ADVANCED LEVEL EXAMINATION

Daisy

CORPORATE REPORTING

ANSWERS

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1 Elephant Ltd

Marking guide

Requirement	Marks	Skills
(1) In respect of each of the two audit issues identified by Kim Kerman (Exhibit 1), review relevant transactions in the data analytics software; and	20	Significance of year-end balance Incentives to misstate Entries indicating risk
• Set out and explain the appropriate financial reporting treatment, including correcting journal entries.		**Issue 1 Invoice finance** Identify SRC006970 £150k and SRC 006971 £75k in DAS Assimilate the scenario Identify that £225k is a loan Calculate interest expense and spread over 6 months Journals Consider need for loss allowance Show or explain presentation for the SOFP of trade receivables and CRD payable
• Identify and explain the key audit risks and procedures.		Appropriate procedures addressing following risks: • Complex • Impairment • Going concern • Control risks
FR treatment		**Issue 2 Formstat loan** Explain FR – financial asset – initial measurement at fair value – PV of cash receipts Calculation of interest expense Subsequent measurement – amortised cost

Requirement	Marks	Skills
		Year-end balance – monetary asset retranslated at £1 = €1.10 PorL – calculate interest income Calculate exchange gain Explain loss allowance required Journal
Audit risks and procedures		Risk that the loan is impaired Risk that 6% is not a market rate Classification not appropriate Control risk Related party risk Risk may be part of a barter transaction Appropriate procedures addressing risks
(2) In respect of Kim's preliminary analytical procedures for other receivables (Exhibit 2), for each of the accounts in 'loans to directors' and in 'other car loans' (Exhibit 2), review relevant transactions in the data analytics software and: • Identify and explain the key audit risks • Set out the information and explanations that you need from Elephant's management.	12	**Loans to directors** Confirm transactions in DAS to support explanation Give examples from DAS of debit and credit transactions from bank current account to directors' loan accounts Identify date error Transparency and disclosure Legality Impairment Relevant questions to support FR treatment and audit risks.
Examine transactions		**Other car loans** Identify potential incorrect treatment of expenses and lease contracts Give examples of transactions from DAS

Requirement	Marks	Skills
Audit risks		Costs incorrect in receivables – should be expensed – understate profit – overstate receivables Lease agreements not treated correctly
Information and explanations required		Relevant questions to support FR treatment and audit risk
(3) Set out and explain the financial reporting treatment for the Werbe plc share option scheme (Exhibit 3).	8	Explanation – of why expense recognised Identify equity settled transaction and explain Calculate £900,000 and spread over four years Expense £225,000 and journal
Total marks available	**55**	
Maximum marks	**40**	

(1) **Audit issue 1 invoice financing arrangements**

Appropriate financial reporting treatment

From examination of the transactions in the DAS in advance of the audit, I have familiarised myself with how the client records transactions with CRD.

Helen identified in her notes a transaction posted by Frank Wright as unusual.

Using the stacked bar chart – with effective period and document type as the secondary variable – the following transaction in September was identified and is unusual.

Tutorial note

There are different ways to use the DAS to arrive at this transaction, all are acceptable

Transaction ID	Account code	Amount	Effective date	Document type	Description	User ID
SRC006970	20010	150,000	29/09/2018	SRC sales receipt	Cash from invoice finance company	FWright
SRC006970	20021	-150,000	29/09/2018	SRC sales receipt	Cash from invoice finance company	FWright

This transaction is unusual because cash from CRD should be recorded as a nominal journal according to Helen's system notes. Frank has now told me about a new arrangement with CRD in which some of the trade receivables are sold with recourse and that cash received on these receivables is recorded as a SRC – sales receipt not as a Nominal journal.

There are 7 'SRC – sales receipts' debited in the bank account code 20010 and the double entry for 5 of these is as expected, which is a credit to trade receivables as per the systems notes prepared by Helen Holden.

I identified the above SRC – sales receipt for £150,000 which has been credited to Invoice finance and not to Trade receivables.

There is another credit transaction; SRC – sales receipt in the Invoice Finance account in December 2018 for £75,000 posted by A Bloggs.

Transaction ID	Account code	Amount	Effective date	Document type	Description	User ID
SRC006971	20010	75,000	29/12/2018	SRC sales receipt	Cash from invoice finance company	ABloggs
SRC006971	20021	-75,000	29/12/2018	SRC sales receipt	Cash from invoice finance company	ABloggs

I need to confirm the nature of these two amounts for £150,000 and £75,000 = £225,000 which I believe have been received under the new arrangement – this should be confirmed with further discussion with Frank Wright and with my audit procedures.

I also have identified using the stacked bar chart in the Invoice Finance account in December 2018, that only £55k of sales invoices have been transferred to CRD. This is out of line with the other months and should be investigated. It is possible that none of the invoices transferred under the new arrangement have been collected by CRD – I would need to confirm this with the client and obtain CRD's statement at 31 December 2018.

Financial reporting treatment

To advise on the financial reporting, a key question I need to ask Frank Wright is whether the £225k relates to the new arrangement and whether any of the receivables relating to this £225k have been collected by CRD.

Assuming that the £225k is paid under the new arrangement, CRD has effectively advanced a loan of £225k to Elephant – Frank Wright has said that trade receivables will be presented net of the invoice finance account balance. This presentation will understate receivables and understate the liabilities on Elephant's statement of financial position.

Under the new arrangement, CRD has the right to return receivables not collected within 6 months. This arrangement is 'with recourse' with respect to some of the trade receivables balance.

The appropriate financial reporting under IFRS 9 is to recognise the receivable and the finance creditor separately – trade receivables are not derecognised.

Although this does not impact on profit for the year it will significantly change the picture presented by the SOFP – as the company is hoping to raise finance from the bank, any conditions regarding the relationship of debt to equity will be affected by the presentation of the invoice finance account as a payable.

Elephant has received cash representing 90% of its transferred receivables in cash, but whether it can retain this amount permanently is dependent on the performance of CRD in recovering all of the receivables.

Elephant may have to repay some of it and therefore retains the risks and rewards of 100% of the receivables amount. Therefore, we need to consider whether an allowance is appropriate against trade receivables.

The receivables should not be derecognised and the £225k should not be presented as a reduction of receivables but as a loan.

The 10% of the receivables that Elephant will never receive in cash should be treated as interest over the six-month period; it should be recognised as an expense in profit or loss and increase the carrying amount of the loan.

At the end of the six months, the receivables should be derecognised by netting them against the amount of the loan that does not need to be repaid to CRD. The amount remaining is bad debts which should be recognised as an expense in profit or loss.

Assuming that £225,000 represents 90% of the trade receivables transferred under the new contract, an interest charge of £25,000 should be recognised in the statement of profit or loss over the 6 months of the contract period. Therefore, an expense of £12,500 should be recognised in the year ended 31 December 2018.

		£
DEBIT	Interest	12,500
CREDIT	Loan from CRD	12,500

Being interest expense for 6 months

		£
DEBIT	Invoice finance	225,000
CREDIT	Loan from CRD	225,000

Being transfer of loan received from CRD

Presentation on the statement of financial position

Account Code	Account Description	31 December 2017	31 December 2018	Difference	Increase /decrease
		£	£	£	%
21010	Receivables Control Account	364,641	610,382	245,741	↑67%
20021	Invoice Finance account	54,578	(425,414 – 225,000) = (200,414)	(254,992)	↑467%
Trade receivables net of invoice finance		419,219	409,968	(9,251)	↓2.2%
Loan from CRD – payable (225,000 + 12,500)			237,500		

Loss allowance

For trade receivables that do not have an IFRS 15 financing element, the loss allowance is measured at the lifetime expected credit losses, from initial recognition.

For other trade receivables, the entity can choose (as a separate accounting policy for trade receivables) to apply the three-stage approach or to recognise an allowance for lifetime expected credit losses from initial recognition.

Further information on the expected loss provision is required before an adjustment can be recommended.

Identify and explain the key audit risks and procedures

The key audit risks arising from the new arrangement for invoice financing and how to address it in each case:

Audit risks	Key procedures
The agreement is now more complex which increases the audit risk that the accountant has not understood the significance of the change and this is evidenced by his intention to treat the invoice finance account as a deduction from receivables	Examine the contract with CRD to agree terms and ensure appropriate financial reporting treatment. Reconcile the year-end balances to a statement from CRD to confirm the finance advanced and the amount of receivables transferred with recourse

Audit risks	Key procedures
Due to the complexity of the arrangement, the client's staff may record the transactions for the existing arrangement incorrectly	Select a sample of invoices sent to CRD under the existing terms and new terms and agree to the correct recording in the client's accounting records
For those trade receivables under the new arrangements, Elephant has handed the control over the collection of its trade receivables to CRD which increases the risk that the receivables are not collected, and the impairment allowance is understated. As CRD can return the receivable after 6 months if it's not collected, this will increase further the chance that the receivable is not recoverable.	Examine the controls over client acceptance procedures to ensure valid. Confirm control procedures for credit worthiness by agreeing to credit checks undertaken by Elephant under client acceptance procedures Evaluate the probability that receivables will be returned to Elephant and determine whether an impairment charge should be calculated
There is a control risk as there is a mixed portfolio of old arrangement and new arrangement receivables which need separate identification and treatment in Elephant's accounting records. Regular reconciliations appear not to be performed between CRD's statement and the accounting records – this increases the control risk over the recognition and potential impairment of receivables.	Reperform the reconciliation of the year end statement from CRD to the accounting records at 31 December 2018 Obtain independent confirmation of the balances with CRD
Using short term finance of this nature increases the risk of going concern issues	Perform a going concern review to determine whether the financial statements are fairly stated

Audit issue 2 Formstat loan £315,641

Appropriate financial reporting

The loan to Formstat represents a financial asset for Elephant. IFRS 9 requires a financial asset to be measured initially at fair value. A zero-interest rate loan issued at par would not result in an arm's length transaction and IFRS 9 requires the fair value in such a case to be determined as the present value of the cash receipts under the effective interest rate method.

The discount rate should be equivalent to that of similar loans. The loan will meet the business model test and the contractual cash flows test (payments of principal, being the initial and redemption values). It should be subsequently measured at amortised cost.

The initial fair value of the loan when issued on 1 January 2018 is therefore:

€378,769/$(1.06)^2$ = €337,103

In terms of sterling this is translated at

€337,103 / 1.20 = £280,919

The difference of the £315,641 and £280,919 = £34,722 is recognised as an expense in the statement of profit or loss.

Each year the unwinding of the loan for 6% will be treated as finance income. It would be appropriate to use the amortised cost method as the loan is a non-derivative financial asset; there is a determinable repayment date and the intention appears to hold the investment to maturity. The loan at the financial year end of 31 December 2018 is:

€337,103 × 1.06 = €357,329

This is a monetary asset and would be translated at the year-end rate of £1 = €1.10. In the financial statements of Elephant, it would therefore be translated as:

€357,329/ 1.10 = £324,845

There are two elements to this transaction for financial reporting purposes:

- Interest income on the loan
- Exchange gain

Interest income

The interest income is recognised at the effective rate, even though there is no cash interest received.

As the interest accrues over the year, it is translated at the average exchange rate.

The interest in € is therefore:

€337,103 × 6% = €20,226 – translated at the average rate of £1 = €1.15 = £17,588

Exchange gain

The exchange gain has two elements:

On the interest is (€20,226/1.15) £17,588 – (€20,226/1.10) £18,387 = £799

On the loan is (€337,103/1.2) £280,919 – (€337,103/1.10) £306,457 = £25,538

Credit loss – impairment

On initial recognition of the financial asset, an impairment allowance is recognised based on 12-month expected credit losses. Further information will be required to make this adjustment.

Correcting journal entries are as follows:

	£
DEBIT Interest cost £315,641 – £280,919	34,722
CREDIT Formstat – financial asset	34,722
CREDIT Exchange differences (£799 + £25,538)	26,337
CREDIT Interest income	17,588
DEBIT Formstat financial asset	43,925

Identify and explain the key audit risks and procedures

The key audit risks arising from the Formstat loan and how to address it in each case:

Audit risks	Procedures
Formstat may not be able to repay the loan and it would then be impaired. This is a key risk as there are no cash interest payments to observe that these can at least be serviced.	Confirm procedures used to verify the creditworthiness of Formstat when the loan was originally extended. Verify the terms of the loan and whether any security has been pledged if the loan is not repaid – eg, enquire whether there is a charge over assets as security for the loan.
The market rate of interest of 6% may not be a risk equivalent in which case the measurement of the loan and the interest payments would be incorrect.	Compare rates to corporate loans to similar companies where interest is paid in full.
Classification of the loan as loans and receivables may be inappropriate. There is a control risk in authorising a large loan on favourable terms.	Confirm level of authorisation of loan (main board) and agree to board minute. Confirm treasury procedures to attest information on creditworthiness, legal advice and means of drawing up loan agreements. Recommend the correct financial reporting treatment of the loan.
Consider whether there is a risk of a link between the provision of the loan and the supply of services to Formstat.	Examine the contractual supply agreement with Formstat – to ensure that sales are made at market rates.
Given the generous terms of the loan, there is a risk that there is a related party connection.	Challenge management about the connections and relationship with Formstat. Review board minutes for contracts and arrangements with Formstat.

Audit risks	Procedures
Jo Holme has referred to a deal on the price charged to Elephant by Formstat for services - there is a risk of inappropriate revenue recognition for sales to Formstat – could be a barter transaction.	Prepare analytical procedures on history of sales to Formstat and determine whether current sales are made under similar terms.

(2) **Key audit risks and outstanding information and explanations**

Loans to directors

Kim has identified the percentage changes and the nature of three of the loans – 1, 5 and 7 – as loans to directors.

In the question, Frank told Kim Kerman that, to increase profit in the year ended 31 December 2017 and 2018, Amy, Gerry and Jo agreed to take out loans from Elephant instead of receiving remuneration. He has recorded these in the car loan accounts 1, 5 and 7 – Account codes 26500, 26520 and 26530.

From examination of the transactions in these accounts in the DAS, it appears that this has continued in the year ended 31 December 2018 and the directors' loan account balances are now significant and have a material impact on the statement of financial position at 31 December 2018.

Each account shows entries from the bank current account to the debit of the car loan accounts.

For example:

Account code 26500 Car loan 1 A Quincey shows monthly debit entries which are transfers from the bank current account.

For example, Transaction NOM060406 – a debit to Car Loan 1 of £4,940 with the reference A Quincey salary.

These debit transactions represent a total of £81,453 paid to A Quincey.

	£
12 × £4,940	59,280
AQ Tax	10,915
1 × £11,258	11,258
	81,453

The credit entries total £7,053. These are salary journals which are credited to the directors' loan accounts to reduce the balance outstanding.

For example, transaction NOM060096 Sal Jnl March 2017 £520.

The dates appear to be incorrect on these salary journals and this will be queried with Frank Wright.

Key audit risks

There are risks over the transparency and disclosure and legality of these loans as well as a possible impairment issue.

- Transparency and disclosure

The nature of the audit risk is that the loans may not be appropriately disclosed in the accounts. The accounts are called 'car loan' – this is an odd description – there may be an attempt to conceal the loans from the company's parent company.

The directors may not be acting transparently – replacing remuneration with a loan will reduce expenses and increase profit and without adequate disclosure the reported profit and the statement of financial position would not be presented fairly.

Loans to directors are related party transactions which require disclosure in the financial statements.

If the financial statements (or directors' remuneration report) omit or incorrectly disclose information on directors' emoluments, loans and other transactions, the correct disclosure must be included in the auditor's report (due to the particularly sensitive nature of this information and its importance to users of the accounts).

- Legality

The CA 2006 imposes restrictions on dealings between a company and its directors in order to prevent directors taking advantage of their position.

Disclosures ensure that shareholders and other stakeholders will be informed about all the significant transactions entered into by a company with its management that might benefit those individuals.

Members' approval of directors' loans is required for all companies.

The following rules apply to all companies:

Loans > £10,000 must be approved by the members of the company. In order for the resolution to be passed, members must be provided with details of the nature of the transaction, the amount of the loan and the purpose for which it is required and the extent of the company's liability.

Advances for legitimate business expenditure do not require approval. However, the value of any transaction is not allowed to exceed £50,000.

- Impairment

The total of the loans is £326,268 – this is significantly greater than materiality and the increase from the previous year is £203,047. Examination of the transactions in these accounts show that the directors appear to each have repaid £20,000 in January 2018.

For example, see NOM059602 in account code 26500. However, £20,000 has been drawn down on 10/2/2018 – see NOM059861 £20,000.

Information and explanations from management

- Inquire of management as to the reason for the existence of the loan accounts with directors.
- Obtain evidence that the loans are appropriately disclosed and authorised.
- Request copy of loan documentation (if any) and examine loan terms to ensure financial reporting treatment is correct.
- Obtain management representations confirming the existence of the loans at year end and recoverability of the loans.
- Inquire about the repayment terms and the directors' intention to repay loans.
- There may be other legal and tax implications, ask directors to confirm and provide evidence that the loans are compliant with company and tax law.
- Ask for an explanation of why the salary journals are dated 2017.

Other car loans

Kim has said that 'the increases for each of the accounts with a 'car loan' account code from the year ended 31 December 2017 to 31 December 2018 are not material'.

However, Account code 26505 car loan 2 £46,293 and Account code 26537 Car loan 8 £37,113 year end balances are greater than £30,000 materiality and these should be investigated.

Cumulatively – the other year end balances too exceed materiality and given the nature of the balances these should be aggregated and examined as one line item.

Costs included in receivables which should be expenses

An examination of these accounts reveals that expenses which should be debited to profit or loss have been included in the receivable balance – this understates profit for the year and overstates receivables.

For example, Car loan 8 Account code 26537 includes costs for

NOM059014 Shell Pepys SS – JH Dec/Fuel £70

NOM058826 Admiral insurance £73

NOM059369 Halfords Wiper blades £40

Although these amounts are small in value individually, the amounts should be summarised as cumulatively to ascertain if the movements in these accounts exceed materiality. An audit adjustment should be recommended if the costs are valid business expenses to transfer these to the statement of profit or loss.

If the costs are not valid business expenses, then the costs should be transferred to the respective directors' loan account.

- Incorrect financial reporting treatment of car leases

Account code 26524 Car loan 6 includes costs of car leasing.

For example, NOM059666 – Volvo Car Leasing NG13KZD

There is an audit risk that leases have been incorrectly recognised in the financial statements.

Kim has not examined Account Code 26510 Other loan receivable – from examination of the transaction in this account code, it appears also to be an employee loan and should be included in Kim's sample.

For example, NOM059207 HSBC C Smith £697 debit

There are also two further accounts Car Loans 9 and 10 which have not been examined.

Audit risks

The key audit risk here is that expenses and profit are understated and other receivables overstated.

There is a risk that the financial reporting for leases is not correct which could materially understate assets and liabilities.

Additional information

- Inquire of management as to the reason for the existence of the other loan – confirm the nature of the loans.
- Enquire why costs which appear to be expenses are being recorded in receivables.
- Enquire about the nature of the account code 26510 – other loan receivable – who is C Smith?

(3) **Financial reporting treatment for Werbe plc share option scheme**

Frank's reasons for not adjusting for the share options are not valid.

No cash, no adjustment?

IFRS 2 requires an entity to recognise share-based payment transactions in its financial statements. Transactions in which an entity receives goods or services as consideration for equity instruments of the entity (including shares or share options) are share-based payment transactions. Such transactions give rise to expenses (or, if applicable, assets) that should be measured at fair value.

To ignore such costs would understate profit.

Options over shares in parent company?

Payment for goods or services received by an entity within a group may be made in the form of granting equity instruments of the parent company, or equity instruments of another group company.

Under IFRS 2 this type of transaction qualifies as an equity-settled, share-based payment transaction within the scope of IFRS 2.

Financial reporting treatment

Entries should have been made to record the estimated fair value of the share option scheme at the grant date. This amount should be recognised over the vesting period.

A share option expense should have been recorded as follows:

5,000 × 4 directors options × fair value of £45 = £900,000, which should be recognised equally over the four years to 31 December 2021 falling into financial years as follows:

Year ending	**£**
31 December 2018	225,000
31 December 2019	225,000
31 December 2020	225,000
31 December 2021	225,000

Journal

	£
Debit Expenses - remuneration	225,000
Credit Equity	225,000

APPENDIX TO THE ANSWER: QUESTION 1

The following section explains the data analytics 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 Corporate Reporting exam.)

The Advance information sets out the journals for the invoice finance arrangement. In preparation for the exam, it is advised that the invoice finance system notes in the Advance information are used to understand the recording of the transactions.

Using the Explore module, use the Accounts view: Asset to identify the relevant accounts:

- Account code 20021 – Invoice finance account
- Account code 21010 – Receivables
- Account code 20010 – Bank Account

And in Expenses:

- Account code 76010 – Bank charges and interest.

In the 11 months data:

Asset

ACCOUNT	PY BALANCE	CY BALANCE	DIFFERENCE		
11010 - Motor Vehicle 1	5,550	30,965	25,415	↑458 %	☐
11015 - Motor Vehicle 1 Depreciation	-1,388	-1,388	0	0 %	☐
12020 - Plant Equipment	1,311	1,311	0	0 %	☐
13010 - Fixtures & Fittings	24,278	50,736	26,457	↑109 %	☐
13020 - Office Equipment	183,432	286,101	102,669	↑56 %	☐
13025 - Office Equipment Depreciation	-141,653	-116,542	25,111	↓18 %	☐
20010 - Bank, Current Account	-2,424	114,392	116,816	↑4819 %	☑
20011 - Tracker Account	95	95	0	↑0 %	☐
20012 - Bank account 2	650	1,115	465	↑72 %	☐
20014 - Bank account 3	23,106	43,048	19,942	↑86 %	☐
20017 - Overseas bank account	100	100	0	0 %	☐
20021 - Invoice Finance account	54,578	-225,714	-280,291	↑514 %	☑
20030 - Petty Cash	400	738	338	↑84 %	☐
20040 - Credit card	-13,013	-14,537	-1,525	↑12 %	☐
21010 - Receivables Control Account	364,641	553,032	188,391	↑52 %	☑
21040 - Floats	100	100	0	0 %	☐
TOTAL SELECTED	**416,795**	**441,710**	**24,915**	**↑6 %**	

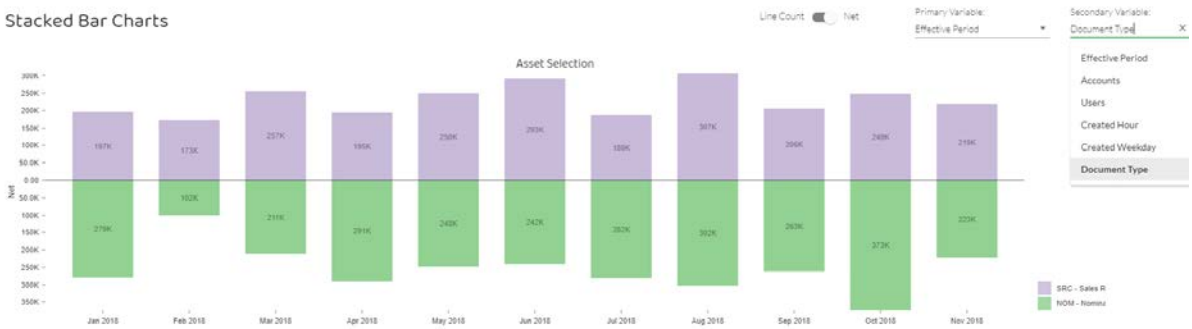
In Expenses in the 11 months data:

Expense

ACCOUNT	PY BALANCE	CY BALANCE	DIFFERENCE	
73020 - Postage	581	554	-27	↓5 %
73030 - Telephone, Office	4,269	4,544	275	↑6 %
73035 - Telephone - Mobile	9,868	9,158	-710	↓7 %
73040 - Computer Software	22,659	15,627	-7,031	↓31 %
73060 - Staff Welfare	5,896	5,159	-738	↓13 %
73070 - Subscriptions	9,757	6,674	-3,082	↓32 %
73090 - Sundry Admin Charges	1,022	1,007	-16	↓2 %
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	75,612	7,486	↑11 %

To follow the journal entries in advance of the examination:

Use Explore, assets, select Account code 20021 – Invoice finance account, set Primary variable to Effective period and secondary variable to Document type. This shows the total debit entries by month – SRC Sales receipts (transfers of invoices from Account code 21010 – Receivables) and credit entries – Nominal journals from Account code 20010 – Bank Account.



Select and click any Purple stack and drill down to a transaction. For example in June – SRC006770 shows a credit posting from trade receivables to debit invoice finance account with an invoice transferred to CRD.

Transaction 'SRC006770'

Transaction Id	Account Code	Amount	Effective Date	Document Type	Journal Description	User Id	Line Description	Entered Date
SRC006770	20021	13,277	02/06/2018	SRC - Sales Receipt	18712 - 18712	TPOTTS		08/06/2018
SRC006770	21010	-13,277	02/06/2018	SRC - Sales Receipt	- SRC006770 - Posting Run Control	TPOTTS		08/06/2018

Show 10 lines

Showing 1 to 2 of 2 lines

CANCEL

Click any green stack and drill down to a transaction. For example in April NOM060494 shows a debit posting from the bank account to credit invoice finance account with cash received from CRD.

Transaction 'NOM060494'

Transaction Id	Account Code	Amount	Effective Date	Document Type	Journal Description	User Id	Line Description	Entered Date
NOM060494	20010	50,000	05/04/2018	NOM - Nominal Journal	TFR	JSMITH	013345_004	11/04/2018
NOM060494	20021	-50,000	05/04/2018	NOM - Nominal Journal	TFR	JSMITH	013345_004	11/04/2018

Show 10 lines

Showing 1 to 2 of 2 lines

CANCEL

To identify the finance charges journal, select any green stack and drill down to a Close finance charge transaction. For example, in April NOM060845, shows the Credit of £15,151 to invoice finance and debit to 76010, bank charges and interest.

Transaction 'NOM060845'

Transaction Id	Account Code	Amount	Effective Date	Document Type	Journal Description	User Id	Line Description	Entered Date
NOM060845	76010	14,631	29/04/2018	NOM - Nominal Journal	Close Finance charge - Service Charge	ABLOGGS	014240_004	05/05/2018
NOM060845	76010	479	29/04/2018	NOM - Nominal Journal	Close Finance charge - discount charge	ABLOGGS	014240_004	05/05/2018
NOM060845	76010	27	29/04/2018	NOM - Nominal Journal	Close Finance charge - TT charge	ABLOGGS	014240_004	05/05/2018
NOM060845	76010	15	29/04/2018	NOM - Nominal Journal	Close Finance charge - Factoring charge	ABLOGGS	014240_004	05/05/2018
NOM060845	20021	-15,151	29/04/2018	NOM - Nominal Journal	Close Finance charge - May charges part to be credited	ABLOGGS	014240_004	05/05/2018

Show 10 lines

Showing 1 to 5 of 5 lines

CANCEL

In the Advance information, Helen refers to a specific SRC transaction in September. Select account code 20021 invoice finance, use the stacked bar chart – with effective period and document type as the secondary variable, select the purple September stack.

Review the transactions. The SRC transactions should be debit transactions – the last one is a credit transaction.

SRC006891	19088 - 19088	16,516	0	20021	29/09/2018	FWRIGHT	SRC - Sales Receipt	05/10/2018 18:00:01
SRC006892	19134 - 19134	600	0	20021	29/09/2018	ABLOGGS	SRC - Sales Receipt	05/10/2018 17:49:24
SRC006970	Cash from invoice finance company	0	150,000	20021	29/09/2018	FWRIGHT	SRC - Sales Receipt	05/10/2018 09:44:22

Drill down to identify the postings:

Transaction 'SRC006970'

Transaction Id	Account Code	Amount	Effective Date	Document Type	Journal Description	User Id	Line Description	Entered Date
SRC006970	20010	150,000	29/09/2018	SRC - Sales Receipt	Cash from invoice finance company	FWRIGHT		05/10/2018
SRC006970	20021	-150,000	29/09/2018	SRC - Sales Receipt	Cash from invoice finance company	FWRIGHT		05/10/2018

Show 10 lines

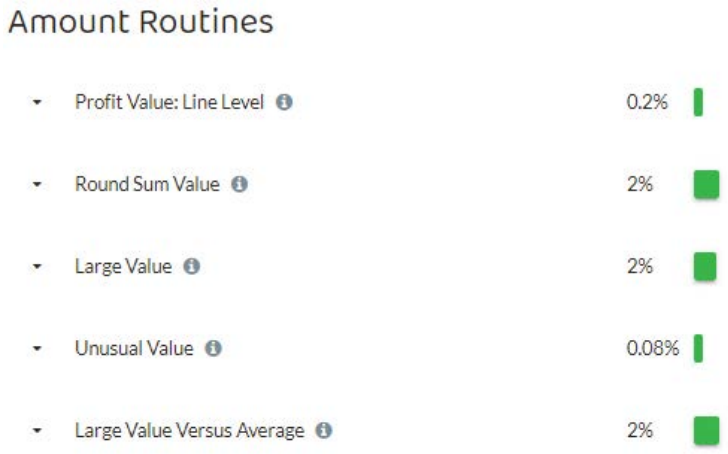
Showing 1 to 2 of 2 lines

CANCEL

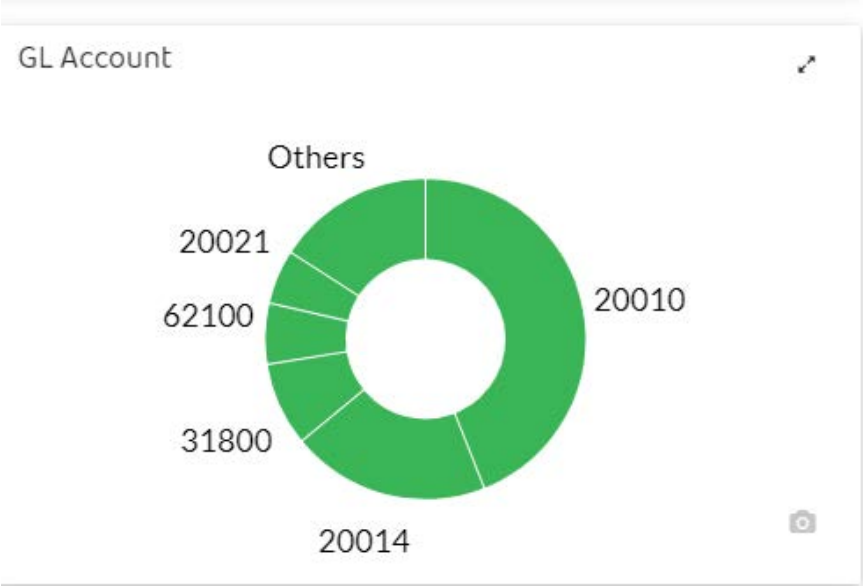
This is a cash receipt from the bank account, not an invoice transferred from trade receivables.

This transaction could also have been found using the detect module.

Select Large Value:



Select Account 20021:



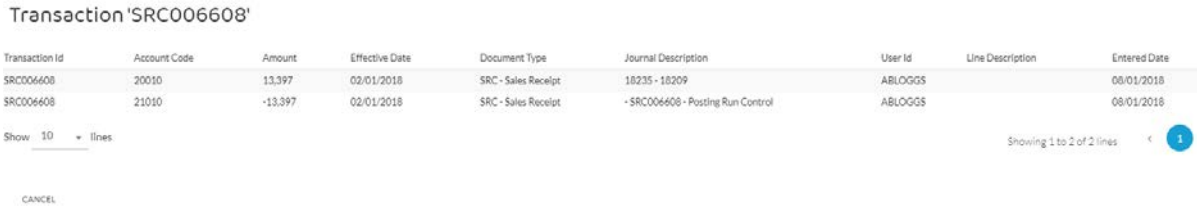
Review the large SRC transactions:

SRC006641	18250 - 18250	34,381	0	20021	06/02/2018	FWRIGHT	SRC - Sales Receipt	12/02/2018 06:49:08
SRC006690	18398 - 18398	38,760	0	20021	21/03/2018	ABLOGGS	SRC - Sales Receipt	27/03/2018 13:16:13
SRC006772	18724 - 18724	54,072	0	20021	05/06/2018	FWRIGHT	SRC - Sales Receipt	11/06/2018 19:05:07
SRC006829	18848 - 18848	65,691	0	20021	01/08/2018	FWRIGHT	SRC - Sales Receipt	07/08/2018 09:51:29
SRC006830	18914 - 18914	53,682	0	20021	01/08/2018	TPOTTS	SRC - Sales Receipt	07/08/2018 17:51:17
SRC006865	19042 - 19042	62,827	0	20021	04/09/2018	FWRIGHT	SRC - Sales Receipt	10/09/2018 13:50:39
SRC006889	19140 - 19140	102,177	0	20021	29/09/2018	FWRIGHT	SRC - Sales Receipt	05/10/2018 06:12:43
SRC006927	sin19201 - bgc	42,706	0	20021	27/10/2018	FWRIGHT	SRC - Sales Receipt	02/11/2018 08:09:03
SRC006928	19245 - 19245	52,808	0	20021	30/10/2018	TPOTTS	SRC - Sales Receipt	05/11/2018 12:48:48
SRC006970	Cash from invoice finance company	0	150,000	20021	29/09/2018	FWRIGHT	SRC - Sales Receipt	05/10/2018 09:44:22

To check whether there are any cash amounts posted to invoice finance which are not posted as Nominal journals, use Explore, select the Bank account code 20010, stacked bar chart with primary variable as effective period and secondary variable as document type:

The SRC sales receipt transactions are in orange. There are only a very small number of these in January and February. In preparation for the exam, select the stacks for January and February, click the SRC – orange areas and drill down to the transactions to check the postings.

January – SRC006608 – is a posting correctly to trade receivables as per Helen's system notes:



Transaction 'SRC006608'

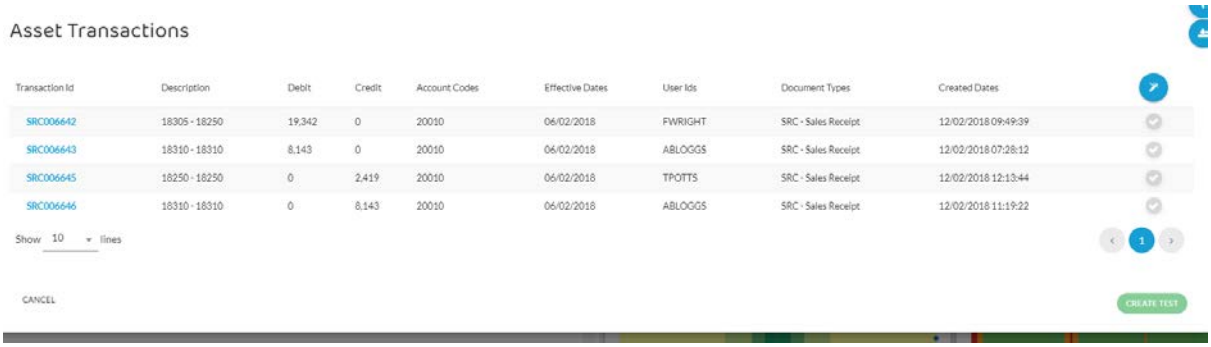
Transaction Id	Account Code	Amount	Effective Date	Document Type	Journal Description	User Id	Line Description	Entered Date
SRC006608	20010	13,397	02/01/2018	SRC - Sales Receipt	18235 - 18209	ABLOGGS		08/01/2018
SRC006608	21010	-13,397	02/01/2018	SRC - Sales Receipt	- SRC006608 - Posting Run Control	ABLOGGS		08/01/2018

Show 10 lines

Showing 1 to 2 of 2 lines

CANCEL

In February, there are four transactions which are also postings between the bank account and the trade receivables account.



Asset Transactions

Transaction Id	Description	Debit	Credit	Account Codes	Effective Dates	User Ids	Document Types	Created Dates
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

Show 10 lines

CANCEL

CREATE TEST

Click on the orange area in September to show the transaction identified by Helen above. This transaction is unusual because it is credited to Invoice finance and not to Trade receivables.

Transaction 'SRC006970'

Transaction Id	Account Code	Amount	Effective Date	Document Type	Journal Description	User Id	Line Description	Entered Date
SRC006970	20010	150,000	29/09/2018	SRC - Sales Receipt	Cash from invoice finance company	FWRIGHT		05/10/2018
SRC006970	20021	-150,000	29/09/2018	SRC - Sales Receipt	Cash from invoice finance company	FWRIGHT		05/10/2018

Show 10 lines

Showing 1 to 2 of 2 lines

CANCEL

In the examination, a further transaction of the same nature is discoverable in month 12:

Transaction 'SRC006971'

Transaction Id	Account Code	Amount	Effective Date	Document Type	Journal Description	User Id	Line Description	Entered Date
SRC006971	20010	75,000	29/12/2018	SRC - Sales Receipt	Cash from invoice finance company	ABLOGGS		04/01/2019
SRC006971	20021	-75,000	29/12/2018	SRC - Sales Receipt	Cash from invoice finance company	ABLOGGS		04/01/2019

Show 10 lines

Showing 1 to 2 of 2 lines

CANCEL

Using the stacked bar chart for Invoice Finance for December, confirms that only £55k sales invoices have been transferred to the invoice finance account for December:

Car loans

The exam question highlights the car loans 1, 5 and 7 – account codes 26500, 26520 and 26530.

To confirm the postings highlighted in the question, use accounts view, explore, select Car loan 1 account code 26500 – select view transactions and review the postings.

Asset Transactions

Transaction Id	Description	Debit	Credit	Account Codes	Effective Dates	User Ids	Document Types	Created Dates
NOM059106	A Quincey salary - A Quincey salary	4,940	0	26500	26/12/2018	TPOTTS	NOM - Nominal Journal	01/01/2019 14:54:39
NOM059203	TFR	11,258	0	26500	30/12/2018	FWRIGHT	NOM - Nominal Journal	05/01/2019 08:26:29
NOM059282	Salary Jnl Jan 2017 - January 2017 salary journal	0	520	26500	31/12/2018	JSMITH	NOM - Nominal Journal	06/01/2019 18:53:56
NOM059602	A Quincey - Loan from Director	0	20,000	26500	23/01/2018	ABLOGGS	NOM - Nominal Journal	29/01/2018 13:31:59
NOM059647	A Quincey salary - A Quincey salary	4,940	0	26500	26/01/2018	TPOTTS	NOM - Nominal Journal	01/02/2018 12:31:05
NOM059719	Salary Jnl Feb 2017 - Salary journal - February 2017	0	520	26500	28/01/2018	JSMITH	NOM - Nominal Journal	03/02/2018 06:13:47
NOM059861	TFR	20,000	0	26500	10/02/2018	ABLOGGS	NOM - Nominal Journal	16/02/2018 16:07:31
NOM060062	A Quincey salary - A Quincey salary	4,940	0	26500	23/02/2018	TPOTTS	NOM - Nominal Journal	01/03/2018 08:54:13
NOM060096	Sal Jnl March 2017 - Salary journal March 2017	0	520	26500	24/02/2018	ABLOGGS	NOM - Nominal Journal	02/03/2018 10:34:23
NOM060406	A Quincey salary - A Quincey salary	4,940	0	26500	27/03/2018	JSMITH	NOM - Nominal Journal	02/04/2018 08:19:07
NOM060459	Salary Jnl Apr 2017 - Salary journal April 2017	0	620	26500	30/03/2018	TPOTTS	NOM - Nominal Journal	05/04/2018 19:21:44
NOM060755	A Quincey salary - A Quincey salary	4,940	0	26500	25/04/2018	EDAVIDS	NOM - Nominal Journal	01/05/2018 12:56:59
NOM060893	Salary Jnl May 2017 - Salary journal May 2017	0	620	26500	30/04/2018	FWRIGHT	NOM - Nominal Journal	06/05/2018 14:45:20
NOM061183	A Quincey salary - A Quincey salary	4,940	0	26500	26/05/2018	ABLOGGS	NOM - Nominal Journal	01/06/2018 16:16:39
NOM061243	Salary journal - Salary journal June 2017	0	620	26500	30/05/2018	FWRIGHT	NOM - Nominal Journal	05/06/2018 10:30:21
NOM061298	710120 - 710120/HMRC - AQ Tax	10,915	0	26500	07/06/2018	ABLOGGS	NOM - Nominal Journal	13/06/2018 10:34:37
NOM061556	A Quincey salary - A Quincey salary	4,940	0	26500	26/06/2018	JSMITH	NOM - Nominal Journal	02/07/2018 10:10:52
NOM061621	Salary jnl July 2017 - Salary journal July 2017	0	613	26500	29/06/2018	FWRIGHT	NOM - Nominal Journal	05/07/2018 14:07:39
NOM061898	Salary Jnl Aug 2017 - Salary journal August 2017	0	604	26500	24/07/2018	FWRIGHT	NOM - Nominal Journal	30/07/2018 11:16:20

Drilling down shows the debit transactions are payments from the bank account. For example, transaction NOM059106.

Transaction 'NOM059106'

Transaction Id	Account Code	Amount	Effective Date	Document Type	Journal Description	User Id	Line Description	Entered Date
NOM059106	26500	4,940	26/12/2018	NOM - Nominal Journal	A Quincey salary - A Quincey salary	TPOTTS		01/01/2019
NOM059106	20010	-4,940	26/12/2018	NOM - Nominal Journal	A Quincey salary - A Quincey salary	TPOTTS		01/01/2019

Show 10 lines

Showing 1 to 2 of 2 lines

CANCEL

The credit transactions are part of a large salary journal recording costs and payroll liabilities.

Transaction 'NOM059282'

Transaction Id	Account Code	Amount	Effective Date	Document Type	Journal Description	User Id	Line Description	Entered Date
NOM059282	62100	56,463	31/12/2018	NOM - Nominal Journal	Salary Jnl Jan 2017 - January 2017 salary journal	JSMITH	013707_004	06/01/2019
NOM059282	62120	31,744	31/12/2018	NOM - Nominal Journal	Salary Jnl Jan 2017 - January 2017 salary journal	JSMITH	013737_004	06/01/2019
NOM059282	71000	10,139	31/12/2018	NOM - Nominal Journal	Salary Jnl Jan 2017 - January 2017 salary journal	JSMITH	013739_004	06/01/2019
NOM059282	71500	8,818	31/12/2018	NOM - Nominal Journal	Salary Jnl Jan 2017 - January 2017 salary journal	JSMITH	013787_004	06/01/2019
NOM059282	62105	5,234	31/12/2018	NOM - Nominal Journal	Salary Jnl Jan 2017 - January 2017 salary journal	JSMITH	013737_004	06/01/2019
NOM059282	62125	3,228	31/12/2018	NOM - Nominal Journal	Salary Jnl Jan 2017 - January 2017 salary journal	JSMITH	013737_004	06/01/2019
NOM059282	62130	2,895	31/12/2018	NOM - Nominal Journal	Salary Jnl Jan 2017 - January 2017 salary journal	JSMITH	013739_004	06/01/2019
NOM059282	71510	1,077	31/12/2018	NOM - Nominal Journal	Salary Jnl Jan 2017 - January 2017 salary journal	JSMITH	013846_004	06/01/2019
NOM059282	91060	686	31/12/2018	NOM - Nominal Journal	Salary Jnl Jan 2017 - January 2017 salary journal	JSMITH	013739_004	06/01/2019
NOM059282	62135	291	31/12/2018	NOM - Nominal Journal	Salary Jnl Jan 2017 - January 2017 salary journal	JSMITH	013739_004	06/01/2019
NOM059282	26520	-285	31/12/2018	NOM - Nominal Journal	Salary Jnl Jan 2017 - January 2017 salary journal	JSMITH	013697_004	06/01/2019
NOM059282	26530	-346	31/12/2018	NOM - Nominal Journal	Salary Jnl Jan 2017 - January 2017 salary journal	JSMITH	013697_004	06/01/2019
NOM059282	21200	-495	31/12/2018	NOM - Nominal Journal	Salary Jnl Jan 2017 - January 2017 salary journal	JSMITH	013697_004	06/01/2019
NOM059282	62100	-509	31/12/2018	NOM - Nominal Journal	Salary Jnl Jan 2017 - January 2017 salary journal	JSMITH	013737_004	06/01/2019
NOM059282	26500	-520	31/12/2018	NOM - Nominal Journal	Salary Jnl Jan 2017 - January 2017 salary journal	JSMITH	013697_004	06/01/2019
NOM059282	26561	-790	31/12/2018	NOM - Nominal Journal	Salary Jnl Jan 2017 - January 2017 salary journal	JSMITH	013706_004	06/01/2019
NOM059282	71060	-4,878	31/12/2018	NOM - Nominal Journal	Salary Jnl Jan 2017 - January 2017 salary journal	JSMITH	013787_004	06/01/2019
NOM059282	32010	-34,404	31/12/2018	NOM - Nominal Journal	Salary Jnl Jan 2017 - January 2017 salary journal	JSMITH	013707_004	06/01/2019
NOM059282	31800	-78,347	31/12/2018	NOM - Nominal Journal	Salary Jnl Jan 2017 - January 2017 salary journal	JSMITH	013706_004	06/01/2019

Show 100 lines

Showing 1 to 19 of 19 lines

CANCEL

To identify expenses which should be debited to expenses, review the transactions in Car loan 8. Use Explore – select account code 26537, click and review transactions.

Asset Transactions

Transaction Id	Description	Debit	Credit	Account Codes	Effective Dates	User Ids	Document Types	Created Dates
NOM058822	Lex Autolease - Lex Autolease/LH car	375	0	26537	02/12/2018	FWRIGHT	NOM - Nominal Journal	08/12/2018 06:49:23
NOM058826	Admiral Insurance - Admiral Ins/LH car	73	0	26537	05/12/2018	FWRIGHT	NOM - Nominal Journal	11/12/2018 17:24:14
NOM059014	Shell Pepys SS - JH Dec/Fuel	70	0	26537	02/12/2018	FWRIGHT	NOM - Nominal Journal	08/12/2018 09:37:27
NOM059057	ATS - ATS/MOT re LH car	39	0	26537	20/12/2018	EDAVIDS	NOM - Nominal Journal	26/12/2018 18:48:15
NOM059354	Jaguar - MT Jan/Winter tyres installed	72	0	26537	14/12/2018	TPOTTS	NOM - Nominal Journal	20/12/2018 07:30:32
NOM059369	Halfords - Halfords - Wiper Blades	40	0	26537	03/01/2018	ABLOGGS	NOM - Nominal Journal	09/01/2018 06:44:40
NOM059444	Lex Autolease - Lex Autolease/LH car	203	0	26537	12/01/2018	ABLOGGS	NOM - Nominal Journal	18/01/2018 07:07:33
NOM059459	Wetherby SS - JH Jan/Fuel	76	0	26537	01/01/2018	JSMITH	NOM - Nominal Journal	07/01/2018 18:38:16
NOM059494	RAC Insurance - JH Jan/LH car insurance	338	0	26537	28/12/2018	FWRIGHT	NOM - Nominal Journal	03/01/2019 13:05:22
NOM059495	RAC Insurance - JH Jan/LH car	4	0	26537	29/12/2018	FWRIGHT	NOM - Nominal Journal	04/01/2019 09:56:04

Show 10 lines

‹ 1 2 3 4 5 ... 9

2 **Snedd**

Scenario

This question involves adjusting the financial statements of three companies (a parent and two subsidiaries), and applying the principles of acquisition accounting to produce consolidated financial statements. The most recently acquired subsidiary is based overseas, and its results and position (in the form of a trial balance) require translation. Other issues covered include adjustments within and outside the measurement period, an adjustment to the overseas financial statements in order to comply with IFRS, payment of a supplier in ordinary shares and deferred tax adjustments.

Marking guide

Requirement	Marks	Skills
Acquisition of Bellte	8	Original calculation of goodwill, including: Correct treatment of contingent liability Non-controlling interest Fair value uplift of specialist plant Re-calculation of goodwill taking account of new information
Acquisition of Terald	7	Calculating increase in fair value of the financial asset Correct translation of SPLOCI and SOFP items Goodwill on consolidation
Deferred tax	4	Calculation of temporary differences Recognising deferred tax liability
Share-based payment	3	Explanation and adjusting entries correctly set out
Preparation of Snedd's consolidated statement of profit or loss and other comprehensive income for the year ended 31 May 20X4 and a consolidated statement of financial position at that date.	8	Taking account of adjustments Setting out workings clearly
Maximum/available marks	**30**	

Explanation of the correct financial reporting treatment, showing appropriate adjustments

1 **Investment in Bellte Ltd**

Goodwill on the acquisition date of 1 June 20X3 was originally calculated as follows:

	£'000	£'000
Consideration transferred		800.0
Non-controlling interest (25% × £922)		230.5
		1,030.5
Net assets acquired		
Net assets at carrying amount	932.0	
Less contingent liability at fair value	(20.0)	
Add fair value uplift in specialist plant (£60,000 – £50,000 (W1))	10.0	
		922.0
Goodwill on acquisition		108.5

WORKING

(1) Carrying amount of specialist plant at 1 June 20X3: 5/10 × £100,000 = £50,000

However, the goodwill amount of £108,500 was based upon provisional values. IFRS 3, *Business Combinations*, requires that during the measurement period following acquisition the acquirer should retrospectively adjust provisional amounts recognised at the acquisition date to reflect new information obtained about the facts and circumstances that existed at the acquisition date.

In this case, the settlement of the contingent liability occurred within the measurement period (which cannot exceed 12 months). The valuation of the specialist plant, however, did not occur until after the 12 months had elapsed, and therefore the provisional fair value cannot be retrospectively altered.

The recalculation of goodwill is as follows:

	£'000	£'000
Consideration transferred		800.0
Non-controlling interest (25% × £902)		225.5
		1,025.5
Net assets acquired		
Net assets at carrying amount	932.0	
Less contingent liability at fair value	(40.0)	
Add fair value uplift in specialist plant (£60,000 – £50,000 (W1))	10.0	
		902.0
Goodwill on acquisition		123.5

Goodwill is increased by the group's share of the additional value of the contingent liability (£40,000 – £20,000) × 75% = £15,000. NCI at acquisition is decreased by £5,000.

Tutorial note

Journal entries are required as follows:

		£'000	£'000
DEBIT	Goodwill	15	
DEBIT	Non-controlling interests	5	
DEBIT	Contingent liability recognised	20	
CREDIT	Bellte operating expenses		40

Treatment of specialist plant:

In the consolidated financial statements this plant was recognised at the date of acquisition, 1 June 20X3, at its provisional fair value of £60,000. At that date it had a remaining useful life of five years. Because the valuation of the plant was made after the end of the maximum measurement period of 12 months, the estimate of its value at the date of acquisition of 1 June 20X3 was no longer relevant, and therefore the provisional amount is not adjusted retrospectively.

In Bellte's own financial statements the carrying amount of the specialist plant at 31 May 20X4 was: £50,000 – (£50,000/5) = £40,000 ie, depreciated cost.

The carrying amount of the specialist plant in the consolidated financial statements at 31 May 20X4 is calculated as follows:

£60,000 – (£60,000/5) = £48,000

The consolidation adjustment required in respect of depreciation is:

(£60,000/5) – (£50,000/5) = £2,000

Tutorial note

A journal entry is required as follows:

		£'000	£'000
DEBIT	Cost of sales	2	
CREDIT	Non-current assets		2

2 **Investment in Terald Inc**

First, an adjustment must be made in respect of the measurement of the financial asset. The increase in fair value is D$5,000 which must be recognised as a gain in profit or loss, and as an increase in the carrying amount of the asset.

Profit for the year in Terald is D$20,000 (Revenue D$150,000 – cost of sales D$112,000 – operating expenses D$15,000 – tax D$3,000) before accounting for the fair value increase in respect of the financial asset, all of which is attributable to the post-acquisition period. Of the D$20,000 profit half is attributable to the pre-acquisition period (first six months of the year) and half is attributable to the post-acquisition period. Therefore, equity at the date of acquisition, 1 December 20X3, was D$160,000 (Share capital D$10,000 + Retained earnings at 1 June 20X3 D$140,000 + Pre-acquisition profit: D$10,000).

The amounts to be consolidated by Snedd are therefore as shown in the table below. In compliance with IAS 21, *The Effects of Changes in Foreign Exchange Rates*, profit or loss items are translated at average rate, and financial position items are translated at closing rate.

Profit or loss

	D$'000	**Rate**	**£'000**
Revenue (150/2)	75.0	2.1	35.7
Cost of sales (112/2)	(56.0)	2.1	(26.7)
Gross profit	19.0	2.1	9.0
Operating expenses (15/2)	(7.5)	2.1	(3.6)
Other income (fair value increase in financial asset)	5.0	2.1	2.4
Profit before tax	16.5	2.1	7.8
Tax (3/2)	(1.5)	2.1	(0.7)
Profit for the six months ended 31 May 20X4	15.0	2.1	7.1

Statement of financial position

	D$'000	**Rate**	**£'000**
Non-current assets (160 + 5)	165	2.2	75.0
Current assets	50	2.2	22.7
Total assets	215		97.7
Current liabilities	40	2.2	18.2
Therefore: equity	175	2.2	79.5
	215		97.7

Reconciliation of exchange gain/loss

Opening net assets of £80,000 (D$160/2) plus profit of £7,100 = £87,100. Closing net assets at closing rate = £79,500. Therefore there has been an exchange loss of £7,600 (£87,100 – £79,500):

Exchange loss

	£'000	£'000
Opening net assets of D$160 at opening rate of 2.0	80.0	
Opening net assets of D$160 at closing rate of 2.2	72.7	
		7.3
Profit for the six months ended 31 May 20X4 of D$15.0 at average rate of 2.1	7.1	
Profit for the six months ended 31 May 20X4 of D$15.0 at closing rate of 2.2	6.8	
		0.3
Exchange loss		7.6

Goodwill on consolidation is calculated as follows:

	D$
Consideration transferred: £100,000 × 2.0	200,000
Less net assets of Terald at date of acquisition	(160,000)
Goodwill	40,000

On 1 December 20X3, the sterling equivalent of goodwill was D$40,000/2 = £20,000.

This is retranslated on 31 May 20X4 at the closing rate of exchange of 2.2 = D$40,000/2.2 = £18,200 (to nearest £'000). There has therefore been a loss on exchange of £20,000 – £18,200 = £1,800.

The overall exchange loss of (£7,600 + £1,800) £9,400 is recognised in other comprehensive income.

3 **Deferred tax**

Temporary differences for Snedd at 31 May 20X4:

	£'000
In respect of accelerated capital allowances	300
In respect of revaluation surplus	600
	900
Deferred tax liability to be recognised: £900,000 × 22%	198

At 31 May 20X3 Snedd's deferred tax balance was £92,000. A further £106,000 is required to increase the deferred tax balance at 31 May 20X4 to £198,000. The element of deferred tax relating to the revaluation surplus must be calculated and presented separately in other comprehensive income:

£600,000 × 22% = £132,000. This leaves a credit of £26,000 (£132,000 – £106,000) to be credited to income tax expense.

Temporary differences for Bellte at 31 May 20X4 are £180,000. Calculated at 22%, the deferred tax liability to be recognised is £180,000 × 22% = £39,600. The deferred tax balance at 31 May 20X3 was £46,000, and therefore the adjustment required is to debit deferred tax and credit income tax expense in profit or loss with £46,000 – £39,600 = £6,400.

The debit to other comprehensive income is £132,000.

The total credit to consolidated income tax expense is £26,000 + £6,400 = £32,400.

The total credit to consolidated deferred tax is £106,000 – £6,400 = £99,600.

4 **Payment of a supplier in shares**

The issue of shares to Whelkin Ltd falls within the scope of IFRS 2, *Share-based Payment*. It is an equity-settled transaction because, essentially, Snedd has received goods in exchange for an issue of shares. This type of transaction, with a third party, is normally measured at the fair value of goods and services received, and should be recorded when the goods are received. The fair value of the issue of 270 shares to Whelkin is therefore measured at £6,000 which is the value of the goods provided to Snedd. The consultant's estimate of the fair value of Snedd's shares at 1 April 20X4 is not relevant.

The prescribed accounting treatment is to recognise the fair value of the goods provided in profit or loss, with a credit to equity. In this case, the fair value of the goods has already been recognised in profit or loss as part of purchases of goods for production. The adjusting entry is to derecognise the trade payable of £6,000 from current liabilities, with a corresponding credit to equity.

Snedd Group – Consolidated statement of profit or loss and other comprehensive income for the year ended 31 May 20X4

	£'000
Revenue	10,732.7
Cost of sales	(7,170.7)
Gross profit	3,562.0
Operating expenses and finance costs	(2,004.2)
Profit before tax	1,557.8
Tax	(350.3)
Profit for the year	1,207.5
Other comprehensive income	458.6
Total comprehensive income for the year	1,666.1
Profit attributable to:	
Owners of the parent	1,168.4
Non-controlling interests (W1)	39.1
	1,207.5
Total comprehensive income attributable to:	
Owners of the parent	1,627.0
Non-controlling interests	39.1
	1,666.1

Snedd Group – Consolidated statement of financial position at 31 May 20X4

	£'000
Assets	
Non-current assets	
Goodwill	141.7
Property, plant and equipment	5,058.0
	5,199.7
Current assets	2,973.7
Total assets	8,173.4
Equity and liabilities	
Equity attributable to owners of the parent	
Share capital	306.0
Retained earnings (W2)	4,225.4
Other components of equity	458.6
	4,990.0
Non-controlling interests (W1)	264.6
Non-current liabilities	
Deferred tax	237.6
Current liabilities	2,681.2
Total equity and liabilities	8,173.4

WORKINGS

(1) **Non-controlling interests – Bellte**

	£'000
At 1 June 20X3 (as in revised goodwill calculation)	225.5
NCI share of profit for the year: (£112 + 40 (Contingent liability) – 2 (additional depreciation) + 6.4 (deferred tax – see section 3)) × 25%	39.1
At 31 May 20X4	264.6

(2) **Consolidated retained earnings**

	£'000	£'000
Snedd: £4,075,000 plus deferred tax £26,000		4,101.0
Bellte: £1,014,000 less pre-acq of £902,000	112.0	
Adjustments: (£40,000 operating expenses – £2,000 depreciation + £6,400 deferred tax)	44.4	
	156.4	
Group share: 75%		117.3
Terald: post-acquisition (£75,000 – £67,900 see W4)		7.1
At 31 May 20X4		4,225.4

(3) **Snedd Group – consolidation schedule at 31 May 20X4**

	Snedd £'000	Bellte £'000	Terald £'000	Adj 1 £'000	Adj 2 £'000	Adj 3 £'000	Adj 4 £'000	£'000
Revenue	8,511.0	2,186.0	35.7					10,732.7
Cost of sales	(5,598.0)	(1,544.0)	(26.7)	(2.0)				(7,170.7)
Gross profit	2,913.0	642.0	9.0					3,562.0
Operating exps	(1,541.0)	(502.0)	(3.6)	40.0	2.4			(2,004.2)
PBT	1,372.0	140.0	5.4	38.0	2.4			1,557.8
Tax	(354.0)	(28.0)	(0.7)				32.4	(350.3)
Profit for the year	1,018.0	112.0	4.7	38.0	2.4		32.4	1,207.5
OCI	600.0				(9.4)		(132.0)	458.6
TCI	1,618.0	112.0	4.7	38.0	(7.0)		(99.6)	1,666.1
Assets								
Goodwill				123.5	18.2			141.7
PPE	3,512.0	1,463.0	75.0	8.0				5,058.0
Investments	900.0			(800.0)	(100.0)			–
Current assets	2,365.0	586.0	22.7					2,973.7
Total assets	6,777.0	2,049.0	97.7	(668.5)	(81.8)			8,173.4
Equity and liabilities								
Share capital	300.0	30.0	*4.5	(30.0)	(4.5)			300.0
RE	4,075.0	1,014.0	75.0	(902.0)	(67.9)		32.4	4,225.4
				38.0				
				(39.1)				
Reserves	600.0				(9.4)	6.0	(132.0)	464.6
NCI				225.5				264.6
				39.1				
Deferred tax	92.0	46.0	–				99.6	237.6
Current liabilities	1,710.0	959.0	18.2			(6.0)		2,681.2
Equity and liabilities	6,777.0	2,049.0	97.7	(668.5)	(81.8)	–	–	8,173.4

* Share capital in Terald, translated at closing rate of 2.2 (10/2.2)

(4) **Elimination of pre-acquisition retained earnings in Terald**

	£'000
Total equity in Terald at 31 May 20X4 (see translation of statement of financial position in section 2 of answer)	79.5
Less share capital translated at closing rate of 2.2	(4.5)
Retained earnings at 31 May 20X4	75.0
Post-acquisition retained earnings (see translation of statement of profit or loss in section 2 of answer)	(7.1)
Pre-acquisition retained earnings	67.9

3 Sunnidaze

Marking guide

		Marks
(a)	Prepare a memorandum setting out and explaining the additional audit adjustments and unresolved audit matters identified at our follow up visit together with a brief summary of any additional audit procedures required	15
	Drafting of revised financial statements	
(b)	Your comments on any more general concerns including ethical issues you have in relation to the audit as a whole and what our audit response to these concerns should be	12
(c)	Explanation of treatment of sale and leaseback transaction	8
Total marks		35
Maximum marks		30

(a) **Memorandum**

To: Audit manager
From: Jamie Spencer
Date: 2 November 20X6

Additional audit adjustments and unresolved audit matters, together with additional procedures required

Credit note adjustment not posted

Although the final Jacuzzi was not delivered until after the reporting date, it must have been clear at the year end that 10 were to be delivered and that a discount would therefore be given. We need to check that the discount arose from a commitment pre year end rather than a post year end decision but, assuming this to be the case, an adjustment to account for the discount on nine items should be posted:

DEBIT	Revenue	£9,000	
CREDIT	Receivables		£9,000

This amount is not by itself material but the client's unwillingness to book it is a little concerning. We will need to reassess this along with any other unrecognised adjustments at the end of the audit.

Late adjustments made by client – health club receivable

Clearly it is appropriate to make provision for the health club receivable, because the specialist nature of the product (luxury hot tubs) means that, as per IFRS 15, revenue should not have been booked until the installation was complete (the performance obligation satisfied). However, not so clear that this should be recorded as an exceptional item. The amount must be reversed from revenue.

Hence:

DEBIT	Revenue	£42,000	
CREDIT	Exceptional item		£42,000

In addition, we need to consider the entry for inventory that is expected to be returned. We can only record this at the lower of cost and net realisable value and will need to take into account the cost of bringing the inventory back to the warehouse. Hence, we can only determine the precise entry with more information.

Assuming appropriate to record at cost and average margin made, likely entry is:

DEBIT	Inventory (Assumes margin of approx 47% as per statement of profit or loss and other comprehensive income)	£22,260	
CREDIT	Cost of sales		£22,260

However also it is likely some provision is required against the inventory as this will not be in pristine condition, and therefore the net realisable value is likely to fall below cost.

Tutorial note

Reasonable estimates of this were accepted.

Late adjustments made by client – broader implications of delay in installation

Concerning the goods which were delivered to the health club in June but not installed until some months later – this together with delays in the payment of year end receivables suggests that revenue may be being recognised too early. We will need further audit procedures to consider:

- Extent of revenue recognised for goods delivered pre year end but installed afterwards.
- Whether installation is optional or required for all sales in which case it could be argued that the installation cannot be separated from the supply of goods and no revenue should be recognised until installation is complete.
- Whether there is a separate charge for installation and if so, when is that element invoiced.
- Does some installation revenue need to be deferred at year end or is a cost accrual more appropriate. Has such an accrual been made?
- Whether customers actually required the goods to be delivered pre year end. Possible that revenue has been artificially accelerated into the prior year especially as post year end sales are quite low. Need to look at customer order information re required date of delivery and consider circularising customers. Particular attention should also be given to invoices still not paid or paid some time after year end.

Bonus accrual

The entry seems reasonable as the bonus clearly relates to performance for the financial year which draft accounts show has met the target.

It is unclear whether the related social security taxes have been accrued – we need to check this.

In addition, adjustments may mean that the target operating profit has not in fact been met, in which case the bonus would need to be reversed.

Dividend

This should not be accrued unless actually declared pre year end which seems unlikely. There may well have been a similar error in prior year as brought forward retained earnings were nil so will need to check this.

Intangible assets

Intangible assets do not seem to have been amortised since their acquisition which is an error. Total amortisation to the reporting date should be £250,000 on a straight line basis of which £200,000 should have been booked in prior years (see consideration under general matters below of potential implications of this). Hence adjustment required:

DEBIT	Operating expenses	£50,000	
DEBIT	Retained earnings at 30 June 20X5	£200,000	
CREDIT	Intangible asset		£250,000

We need to consider whether the remaining balance of £250,000 is impaired, given reducing sales of the DupaSpa product. If sales are expected to continue at the 20X6 level then the asset is probably not impaired as £400,000 @ 47% = £188,000 of margin generated in one year. However we need to look in more detail at forecast sales for the DupaSpa product and the cash flows arising and perform sensitivity analysis.

Cash after date – recoverability of receivables

We are now four months after the year end so we would expect all balances outstanding at the reporting date to have been paid. It seems unlikely that a nil provision against the £186,000 outstanding is adequate, especially as some debts are due from local builders who may be experiencing financial difficulty. Again much more analysis is required to determine the level of allowance required – we need to look at each customer in turn and analyse the reasons for non-payment.

We should also consider days sales outstanding (DSO) at the year end and on average when considering whether receipts have been received within the anticipated time period or whether there is any indication of extended payment terms being offered.

Bank loan

The instalment of £400,000 due on 31 December 20X6 should be classified within current liabilities not long term creditors.

It is not clear how the loan arrangement fee has been treated – it may have been expensed, or recognised within other current assets. It should be deducted from the liability (£2,000,000 – £40,000) on initial recognition. An effective interest rate would then need to be calculated to incorporate the 5% interest and the £40,000 transaction costs. In order to perform the required adjustment, enquiries need to be made about how this was treated in the first place.

For year ended 30 June 20X6, a crucial measure for the covenant is an operating profit of no lower than £280,000.

Draft financial statements show £467,000, adjusted to £388,000 (467 – 9 – 42 + 22 – 50) by the above adjustments. However there are also potentially significant adjustments re loan fee, bad debts, intangible impairment and revenue recognition which could reduce this below £280,000. In this case the bonus accrual might also be reversed. Hence finalisation of accounts is crucial in determining whether there has been any breach.

It seems odd that there are no restrictions in respect of dividends and major transactions (including sale of shares) in the agreement – there needs to be a review by more senior personnel to ensure that all relevant factors have been summarised and taken into account. In addition, we need to check whether there is any obligation for the auditor to report direct to the bank as this would require a separate engagement.

Review of post year end results

The key issue to be considered here is going concern. Results are not in line with budget and operating profits at this level are insufficient to meet the covenant going forward (which requires £280,000 profit for the year). The inability to comply with loan agreements is a key factor which may cast doubt on the use of the going concern basis of accounting. The cash balance will be seriously depleted once the loan repayment and dividend are paid, although movement for the post year end period is not out of line with operating profit.

It is important that management takes responsibility for the conclusion about whether the entity is a going concern and produces forecasts and arguments to support this, which are then audited. We will need detailed cash flow forecasts for at least a 12-month period (from date of approval) to consider going concern and these should include modelling to ensure that covenants will be met. The budget should be used as a starting point but will need a critical review and sensitivity analysis, as there is an indication that it may be far too optimistic – we need to make sure specifically that factors such as declining sales are taken into account. In addition, ongoing changes to accounting policies in respect of revenue recognition and intangible amortisation need to be taken into account when modelling the covenant compliance as these may affect operating profit in future.

Another factor to consider is the willingness and ability of shareholders to put in more capital. This seems unlikely as they are actually planning to sell. However they are already at risk over bank borrowing and finding a buyer may be difficult.

Maisie's view of forecasts must be considered when planning our work.

Revised summary financial information

	Per draft financial statements £'000	Adjustments £'000	Revised balances £'000
		(9) (42) (50 amortisation)	
Operating profit	467	22	388
Exceptional items	(42)	42	–
Interest payable	(100)		(100)
Profit before taxation	325		288
Taxation	(125)		(125)
Profit after taxation	200		163
Assets			
Property, plant and equipment	392		392
Intangible assets	500	(250)	250
Inventories	1,392	22	1,414
Trade receivables	1,587	(9)	1,578
Other current assets	40		40
Cash and cash equivalents	555		555
	4,466		4,229
Equity and liabilities			
Share capital	1,000		1,000
Retained earnings (from P/L)	200	(37)	163
Long-term borrowings	2,000	(400)	1,600
Trade and other payables	1,141		1,141
Loan		400	400
Tax payable	125		125
	4,466		4,229

(b) **Comments on ethical issues and other concerns**

Ethical considerations and fraud risk

Knowledge of Maisie's view of the forecasts needs further consideration. There is no duty to disclose this to any party outside the client despite concern that wildly optimistic forecasts may be being used to attract investors, unless there is the possibility that there is misconduct by a member of the Institute or reportable fraud.

Discussion of concerns with the directors is possible but would need to be done sensitively and without quoting Maisie's view. The most appropriate way to address this is to plan very rigorous work on the forecasts as part of the going concern review, challenging assumptions and subjecting them to sensitivity analysis.

If this work identified any deliberate attempt to deceive potential investors then that might be fraud and reportable under money laundering regulations – we would need to consult the firm's Money Laundering Compliance Principal (MLCP).

We might also want, at that point, to reconsider whether we wanted to continue to act as auditors.

Potential investment has raised the risk associated with audit conclusions and it may be necessary to revisit risk considerations and/or allocate additional reviews.

New audit engagement partner objectivity

I have not yet met the new audit engagement partner but I note that she has the same surname as the two owners (John and Mary Cotton). I would be extremely surprised if this were to be the case, but is there any family connection between the owners and the firm's engagement partner? Is there any reason why she has just been appointed and are there any issues with the conduct of the audit if she is related in some way? I am sure that the ethics partner at our firm would have been involved in this development but I feel I should at least raise this with you as any threats to objectivity and independence would have an adverse impact on our firm and its reputation.

Tutorial note

While unlikely, these circumstances are theoretically possible. Candidates should be rewarded for noticing the same name and displaying tact and sensitivity in relation to this matter.

Fraud risk

All three directors have a strong incentive to ensure that operating profit is stated at a certain level either because of bonus arrangements or personal guarantees and a desire to sell the company at the best price.

Inappropriate classification of the adjustment to the allowance for receivables and some indication that revenue has been accelerated may suggest that they are prepared to manipulate the results to meet this target as might the high level of unrecognised liabilities identified by our earlier work and their unwillingness to agree to and recognise one of the audit adjustments.

Arnold has potentially been involved in the determination of provisions and other judgmental areas. We need to apply enhanced levels of professional scepticism to ensure that our procedures throughout the audit take into account this risk of fraud and that we revisit any areas where we have relied on written representations from management. We may also enlist the use of a specialist to assist the audit team.

Timescales and need for appropriate focus on audit completion

The financial statements need to be delivered to the bank before the end of November so time is tight. A meeting with the bank is also clearly very important and it is crucial that directors understand fully the status of the audit, further work that is required and final review processes necessary to close down the audit completely. Time must be allowed for audit completion and necessary quality management procedures.

Given the concerns raised earlier about the objectivity and independence of the engagement partner, we may be exposed to some degree of intimidation threat in order to reach an audit conclusion that satisfies the bank and the directors.

Opening balances

Prior year accounts were unaudited and work on intangibles and dividends suggests that they may include a number of misstatements. We need to ensure that sufficient work has been performed on all opening balances. Areas of particular focus might include:

- revenue recognition and cut-off
- purchases
- capitalisation policy and existence of property, plant and equipment
- adequacy of provisions
- classification of items within the financial statements

If there is any indication of accounting irregularity or a deliberate intention to mislead tax authorities or the bank in the past, then we should reconsider whether we want to act for this client at all. It may, however, just be due to ignorance about accounting standards or lack of clarity about the GAAP being followed.

We have full responsibility for comparative figures in the accounts even though no opinion is given on them.

Materiality

Materiality was initially set at £30,000 based on a profit before tax of £551,000. This in itself may be a little high as it is slightly above normal benchmarks, especially given that this is the first year of being audited.

Profit is likely to be much lower and headroom compared to the bank covenant could be very tight. We need to revisit this level of materiality and consider if it should be lower which might well require additional audit procedures.

Another factor relevant to this is the very high level of adjustments identified to date – this far exceeds materiality and presumably estimation of likely mis-statements. Again this could require some re-assessment of performance materiality as applied to each balance tested and to the sample sizes used during our audit procedures. Again additional work may well be necessary.

(c) **Sale and leaseback transaction**

As the transfer is a sale, IFRS 16, *Leases* requires the following:

- The seller/lessee measures the **right-of-use asset arising from the leaseback** as a proportion of the previous carrying amount of the asset that relates to the right of use retained by the seller/lessee:

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

- The seller/lessee only recognises the amount of any gain or loss on the sale that relates to the rights transferred to the buyer.
- The gain relating to the rights transferred is the balancing figure, calculated as total gain less gain on rights retained.
- The present value of the future lease payments in respect of the warehouse building is £272,435 (32,000 × 8.5136), using a discount rate of 10%. This is the figure used to calculate the right-of-use asset.
- The right-of-use asset is subsequently depreciated over the lease term of 20 years. The lease liability should be amortised, using the interest rate implicit in the lease, or if this is not available, Sunnidaze's incremental borrowing rate of 10%.

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