and the expected probability of the option being exercised.

The proportion of the transaction price allocated to the option as a performance obligation would only be recognised at the earlier of the option expiring or the service being delivered to Spooks.

Alternatively, if the option to extend the initial 18 month contract is for services at usual rates and does not offer a discount, it is not a performance obligation of the initial contract and no contract exists for the six month extension until Spooks exercises the option take up those services.

Additional information required to establish appropriate reporting treatment

- The terms of contract with reference to the option to extend contract to determine whether a discount exists
- If discount is offered:
  - Normal price of additional marketing services
  - Discounted price offered
  - Estimate of the probability of exercise of the option

Audit procedures

- Enquire of management as to the reason for this transaction being posted as a sales receipt SRC rather than a sales invoice SIN.
- Examine cash receipts after the year end to confirm receipt of £100,000.
- Examine contract to confirm transaction price and all relevant terms.
- Enquire of management as to the basis of determining the proportion of transaction price related to the second performance obligation, the digital marketing campaign.
- Enquire of management as to the basis for the expected minimum contract bonus and assess for reasonableness.
- Enquire of management as to the basis for concluding that the website design concept equates to 5% of the contract.
- Obtain documentary evidence to confirm Spooks' acceptance of the website design concept.
- Confirm that the deposit and the rest of the consideration is to be invoiced in pounds sterling.

APPENDIX TO THE ANSWER: QUESTION 1

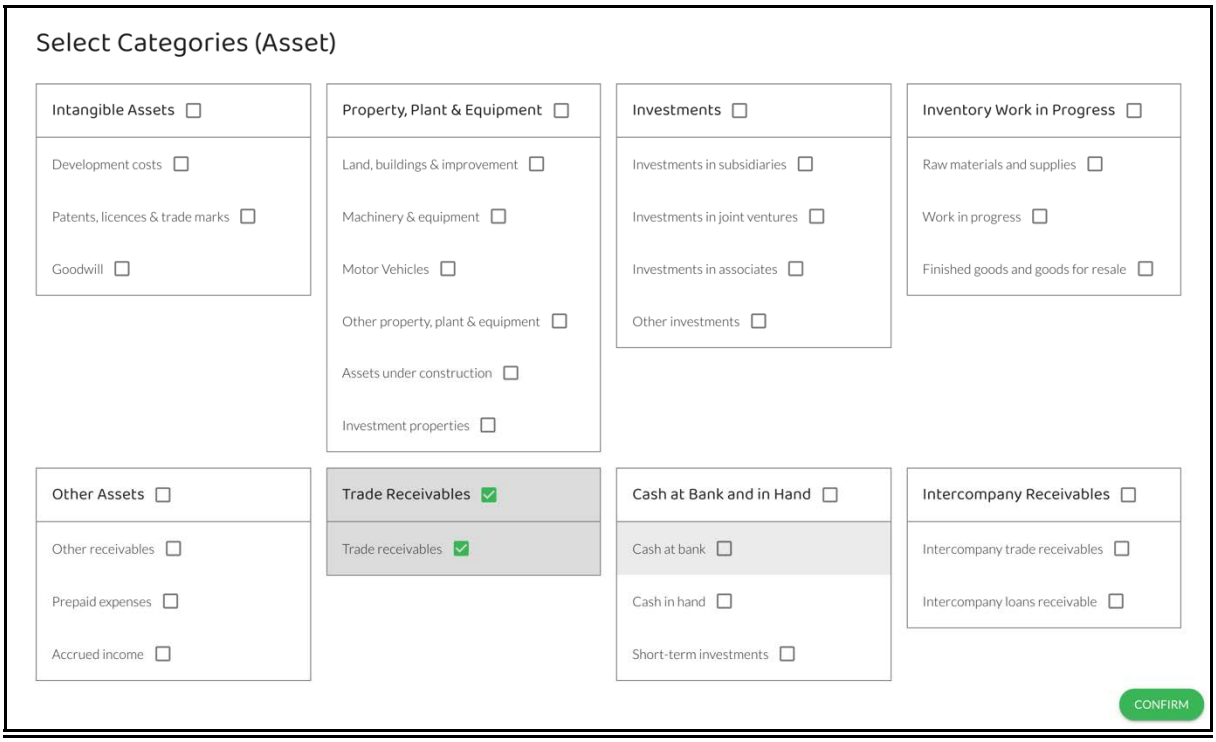
The following section explains the audit software screens used and the navigation methods but is not itself part of the answer. (Note: the data analytics software screens cannot be cut and pasted from the software into your answer in the CR exam.)

To examine composition of Trade Receivables:

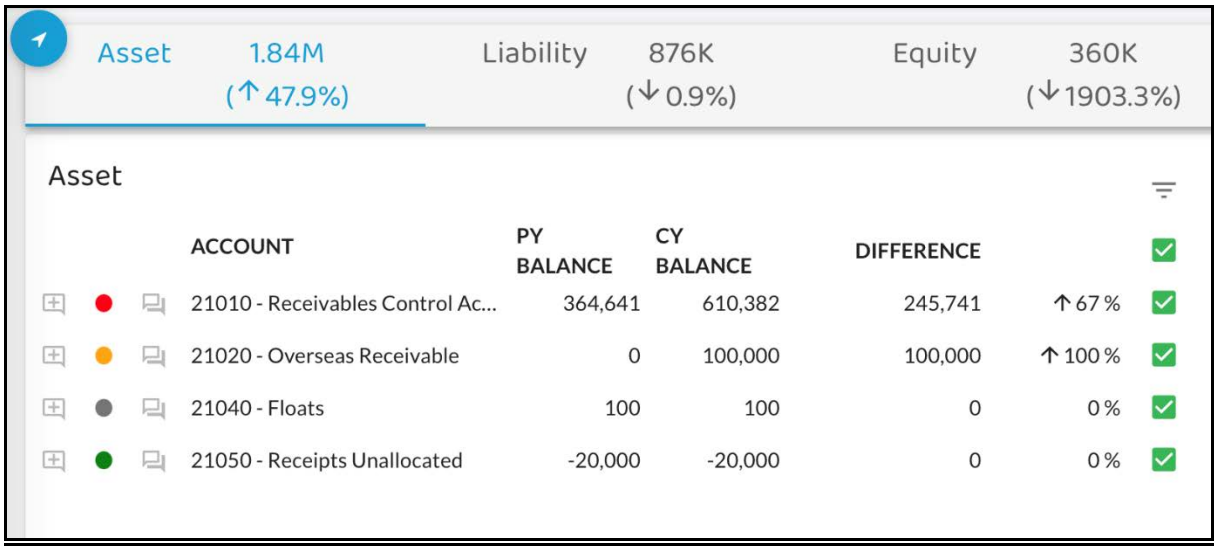
The value of Trade Receivables can be identified from the Financial Statement view within the Explore module.

Statement of Financial Position	Opening	Closing	Difference
Asset	1,243,954	1,839,321	595,367 (↑ 48 %)
Intangible Assets	0	0	0 (0 %)
Property, Plant & Equipment	71,532	251,184	179,653 (↑ 251 %)
Investments	0	0	0 (0 %)
Inventory Work in Progress	0	0	0 (0 %)
Other Assets	764,189	1,090,127	325,938 (↑ 43 %)
Trade Receivables	344,741	690,482	345,741 (↑ 100 %)
Cash at Bank and in Hand	63,492	-192,473	-255,965 (↑ 403 %)
Intercompany Receivables	0	0	0 (0 %)

To view the underlying accounts select Trade Receivables in Account View.



Click CONFIRM to reveal accounts:



This shows the £20,000 credit balance brought forward on 21050 – Receipts Unallocated.

To identify bad debt write offs:

In Account View, select expenses – there is only one expense account with a narrative related to bad debts.

Expense

ACCOUNT	PY BALANCE	CY BALANCE	DIFFERENCE	
73020 - Postage	581	554	-27	↓ 5 %
73030 - Telephone, Office	4,269	4,824	556	↑ 13 %
73035 - Telephone - Mobile	9,868	8,492	-1,376	↓ 14 %
73040 - Computer Software	22,659	31,548	8,889	↑ 39 %
73060 - Staff Welfare	5,896	5,760	-137	↓ 2 %
73070 - Subscriptions	9,757	10,364	607	↑ 6 %
73090 - Sundry Admin Charges	1,022	1,152	130	↑ 13 %
74020 - Motor Repairs	599	188	-410	↓ 69 %
75005 - Charities	250	300	50	↑ 20 %
75010 - Advertising	302	280	-22	↓ 7 %
76010 - Bank, Charges & Interest	68,125	78,023	9,898	↑ 15 %
77010 - Legal Fees	25,365	20,759	-4,607	↓ 18 %
77020 - Accountancy Fees	1,406	1,982	576	↑ 41 %
77030 - Audit Fees	6,900	7,106	206	↑ 3 %
77035 - Consultancy	-105,465	-111,015	-5,551	↑ 5 %
79000 - Bad debt expense	0	9,875	9,875	↑ 100 %
TOTAL SELECTED	0	9,875	9,875	↑ 0 %

Select this account and click on ☰ to reveal transactions

Expense Transactions

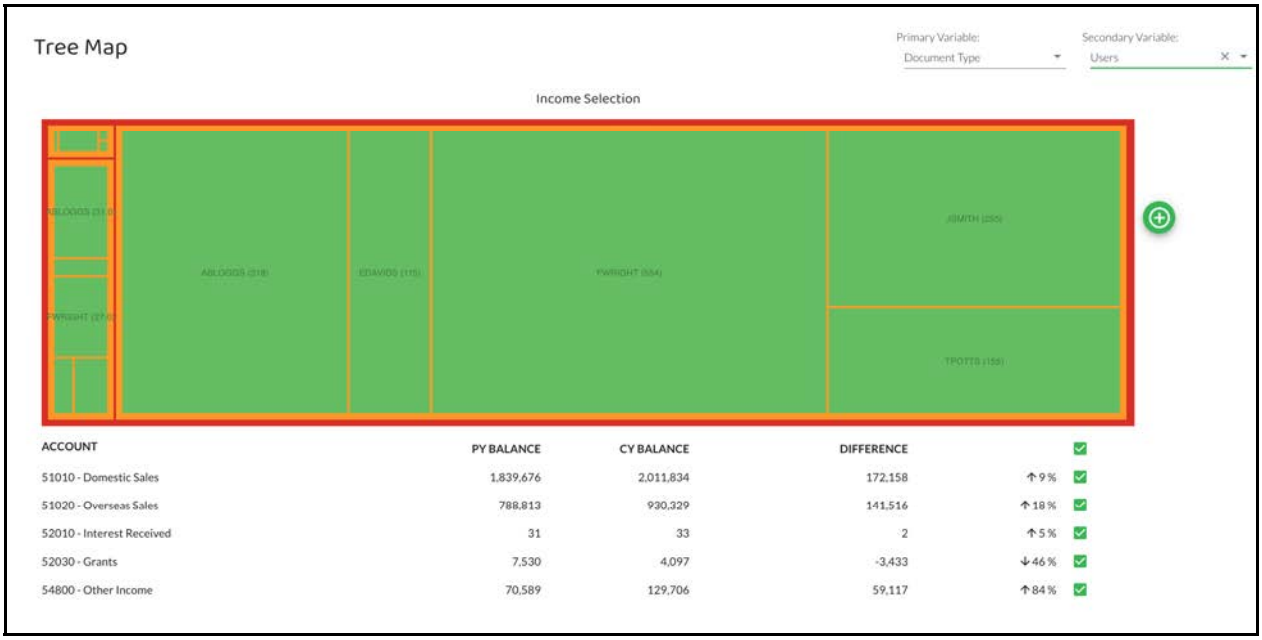
Transaction Id	Description	Debit	Credit	Account Codes	Effective Dates	User Ids	Document Types	Created Dates
NOM003045	Write off Geoworld receivable	9,875	0	79000	28/10/2018	TPOTTS	NOM - Nominal Journal	03/11/2018 10:45:00

Show 10 lines

It shows a single receivable from Geoworld written off in the year.

To identify who has posted sales credits of £5,000 or more:

In Account View select Income and then go to the Tree Map and select Document Type as Primary Variable and Users as Secondary Variable.



Click on each of the green segments within sales credits for TPOTTS, EDAVIDS and JSMITH to reveal their respective sales credits posted.

Income Transactions

Transaction Id	Description	Debit	Credit	Account Codes	Effective Dates	User Ids	Document Types	Created Dates
SCR001145	55384 - Amend invoice 18022 for bank charges	15	0	51020	02/11/2018	EDAVIDS	SCR - Sales Credit	08/11/2018 13:07:13
SCR001181	51247 - To amend for discount taken	327	0	51020	31/07/2018	EDAVIDS	SCR - Sales Credit	06/08/2018 11:19:18
SCR001184	56750 - Additional amends and finalisation of Gillette	700	0	51010	25/07/2018	EDAVIDS	SCR - Sales Credit	31/07/2018 11:47:57
SCR001191	51247 - To amend for discount taken	49	0	51020	18/09/2018	EDAVIDS	SCR - Sales Credit	24/09/2018 08:30:11
SCR001205	56867 - To produce mock-ups as requested.	11,502	0	51020	19/10/2018	EDAVIDS	SCR - Sales Credit	25/10/2018 12:56:10
SCR001206	56869 - To produce mock-ups as requested.	2,853	0	51020	30/10/2018	EDAVIDS	SCR - Sales Credit	05/11/2018 11:52:50

Show 10 lines

Income Transactions

Transaction Id	Description	Debit	Credit	Account Codes	Effective Dates	User Ids	Document Types	Created Dates
SCR001154	55437 - Supply 5000 A5 leaflets	3,887	0	51010	28/01/2018	JSMITH	SCR - Sales Credit	03/02/2018 18:38:47
SCR001172	56706 - To produce Euro packshots as requested.	1,143	0	51020	30/05/2018	JSMITH	SCR - Sales Credit	05/06/2018 18:11:29
SCR001177	51247 - To amend for discount taken	159	0	51020	30/06/2018	JSMITH	SCR - Sales Credit	06/07/2018 08:21:46
SCR001180	56678 - CT JW Takeaway FOP Mock Ups x11	1,200	0	51010	16/06/2018	JSMITH	SCR - Sales Credit	22/06/2018 10:39:30
SCR001182	56353 - To cover project management.	5,000	0	51010	31/07/2018	JSMITH	SCR - Sales Credit	06/08/2018 10:50:59
SCR001204	- To adjust for discount taken	283	0	51010	19/10/2018	JSMITH	SCR - Sales Credit	25/10/2018 19:48:31
SCR001221	57274 - Produce 2 x roller banners artwork and deliver to	216	0	51010	30/11/2018	JSMITH	SCR - Sales Credit	06/12/2018 18:17:13

Show 10 lines

Income Transactions

Transaction Id	Description	Debit	Credit	Account Codes	Effective Dates	User Ids	Document Types	Created Dates
SCR001150	55703 - To supply 6 x roller banners including artwork.	508	0	51010	18/01/2018	TPOTTS	SCR - Sales Credit	24/01/2018 11:28:03
SCR001156	54575 - Imedia banner re-size big hospitality creative	750	0	51010	13/02/2018	TPOTTS	SCR - Sales Credit	19/02/2018 11:50:17
SCR001157	55877 - To amend for currency conversion.	145	0	51020	15/02/2018	TPOTTS	SCR - Sales Credit	21/02/2018 19:58:32
SCR001158	55855 - To produce packshots as requested	109	0	51020	20/02/2018	TPOTTS	SCR - Sales Credit	26/02/2018 08:43:44
SCR001162	51247 - To amend for discount taken	347	0	51020	28/02/2018	TPOTTS	SCR - Sales Credit	06/03/2018 10:18:15
SCR001176	56804 - To add reflections to 10 x CB9 master images.	350	0	51010	30/06/2018	TPOTTS	SCR - Sales Credit	06/07/2018 08:44:08
SCR001183	56939 - VL3 DEMI Mockup CIC's	652	0	51020	31/07/2018	TPOTTS	SCR - Sales Credit	06/08/2018 11:39:58
SCR001189	56974 - Packshots Madonna	782	0	51020	30/08/2018	TPOTTS	SCR - Sales Credit	05/09/2018 19:35:53
SCR001198	57206 - To produce 2000 boxed kits consisting of	21,920	0	51010	29/09/2018	TPOTTS	SCR - Sales Credit	05/10/2018 13:24:47
SCR001213	57238 - PGP Product page evolution	2,950	0	51020	30/11/2018	TPOTTS	SCR - Sales Credit	06/12/2018 12:39:25
SCR001226	57321 - To provide store opening support including	1,660	0	51010	30/11/2018	TPOTTS	SCR - Sales Credit	06/12/2018 12:37:35
SCR001227	57389 - To supply 2 x window posters and deliver to store	120	0	51010	30/11/2018	TPOTTS	SCR - Sales Credit	06/12/2018 17:01:44

Show 25 lines

Scrutiny of the values indicates all three users posted sales credits above the limit for which they were authorised.

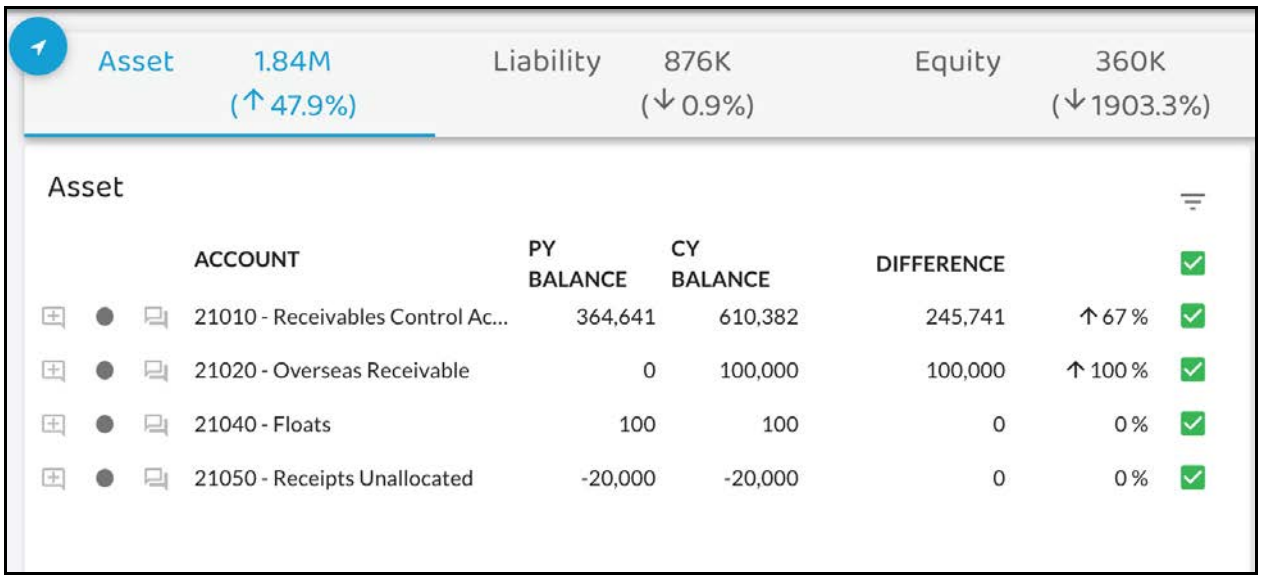
To review transfers of receivables to CRD:

In Account View select 20021 – Invoice Finance in Assets and go to stacked bar charts with effective period as primary variable and document type as secondary.

This indicates very low levels of debit entries to this account in December and suggests the accounting entries to reflect receivables transferred in December may not have been made.

To compare value of sales credits to value of receivables directly collected by Elephant:

In Account View select Trade Receivables.

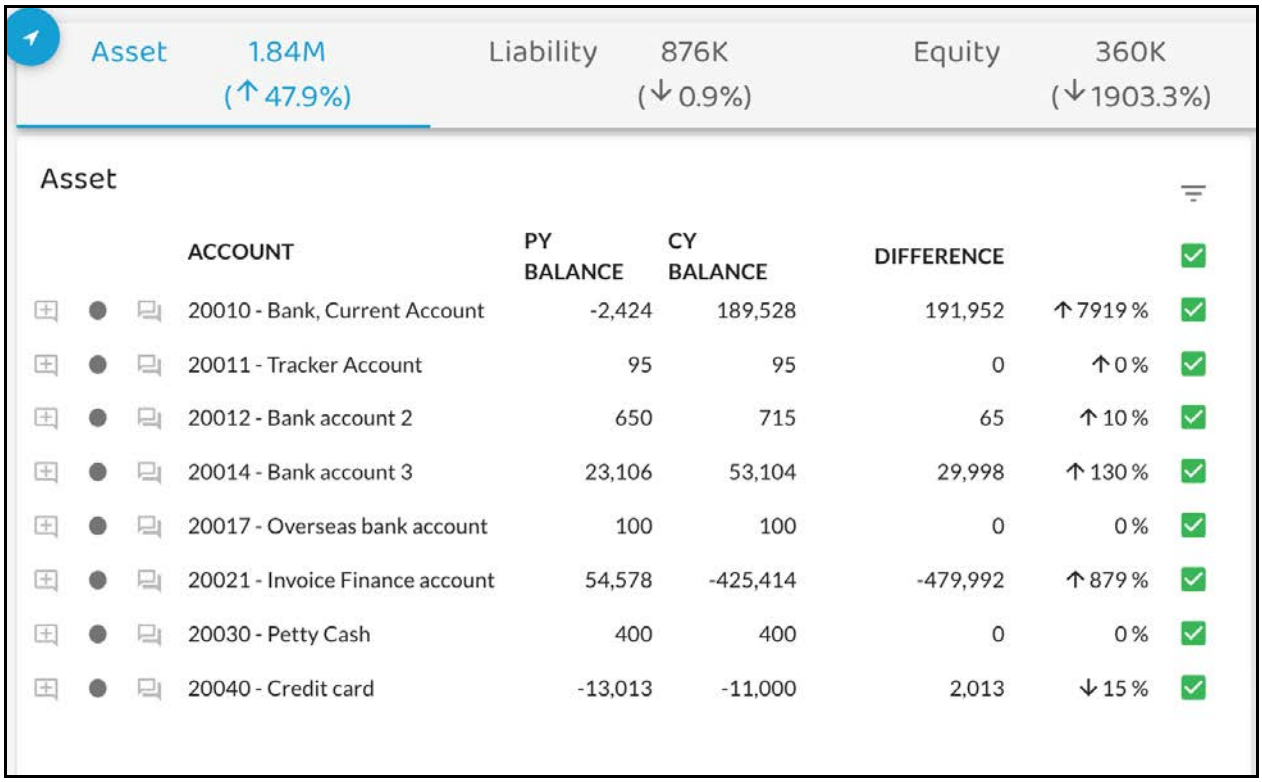


ACCOUNT	PY BALANCE	CY BALANCE	DIFFERENCE	
21010 - Receivables Control Ac...	364,641	610,382	245,741	↑67 %
21020 - Overseas Receivable	0	100,000	100,000	↑100 %
21040 - Floats	100	100	0	0 %
21050 - Receipts Unallocated	-20,000	-20,000	0	0 %

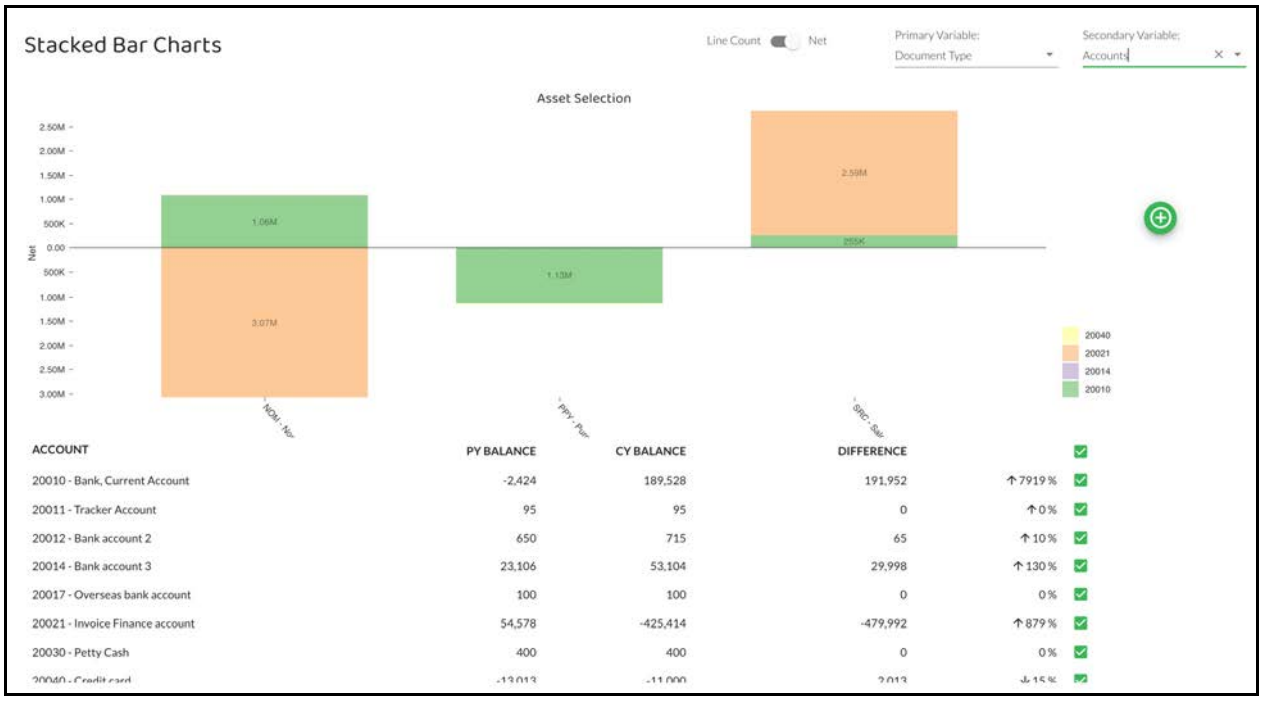
Go to Stacked Bar Charts and select Accounts for the primary variable and Document Type for the secondary.

This indicates a total value of SCR sales credits of £220,201 credited to 21010 – Receivables control A/c.

In Account View select Cash at Bank and in Hand.



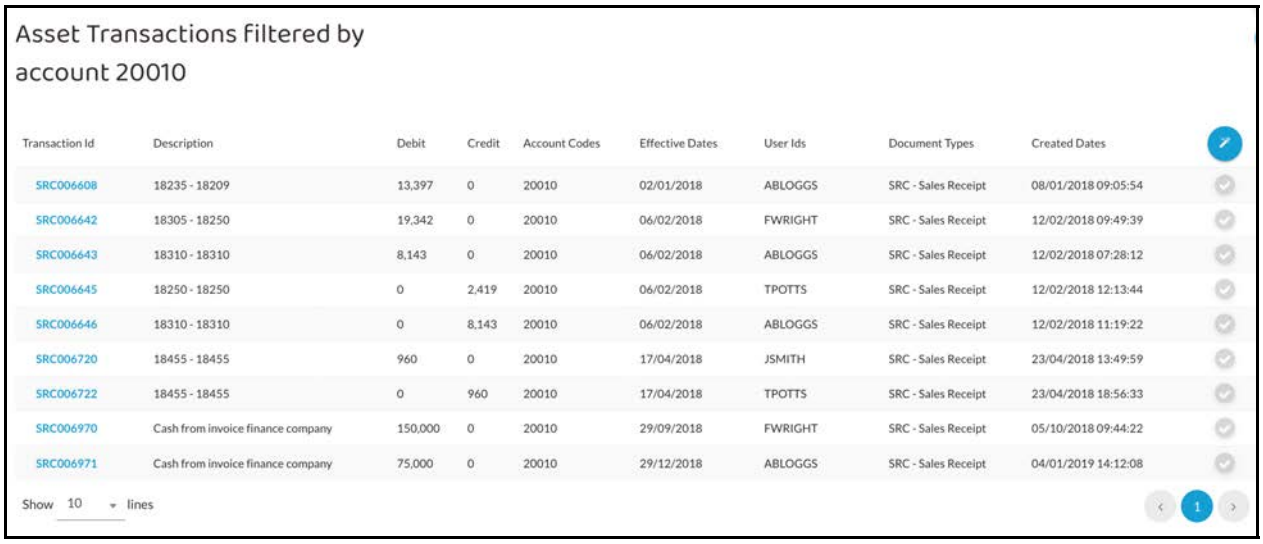
Go to the Stacked Bar Charts and select Document Type as the primary variable and Account as the secondary.



ACCOUNT	PY BALANCE	CY BALANCE	DIFFERENCE	
20010 - Bank, Current Account	-2,424	189,528	191,952	↑7919 %
20011 - Tracker Account	95	95	0	↑0 %
20012 - Bank account 2	650	715	65	↑10 %
20014 - Bank account 3	23,106	53,104	29,998	↑130 %
20017 - Overseas bank account	100	100	0	0 %
20021 - Invoice Finance account	54,578	-425,414	-479,992	↑879 %
20030 - Petty Cash	400	400	0	0 %
20040 - Credit card	-13,013	-11,000	2,013	↓15 %

This indicates that the value of SRC sales receipts debited to 20010 – Bank Current A/c is very low at £255,320.

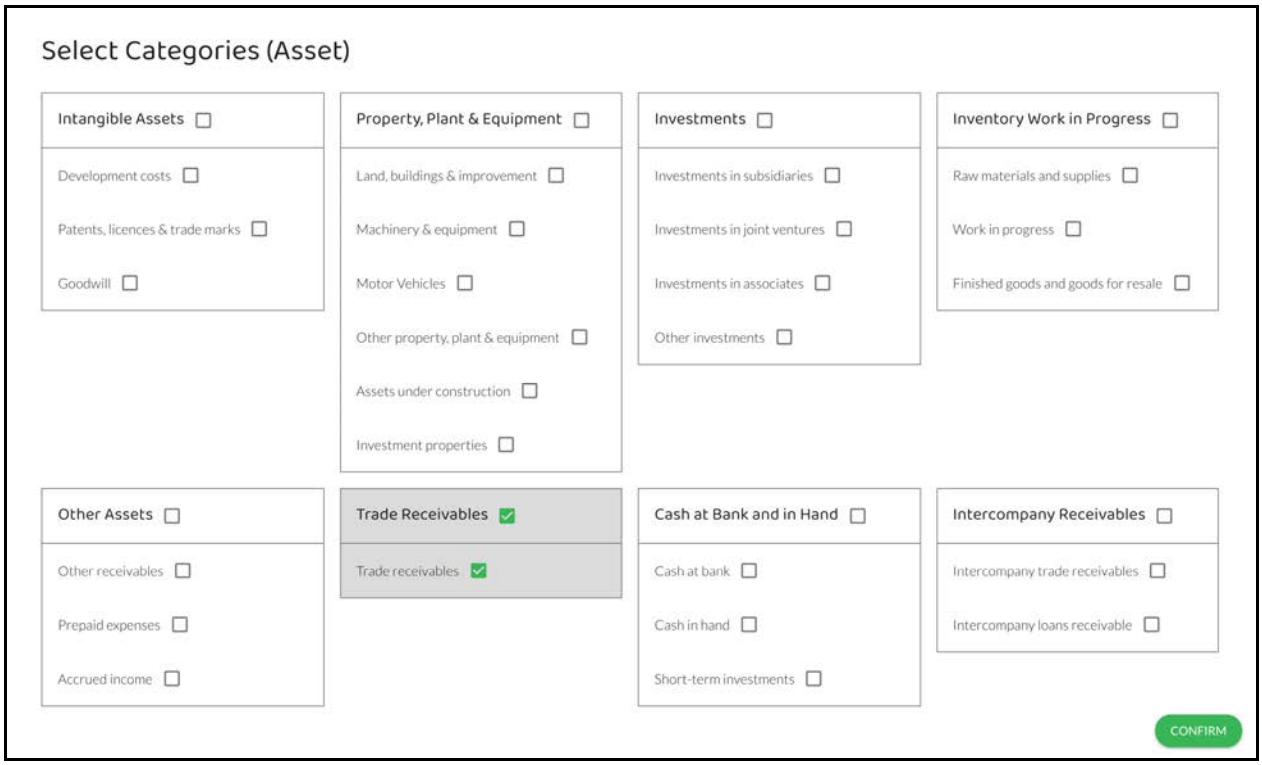
Clicking in the green segment reveals the underlying transactions.



Transaction Id	Description	Debit	Credit	Account Codes	Effective Dates	User Ids	Document Types	Created Dates
SRC006608	18235 - 18209	13,397	0	20010	02/01/2018	ABLOGGS	SRC - Sales Receipt	08/01/2018 09:05:54
SRC006642	18305 - 18250	19,342	0	20010	06/02/2018	FWRIGHT	SRC - Sales Receipt	12/02/2018 09:49:39
SRC006643	18310 - 18310	8,143	0	20010	06/02/2018	ABLOGGS	SRC - Sales Receipt	12/02/2018 07:28:12
SRC006645	18250 - 18250	0	2,419	20010	06/02/2018	TPOTTS	SRC - Sales Receipt	12/02/2018 12:13:44
SRC006646	18310 - 18310	0	8,143	20010	06/02/2018	ABLOGGS	SRC - Sales Receipt	12/02/2018 11:19:22
SRC006720	18455 - 18455	960	0	20010	17/04/2018	JSMITH	SRC - Sales Receipt	23/04/2018 13:49:59
SRC006722	18455 - 18455	0	960	20010	17/04/2018	TPOTTS	SRC - Sales Receipt	23/04/2018 18:56:33
SRC006970	Cash from invoice finance company	150,000	0	20010	29/09/2018	FWRIGHT	SRC - Sales Receipt	05/10/2018 09:44:22
SRC006971	Cash from invoice finance company	75,000	0	20010	29/12/2018	ABLOGGS	SRC - Sales Receipt	04/01/2019 14:12:08

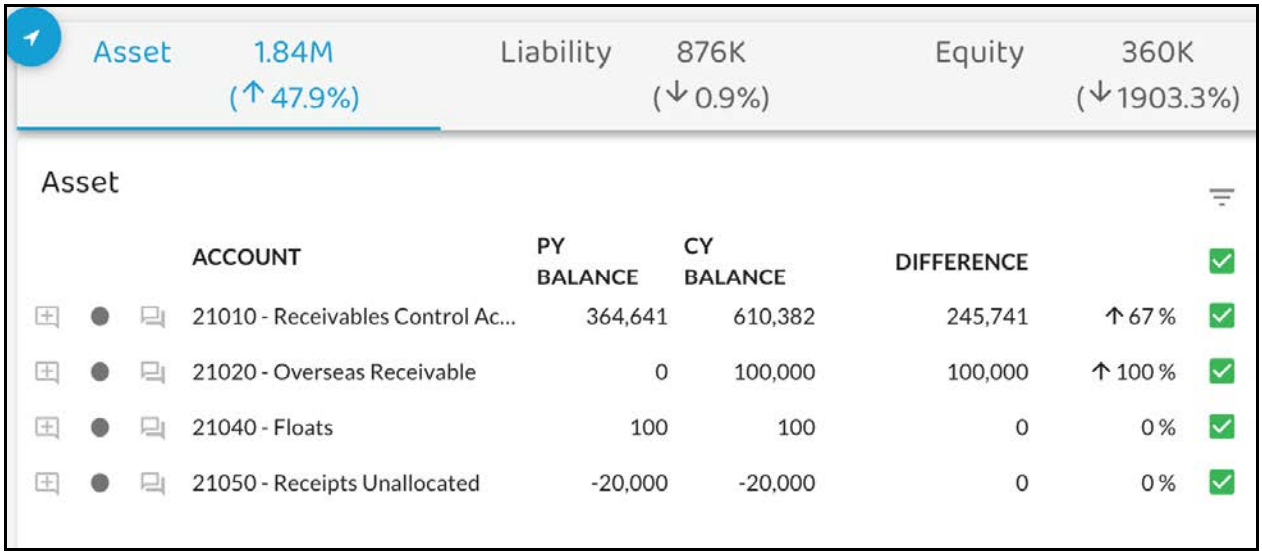
This shows that of this total £225,000 appears to be cash from CRD rather than a receivable directly collected by Elephant. Hence amount of directly collected receivables is even lower.

Select Trade Receivables in Account View in Explore.



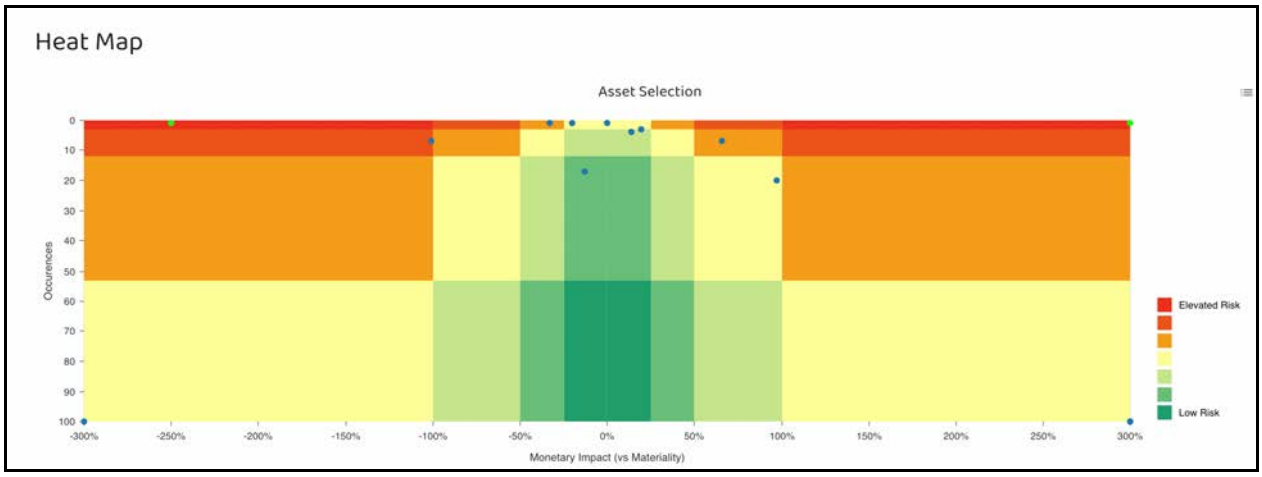
This reveals four underlying accounts.

(The overseas receivable of £100,000 could be investigated directly from here to identify it as Frank's posting on 7 December).

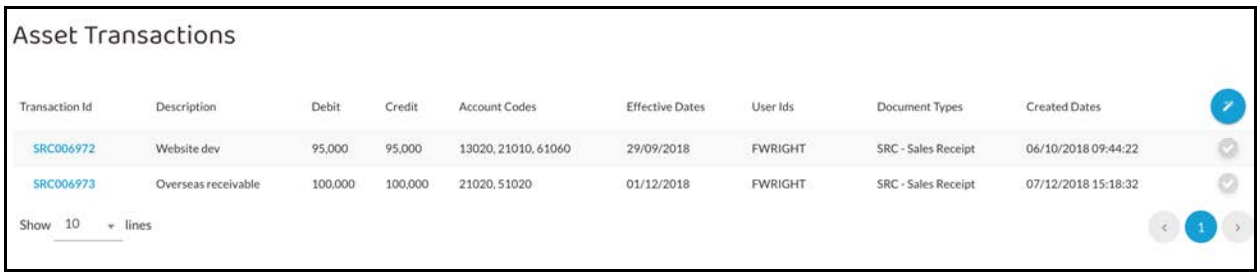


ACCOUNT	PY BALANCE	CY BALANCE	DIFFERENCE	
21010 - Receivables Control Ac...	364,641	610,382	245,741	↑67 %
21020 - Overseas Receivable	0	100,000	100,000	↑100 %
21040 - Floats	100	100	0	0 %
21050 - Receipts Unallocated	-20,000	-20,000	0	0 %

In the Heat Map select the highest Elevated risk.



This reveals two transactions that were posted by Frank including one of £100,000 on 7 December.

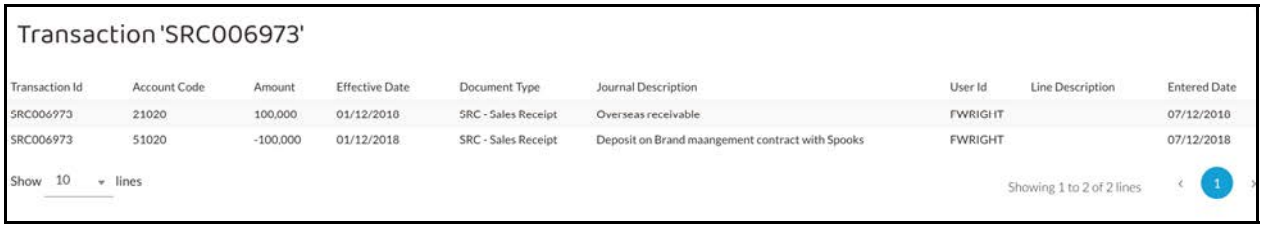


Asset Transactions

Transaction Id	Description	Debit	Credit	Account Codes	Effective Dates	User Ids	Document Types	Created Dates
SRC006972	Website dev	95,000	95,000	13020, 21010, 61060	29/09/2018	FWRIGHT	SRC - Sales Receipt	06/10/2018 09:44:22
SRC006973	Overseas receivable	100,000	100,000	21020, 51020	01/12/2018	FWRIGHT	SRC - Sales Receipt	07/12/2018 15:18:32

Show 10 lines

Click on Transaction Id to see double entry for this transaction.



Transaction 'SRC006973'

Transaction Id	Account Code	Amount	Effective Date	Document Type	Journal Description	User Id	Line Description	Entered Date
SRC006973	21020	100,000	01/12/2018	SRC - Sales Receipt	Overseas receivable	FWRIGHT		07/12/2018
SRC006973	51020	-100,000	01/12/2018	SRC - Sales Receipt	Deposit on Brand maangement contract with Spooks	FWRIGHT		07/12/2018

Show 10 lines

Showing 1 to 2 of 2 lines

Also note transaction posted as a sales receipt SRC, rather than a sales invoice SIN, even though amount not received in cash.

2 Finney plc

Marking guide

Requirement	Marks	Skills
(1) Review the information and prepare a briefing note, including any relevant calculations and journals, that sets out the financial reporting consequences for the year ended 30 September 20X2 of the issues contained in Exhibits 1 and 2.	30	Apply the IFRS 9 impairment model to the loan stock investment. Calculate the impairment allowance. Recognise that when part of a gain or loss on a financial liability relates to own creditworthiness, that part must be treated separately from the rest of the gain or loss. Recognise the opportunity to use hedge accounting for the copper futures contract. Conclude that the net effect of the futures contract on profit or loss is the same, whether hedge accounting is adopted or not. Recognise the gain on disposal of UK investment. Recognise that share appreciation rights are cash-settled share-based payment. Correctly calculate and apply the IFRS 2 treatment.
(2) Redraft financial statements to take account of the financial reporting issues.	7	Identify how the information affects the financial statements and revise them accurately.
Total marks available	**37**	
Maximum marks	**30**	

(1) **Briefing note**

To: Simone Hammond
From: Marina Bujnowicz
Re: Financial Statements for year ended 30 September 20X2
Date: X-X-XX

In this briefing note I will set out the financial reporting consequences of each of the issues and discuss any further financial reporting consequences which may arise in respect of these issues in future financial reporting periods.

I also include re-drafted financial statements of Finney plc incorporating the necessary adjustments as requested.

(a) **Investment in loan stock**

IFRS 9, *Financial Instruments* adopts an 'expected loss' model for impairment; in other words, credit losses are recognised when expected rather than when incurred. On initial recognition (1 October 20X1), Finney has correctly recognised 12-month expected credit losses of 5% × £3,000,000 = £150,000, reflecting the 5% probability that the borrower would default on the loan with a 100% loss.

An impairment loss on a financial asset at amortised cost was correctly recognised in profit or loss, with a corresponding entry to an allowance account, which is offset against the carrying amount of the financial asset in the statement of financial position.

1 October 20X1		**£**	**£**
DEBIT	Profit or loss	150,000	
CREDIT	Impairment allowance		150,000

This will need to be adjusted for information available at the year end.

Finance income for the year needs to be recorded:

30 September 20X2		**£**	**£**
DEBIT	Financial asset (10% × £3m)	300,000	
CREDIT	Profit or loss		300,000

The gross carrying amount of the financial asset (before the allowance for credit losses) is therefore £3,300,000.

At 30 September 20X2, expected credit losses are re-assessed in accordance with IFRS 9, using the 2% probability that the borrower will default on the loan. The impairment allowance needed would be 2% × £3,000,000 = £60,000.

There is also a finance cost, being the unwinding of the discount on the allowance at initial recognition, which is 10% × £150,000 = £15,000. The impairment allowance at 30 September 20X2 is therefore:

	£'000
At 1 October 20X1 (Stage 1) (12-month expected credit losses)	150
Finance cost (unwind discount)	15
	165
Finance income (decrease in allowance)	(105)
At 30 September 20X2	60

The net carrying amount of the bond is therefore £3,300,000 – £60,000 = £3,240,000.

Net finance income (including interest income) is £300,000 + £105,000 – £15,000 = £390,000:

30 September 20X2		**£**	**£**
DEBIT	Financial asset	390,000	
CREDIT	Profit or loss		390,000

(b) **Financial liability**

IFRS 9, *Financial Instruments* requires that financial liabilities which are designated as measured at fair value through profit or loss are treated differently where part of a gain or loss relates to an entity's own creditworthiness. In this case the gain or loss in a period must be classified into:

- gain or loss resulting from credit risk; and
- other gain or loss.

This provision of IFRS 9 was in response to an anomaly regarding changes in the credit risk of a financial liability.

Changes in a financial liability's credit risk affect the fair value of that financial liability. This means that when an entity's creditworthiness deteriorates, the fair value of its issued debt will decrease (and vice versa). IFRS 9 requires the gain or loss as a result of credit risk to be recognised in other comprehensive income, unless it creates or enlarges an accounting mismatch, in which case it is recognised in profit or loss. The other gain or loss (not the result of credit risk) is recognised in profit or loss.

On derecognition any gains or losses recognised in other comprehensive income are not transferred to profit or loss, although the cumulative gain or loss may be transferred within equity.

This is a decrease in the fair value of the liability, which is a fair value gain in the books of Finney. Finney should split the fair value decrease as follows:

Statement of profit or loss and other comprehensive income (extract) for the year ended 30 September 20X2

Profit or loss for the year

	£m
Fair value gain not attributable to change in credit risk	8
Profit (loss) for the year	8

Other comprehensive income (not reclassified to profit or loss)

	£m
Fair value gain on financial liability attributable to change in credit risk	2
Total comprehensive income	10

The journal entries are therefore:

DEBIT	Financial liability	£10m	
CREDIT	Profit or loss		£8m
CREDIT	Other comprehensive income		£2m

(c) **Copper inventories contract**

This is potentially a fair value hedge as it relates to a change in the fair value of an existing asset.

IFRS 9, *Financial Instruments* has an objective-based assessment for hedge effectiveness, under which the following criteria must be met.

(1) There is an economic relationship between the hedged item and the hedging instrument ie, the hedging instrument and the hedged item have values that generally move in the opposite direction because of the same risk, which is the hedged risk.

(2) The effect of credit risk does not dominate the value changes that result from that economic relationship ie, the fair value changes due to credit risk are not a significant driver of the fair value changes of either the hedging instrument or the hedged item.

(3) The hedge ratio of the hedging relationship (quantity of hedging instrument vs quantity of hedged item) is the same as that resulting from the quantity of the hedged item that the entity actually hedges and the quantity of the hedging instrument that the entity actually uses to hedge that quantity of hedged item.

At the inception of the contract the hedge would be effective as it was designated by the compliance department as satisfying the rules.

At 30 September 20X2 the inventories (the hedged item) have fallen in value by £1 million (1,000 tonnes at (£9,200 – £8,200 a tonne)) and the futures contract (the hedging instrument) has increased in value by £950,000. IFRS 9 does not specify in detail how hedge values should be determined but in this case the two alternatives give the same answer (this need not necessarily be the case due to transaction costs and market inefficiencies).

One way of considering the change in value of the hedge instrument is to consider changes in the value of copper per tonne in the futures market measured by a futures contract written at 30 September 20X2 for delivery of copper at 31 December 20X2. This is £8,250 a tonne. On 1 July 20X2 the same contract cost £9,200 per tonne so the change in value of copper on the futures market is £950 (ie, £9,200 – £8,250) per tonne.

Another way of considering the change in value of the hedge instrument is to consider change in the value of the original futures contract itself (not the change in copper prices on the futures market). The futures contract written on 1 July 20X2 requires the holder to sell copper on 31 December for £9,200, whereas to write a contract for delivery on 30 September of copper would now only give a selling price of £8,250. The original contract has increased in fair value from zero to £950 as the contract has value at

30 September by entitling the holder to sell at a higher price than prevailing market conditions. (**Note:** Had copper prices increased – rather than decreased – the futures contract would have negative value ie, would be a liability, as it would have tied the holder into a sale at a price below the prevailing market price.)

Under either method of measurement, hedge effectiveness is therefore 95% (ie, the gain in the value of futures contract of £950,000 divided by loss in value of inventories of £1 million) and is therefore highly effective and so the IFRS hedge accounting rules can be applied.

If Finney invokes the hedge accounting rules then only the ineffective part of the hedge of £50,000 net impacts upon profit in the statement of profit or loss and other comprehensive income. A financial asset of £950,000 is recognised in the statement of financial position, and the copper inventories are reduced in value by £1 million.

The double entry is therefore:

DEBIT	Financial asset	£950,000	
DEBIT	Profit or loss (hedging loss)	£50,000	
CREDIT	Inventories		£1 million

Had Finney not applied the hedging rules then the fall in the value of inventories of £1 million would have been taken to profit or loss via an increase in cost of sales as a result of the requirements of IAS 2 that inventory is shown at the lower of cost and NRV. The increase in the fair value of the futures contract would also be recognised in profit or loss, as it is a derivative and should be classified AFVTPL. The net effect on profit would therefore be the same but the gross amounts of the gain and the loss would be disclosed separately.

The double entry would have been:

DEBIT	Profit or loss (cost of sales)	£1 million	
CREDIT	Inventories		£1 million

And:

DEBIT	Financial asset	£950,000	
CREDIT	Profit or loss (gain on financial asset)		£950,000

Tutorial note

For the purposes of redrafting the financial statements we have assumed that hedging has been applied.

(d) **UK investment – Coppery plc**

These shares are held for trading and therefore correctly categorised as being at fair value through profit or loss.

The acquisition of Coppery by Zoomla means that one financial asset should be derecognised (the shares in Coppery), and replaced by another financial asset (the shares in Zoomla).

As such, a gain on disposal in respect of the shares in Coppery should be recognised in profit or loss.

This is calculated as:

	£'000
Fair value of shares in Zoomla (£1.10 × 2 × 2m)	4,400
Fair value of cash receivable (2m × 0.15)/1.1	273
Net proceeds	4,673
Carrying amount of Coppery shares (3,200 + 300)	(3,500)
Gain on derecognition taken to profit or loss	1,173

A receivable should be recognised in the statement of financial position for the cash due from Zoomla, after taking into consideration the change in the present value for six months.

Therefore a current asset receivable of £286,039 (£300,000/$(1.1)^{0.5}$) is recognised in the statement of financial position at 30 September 20X2. Finance income of £13,312 (£286,039 – £272,727) is credited to profit or loss.

Tutorial note

Alternatively the finance income could be calculated as (½ × (300,000 – 300,000/1.1)) = £13,636. The receivable at 30 September 20X2 would be £286,363 (£272,727 + £13,636).

Unless there is evidence to the contrary, the investment in Zoomla should be treated as an equity investment at fair value through profit or loss, and restated to fair value at 30 September 20X2 of £4.8 million (4m × 120 pence).

The increase in fair value of £400,000 should be recognised in profit or loss. This accounting treatment would also apply to fair value movements in future accounting periods.

The journals are:

Acquisition of Coppery by Zoomla

		£m	**£m**
DEBIT	Investment in Zoomla	4.4	
DEBIT	Receivable	0.273	
CREDIT	Investment in Coppery		3.5
CREDIT	Gain on disposal		1.173

Gain on equity investment in the year

		£m	£m
DEBIT	Investment in Zoomla	0.4	
CREDIT	Profit or loss		0.4

Finance income in the year

		£m	£m
DEBIT	Receivable	0.013	
CREDIT	Finance income		0.013

Share appreciation rights

Share appreciation rights are cash-settled share-based payments. IFRS 2, *Share-based Payment* requires that the entity should measure the goods or services acquired and the liability incurred at the fair value of the liability. The fair value of the liability should be measured at each reporting date until the liability is settled and at the date of settlement. Any changes in fair value are recognised in profit or loss for the period.

	£
1 October 20X1 liability b/f: (200 – 30 (managers)) × 300 SARS × £14 (fair value) × 2/2 (vested)	714,000
Cash paid on exercise: 40 managers × 300 SARS × £21 (intrinsic value)	(252,000)
Expense (balancing figure)	474,000
30 September 20X2 liability c/f: (200 – 30 – 40 (managers)) × 300 SARS × £24 (fair value)	936,000

The expense for the year is accounted for as follows:

DEBIT	Expense (P/L)	£474,000	
CREDIT	Cash		£252,000
CREDIT	Liability		£222,000

(2) Statement of profit or loss and other comprehensive income for year ended 30 September 20X2

	Draft 20X2 £m	Loan stock £m	Financial liability £m	Copper contract £m	Coppery £m	Zoomla £m	Share appn. rights £m	Revised 20X2 £m
Revenue	194							194.00
Cost of sales	(111)							(111.00)
Gross profit	83							83.00
Operating costs	(31)							(31.00)
Gain on disposal	–				1.17			1.17
Operating profit	52							53.17
Share-based payment							(0.5)	(0.50)
Gain on IEI						0.4		0.40
Finance income	3	0.39	8		0.01			11.40
Hedging loss	–			(0.05)				(0.05)
Interest payable	(16)							(16.00)
Profit before taxation	39							48.42
Taxation	(8)							(8.00)
Profit for the year	31							40.42
Other comprehensive income	7		2					9.00
Total comprehensive income for the year	38							49.42

Statement of financial position as at 30 September 20X2

	Draft 20X2 £m	Loan stock £m	Financial liability £m	Copper contract £m	Coppery £m	Zoomla £m	Share appn. rights £m	Revised 20X2 £m
Non-current assets								
Property, plant and equipment	84							84.00
Investment in equity instruments	36				(3.5)	4.4 0.4		37.30
Other financial assets	10	0.39		0.95				11.34
Inventories	66			(1)				65.00
Receivables	56				0.01 0.27			56.28
Total assets	252							253.92
Share capital: £1 shares	75							75.00
Retained earnings	97	0.39	8	(0.05)	1.18	0.4	(0.5)	106.42
Other components of equity	24		2					26.00
Non-current liabilities	27		(10)					17.00
Current liabilities								
Trade and other payables	18						0.2	18.20
Overdraft	11						0.3	11.30
Total equity and liabilities	252							253.92

3 Maxvol

Marking guide

Requirement	Marks	Skills
(a) Set out the ethical and professional issues that arise for L&K and explain the implications for L&K noting any actions that it should take. Identify any additional information you believe L&K should seek.	5	Explain that fee dispute would not present an ethical issue but a commercial impact on the decision to accept the appointment. Identify the perspectives of both parties in the fee dispute. Determine that tax fraud may be a reason for not accepting the appointment as auditor. Use technical knowledge to explain that SBA cannot deny access to working papers according to CA 2006 once formal appointment has been made. Appreciate the implication of any lack of independence of SBA on the non-audit work as well as the reliability of the brought forward balances.
(b) Use analytical procedures (financial statement analysis) to identify and explain the audit risks for the audit of Remixit for the year ending 31 December 20X4 assuming that we accept the Remixit audit engagement. For each risk, set out the key audit procedures you believe we should perform.	18	Link information to identify potential for creative accounting deriving from the deferred consideration for Remixit shares and bank loan renegotiation. Use financial statement analysis to determine that: • profit target under achieving • discrepancy between gross profit and net profit ratios • fall in return on capital employed ratio • increase in current assets out of line with increase in revenue; inventory has increased and may be obsolescent • current liabilities have not increased; may be understated

Requirement	Marks	Skills
		Assimilate information from various parts of the scenario to determine potential misstatement of tax balances. Identify the need for specialist tax advice. Apply technical knowledge to explain incorrect financial reporting treatment of: • valuation of property not in accordance with IFRS 13 • restructuring provision Apply scepticism to the level of current liabilities to identify the potential for understatement. Identify the risks arising from the claim for faulty goods on inventory and other balances. Determine relevant audit procedures for risk identified. Apply scepticism to the quality of work to be performed by the Remixit finance department. Identify the audit risk from dominant personality of Barry and the risks arising from the contingent consideration.
(c) Explain for the Maxvol group for the year ending 31 December 20X4: – The financial reporting issues which arise as a consequence of the Remixit acquisition; and	5	Distinguish between financial reporting issues at company and group level. Apply technical knowledge to determine incorrect treatment of contingent consideration and impact on group financial statements. Distinguish between the treatment of contingent liabilities and the restructuring provision at group and company level.

Requirement	Marks	Skills
– The group audit issues arising from the acquisition. Exclude any issues already raised for the Remixit audit, unless there are different implications for the group. Audit procedures are not required at the moment.	5	Appreciate the timing and materiality of the acquisition on the group audit work. Demonstrate appropriate oversight and challenge of the work performed by the subsidiary auditors. Explain the need for separate audit teams and the overall responsibility of group auditors.
Total marks available	**33**	
Maximum marks	**30**	

(a) **Implications of ethical and professional issues and actions L&K should take**

There are a number of ethical and professional issues raised by and in respect of the previous auditor. However, as L&K are already group auditors, they will be keen to accept appointment as auditor of Remixit if possible and will, in any event, need to gain assurance on Remixit's results from the perspective of group auditor.

Tax matters

The information provided by SBA suggests that Remixit management may have been economical with the truth in the past regarding tax matters. This is information which might affect L&K's decision to act but again further information is required. In particular it is important to understand whether the individuals concerned are still working for the company and whether the chief executive, Barry Gibbons, is implicated. There may also be implications for the accuracy of tax provisions in the prior year accounts (see below).

Access to working papers and explanations

SBA's letter says that it will not grant access to its working papers or provide any further explanations. However the Companies Act 2006 says that it must provide the successor auditor with access to all relevant information, including access to relevant working papers. L&K should respond to the letter, setting out this requirement and stating that it will provide details of the information it requires in due course. It should also point out that this will not be a breach of confidence as it is done in accordance with a mandatory requirement. Remixit should however be informed.

The guidance says that the request should be made after the successor has been formally appointed so it cannot be made until the appointment decision has been made. L&K can however start to think about what information it requires as the guidance also requires the request to be as specific as possible.

Fee dispute

The fee dispute is not in itself a matter which should affect the decision to act but it is useful information and underlines the fact that Remixit (and Barry in particular) may be difficult to deal with. However, Kieran implies that there is another side to the dispute and that SBA may not have provided timely service.

Independence of SBA

A number of factors raise questions about the independence of SBA as auditor of Remixit and therefore the extent to which L&K can rely on the prior year audit work. These include the nature of the other services provided by SBA – tax advisory work; accounting advice; and preparation of accounts. None of these is automatically prohibited by the ethical standard but all raise a potential self-review threat in connection with the audit and, in addition, there may be a self-interest threat if the fees for this work are greater than the audit fee and significant to SBA. A management threat may also exist if the accounting advice and preparation work has strayed into the territory of SBA initiating transactions or undertaking work beyond that of a routine or mechanical nature, and this threat may have been of such significance that this work should have been declined. Additional information is required to assess this. Previous auditors' potential lack of independence is not a matter which would preclude acceptance but caution and full understanding are required.

In addition, SBA may have placed itself in a position of conflict by acting both for Barry in a personal capacity and for Remixit. This is not uncommon but should be part of the consideration.

The risk is further enhanced by the personal association between Barry and the SBA audit partner, although again this would not appear to be a prohibited relationship under the ethical standard but may raise a familiarity threat.

L&K should gain a full understanding of the non audit work performed and the relationships before determining how much reliance to place on SBA's work on the opening balances and how much work it should do itself to gain assurance over those balances. This might influence the extent to which a detailed working paper review is required and may also lead to specific questions about safeguards in the discussion with SBA.

If investigations show that SBA have acted inappropriately then L&K would have an obligation to report the firm to the ICAEW.

(b) **Use of analytical procedures (financial analysis) to identify and explain audit risks for Remixit audit and related audit procedures**

Management incentive/enhanced fraud risk

- There is a significant amount of contingent consideration payable to Barry which is dependent on the results of Remixit for the year ending 31 December 20X4. This gives Barry an incentive to manipulate the results of the company for his own personal benefit.
- Based on the results for the nine months to 30 September and assuming that profits accrue evenly throughout the year, Remixit is on track to make a profit of £2.7 million which is £300,000 short of the £3 million required for the additional consideration to be paid.
- No tax charge has been provided yet on the profit figure for the nine months to 30 September 20X4. The profit after tax figure will be lower. This would not affect the payment of the additional consideration, which is based on projected profit before tax, but is a matter of concern.
- The faulty product claim for a major customer may put more pressure on results if it has a significant effect on the company's reputation.
- Barry continues to work in the business in the role of chief executive and his response to the previous auditor and level of involvement in financial matters suggest that he might be a dominant personality used to getting his own way.
- There is also an allegation from the previous auditors that Remixit management may have been economical with the truth in the past. This would be of particular concern if it involved Barry.
- The expected renegotiation of the bank loans provides further incentive for management to present Remixit's financial results in a positive light. In particular, the bank's focus on Remixit's ability to service the loan in the future means that accounts related to liquidity ratios are particularly vulnerable to manipulation. (See current assets, current liabilities, and equity sections below.)

Audit procedures in response to this risk should include the following:

- Further enquiries about any past actual or suspected fraud.
- Detailed consideration of all judgmental provisions, including assessment of estimation uncertainty or whether there is any evidence of management bias (note: the determination of a suitable tax charge will be addressed in a subsequent section on taxation).
- Consideration of all late/unusual accounting adjustments or journal entries.
- Enhanced procedures on cut-off and completeness of liabilities.
- Enhanced procedures on revenue recognition as this may be an area which is open to manipulation according to the date on which systems or elements are accepted and revenue recognised.

- Detailed analytical review procedures to identify any unexplained or unusual trends which require further analysis (such as the projected increase in revenue).
- Consideration of items over which Barry has particular control such as the manipulation of his salary/bonus to ensure that the profit target is met.

Increase in current assets giving rise to potential risk of overstatement

Summary financial statements for Remixit at 30 September 20X4 show an increase in gross profit margin for 20X4 to 41.4% from 38.6% in 20X3. However, net profit margin has fallen from 24.3% in 20X3 to 24.1% in 20X4 (see workings in Appendix). The cause of this may be attributed to administrative expenses which have risen from £1,530,000 in 20X3 to a projected sum of £2,000,000 (£1,500,000 × 12/9) in 20X4, although this 30.7% increase seems disproportionate to the 8.4% increase in projected revenue. There may be some misclassification of expenditure items between cost of sales and administrative expenses to blame here, or some of these costs may simply be fixed costs that do not vary in line with activity, but our audit should investigate the causes of these discrepancies further.

Return on capital employed has fallen significantly from 86.7% in 20X3 to 47.5% in 20X4 (see Appendix). However, this ratio is distorted by a very large increase in equity, which may need further investigation, as discussed below.

Remixit's financial statements show a 37% increase in current assets compared to only an 8% increase in revenue (assuming revenue accrues evenly throughout the year). The current assets details show that inventory, in particular, has almost doubled from £1.3 million to £2.5 million as at 30 September 20X4. Consequently, inventory days have increased from 72 days in 20X3 to 134 days (see workings in Appendix). Remixit appears to have increasing difficulty in selling its inventory. Another consequence of this is that while the current ratio seems to have improved, in reality Remixit's ability to service future liabilities is compromised: the quick ratio has reduced from an already low 0.52 to 0.41. This fact is likely to cause concern when the company renegotiates its loan agreement in 20X5.

Particular audit focus should be given to the obsolescence of inventory and the adequacy of any provisions. In addition, Remixit's going concern status should be considered: cash flow forecasts should be reviewed, possibly along with a sensitivity analysis showing the likely impact should the bank withdraw the bank facility. We should discuss future financing plans with management and, where relevant, obtain evidence from Maxvol regarding the level of financial support it would provide to Remixit (loan guarantees or intercompany loans). In order to address the profitability issues discussed above, our approach should also consider the following:

- the use of data analytics software to interrogate expenses and confirm the correct classification between cost of sales and administrative expenses as well as attempting to isolate the fixed and variable elements
- determine whether the company's reported cost profile matches the reasons given for the anticipated increase in revenue

Composition of changes in equity

By 30 September 20X4, just before acquisition by Maxvol, Remixit's equity had increased in the year to date by £2.6 million. This was after £1 million of interim dividend had been paid, resulting in a charge to equity. Therefore, a total of £3.6 million has been credited to equity in the 9 months to 30 September 20X4.

£2 million of this relates to the profit to date. However, we will need to review the statement of changes in equity showing reconciliations between the carrying amounts at the beginning of the year and at the year end, to understand the other adjustments which have been made.

Where there has been a change of accounting policies, it will be important to discuss the rationale for the change with management, and consider whether it is correct for the accounting policy to be applied retrospectively. The increase in equity has caused Remixit's gearing ratio to drop from 100% to 35%. The imminent renegotiation of the bank loan may motivate Remixit's management to seek to present the company as low-risk, by manipulating the value of equity to give a lower gearing ratio. It is essential that we deploy suitable levels of professional scepticism when considering the responses to these queries.

Completeness of liabilities

Excluding the provision, current liabilities (mainly consisting of trade payables) have actually decreased despite an increase in activity. Remixit's current ratio has improved, from 1 to 1.25, suggesting that the company is in a better position to support its current liabilities than in 20X3. The loan renegotiation may incentivise Remixit's management to present a higher current ratio, so from an audit perspective, we need to consider the risk of unrecorded liabilities.

Remixit is expected to enter discussions with the bank regarding repayment of the existing loan and the setting up of a new loan in the next financial year. However, as negotiations have not yet started, there is no legal obligation on Remixit to repay the loan within 12 months. Accordingly, the portion of the £2 million loan that is repayable in more than 12 months' time should continue to be shown as a non-current liability. As part of the planning for the next year's audit, we need to understand the result of the renegotiations and consider how this will change the expected future cash flows arising from Remixit's bank loans, and what impact, if any, this has on the going concern assumption.

Audit procedures should include the following:

- Analytical procedures on expenses and accruals.
- Review of post year-end invoices received and payments made to ensure that appropriate accruals have been made where these relate to pre year-end items.
- Review of supplier statement reconciliations.

- Examination of minutes and other documents for evidence of any unrecorded liabilities such as approved bonuses, claims etc.
- Consideration of whether there is/should be a warranty provision given that the lawyer's response mentions a warranty period.

Taxation

The acquisition into the Maxvol group could affect Remixit's tax status and there may also be past issues as indicated by the letter from SBA. As a result, there is an enhanced risk that the tax balances may be misstated leading to the following recommended audit procedures:

- Specialist tax advice is likely to be required as part of our audit and a tax specialist should be identified and fully briefed.
- Details of prior-year tax computations and of any issues raised by HMRC should be obtained.
- The discussion with the previous auditors should include gaining a fuller understanding of the nature and implications of the situation where Remixit management were 'economical with the truth' as this may mean that there is a liability to future tax.
- Discussions should be held with Maxvol's tax department to understand any issues or concerns they have identified from their involvement in Remixit's tax affairs to date.
- Detailed work will be required on current and deferred tax balances.

Tangible non-current assets – valuation risk and disclosures

- In its own financial statements, Remixit has a choice as to whether to continue to record its land and buildings at cost less depreciation or include them at valuation. As the revaluation has been recorded in Remixit's financial statements, it seems likely that the revalued amount is to be used.
- Under IFRS 13, the asset should be valued at the price at which it could be sold in an orderly transaction in either the principal or most advantageous market. It should be at its highest and best value. This implies that the opportunity to sell the piece of land to a developer should potentially be taken into account, resulting in a higher value of £3.5 million and an additional £500,000 revaluation gain. In the most advantageous market, the amount received would be recorded after taking account of transaction costs and transport costs.

Audit procedures on this balance should include the following:

- Review of the detailed external valuation to ensure that the basis used is in accordance with IFRS 13.
- Consideration of the market evidence for the higher valuation of surplus land, including the likelihood of planning permission being granted for the change of use.
- Consideration of the qualifications of the valuer.

Depreciation rate for equipment – risk that the rate may not be appropriate

Equipment is being depreciated over a useful life of five years but discussion with Kieran suggests that its actual life may be much longer.

We need to look at evidence of actual lives and assess what would be the most appropriate useful life for each category of equipment as may not be appropriate to use the same rate for all.

Financial expertise of Remixit team

While additional expertise will now be provided by the Maxvol team there may have been transactions in the first nine months of the year, particularly in the months after SBA had resigned, where the Remixit team did not have enough expertise to determine the correct accounting treatment.

We should enquire as to whether there were any such one-off transactions and look carefully at the financial reporting treatment adopted.

Restructuring provision – risk of misstatement

Under IAS 37, provision for restructuring costs should only be made once a constructive obligation exists and a reliable estimate can be made. This is only the case if a detailed plan has been made and an announcement made to those affected.

We will need to establish whether the appropriate level of commitment and communication existed at 30 September 20X4, given that the restructuring appears to relate to an acquisition which took place the following day. We will also need support for the amounts included as may be a judgmental area capable of manipulation.

Contingent liability – risk associated with judgement and required disclosures

Assuming that the lawyer's assessment of the position remains unchanged, the claim should be disclosed as a contingent liability in Remixit's financial statements.

The key audit procedure here will be obtaining an updated view from Remixit's lawyers. We will also need to consider the broader implications of the faulty product, such as whether an increased provision for products under warranty is required, whether sales will be affected by the loss of reputation, whether any amounts due from the major customer are collectible etc.

(c) **Financial reporting issues and group audit issues arising from the acquisition of Remixit**

Date of acquisition

Need to ensure that the date from which Maxvol has included the results of Remixit is the date on which control passed – this will require scrutiny of the sale and purchase agreement.

Control

Maxvol owns 75% of Remixit and therefore would normally be presumed to have control. We should, however, check that there is nothing in S&P agreement which would change this.

Calculation of fair values and goodwill

Maxvol will need to reflect the acquisition of Remixit in its financial statements for the year ending 31 December 20X4 and record at fair value the separable net assets acquired.

There are a number of issues with the current calculation of goodwill set out by Gil:

- The contingent consideration has not been included in the calculation. IFRS 3 requires that contingent consideration be included and a liability recognised for the fair value of the cash amount payable even if it is not deemed probable that it will be paid. This liability will need to be reassessed once Remixit's results for the year ending 31 December 20X4 have been determined. If it is not payable then the liability will be released and a gain recognised in Maxvol's profit or loss for the year.
- Treatment of the non-controlling interest – at present this has been determined using the proportion of net assets method which is acceptable. However Maxvol could choose to use the fair value method and further discussion is required as to which is to be adopted.
- No taxation charge has been provided by Remixit for the period ending 30 September 20X4 but the tax liability at that date should form part of the calculation of fair values and so current and deferred tax balances should be determined.
- No valuation of equipment appears to have been performed at the acquisition date but equipment too should be valued at fair value in the calculation of goodwill and be brought into Maxvol's financial statements at that value. In addition, the deferred tax impact of the fair value adjustments needs to be taken into account.
- There may be other separable intangibles such as customer lists which should be identified separately from goodwill and a valuer will be required to assess this and determine the amounts of any such intangible assets.
- A liability should not be recognised by Maxvol on acquisition for costs such as reorganisation costs expected to be incurred as a result of the business combination. It would only do so were Remixit to be committed to the plan pre acquisition which seems unlikely here as it only arises due to savings which may be possible post acquisition. Hence the £400k provision should not be part of the fair value calculation.
- The contingent liability should however be included at fair value if the fair value can be measured reliably. This is the case even if an outflow is not probable.

- The matters identified as risks for the Remixit audit may all have implications for the assets and liabilities of Remixit at the acquisition date and these need to be taken into account. Also need to consider work done at the time of the acquisition and extent to which reliance can be placed on this.

Group audit issues

Timing of audit work – the Remixit financial statements were only completed in July in the prior year which is well after the Maxvol deadline for group reporting of 15 February. We need to ensure that the Remixit finance team have the support and resources required to meet this deadline.

Audit scoping generally – the acquisition of a material subsidiary will affect the determination of group audit materiality and also potentially the scope of work required at each significant component. This will need to be taken into account in planning the group audit.

A separate team from L&K will perform the component auditor's work at Remixit – the group audit team will need to assess the extent of the work performed by this team and the implications of any issues arising from the audit for the group audit report.

Specific audit procedures in respect of the consolidation of Remixit's results (once they are available) will need to be planned by the group audit team.

Appendix

	20X4 (projected)	20X3
Gross profit ratio	41.4% (3,600 × 12/9) ÷ (8,700 × 12/9)	38.6% 4,130/10,700
Net profit ratio	24.1% (2,100 × 12/9) ÷ (8,700 × 12/9)	24.3% 2,600/10,700
ROCE	47.5% (2,100 × 12/9) ÷ (4,100 + 1,450 + 550 – 200)	86.7% 2,600 ÷ (1,500 + 1,500 + 500 – 500)
Interest cover	28 times [(£2,100k ÷ 9/12)/(£75k ÷ 9/12)]	26 times (£2,600k/£100k)
Current ratio	1.25 (£3,700k/£2,950k)	1 (£2,700k/£2,700k)
Quick ratio	0.41 [(£3,700k – £2,500k)/£2,950k]	0.52 [(£2,700k – £1,300k)/£2,700k]
Gearing (long-term debt/equity)	35% (£1,450k/£4,100k)	100% (£1,500k/£1,500k)
Payable days	107 days (£2,000k/£5,100k) × 274	122 days (£2,200k/£6,570k) × 365
Inventory days	134 days (£2,500k/£5,100k) × 274	72 days (£1,300k/£6,570k) × 365
Receivables days	31 days (£1,000k/£8,700k) × 274	31 days (£900k/£10,700k) × 365

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