ADVANCED LEVEL EXAMINATION

Orchid

CORPORATE REPORTING

ANSWERS

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1 BathKitz

Scenario

The candidate in this question is working as an analyst for a private equity firm and is required to explain the financial reporting implications of a number of transactions in the year. The candidate is also required to redraft the statement of cash flows and provide a reconciliation of profit before tax to cash flow from operations. Finally the candidate is required to explain why the increase in revenue is not manifesting into an increase in cash.

Marking guide

Requirement	Marks	Skills
Explain the appropriate financial reporting treatment for each of the matters in the email (Exhibit 2) showing journal entry adjustments where possible.	20	Correct treatment of gain on investment property and adjustment to SOCF for rental income Share options – identify correct treatment per IFRS 2 and show journal entries Revenue recognition – identify need for further information Show correct treatment per IFRS 16 of lease of equipment and of new depots Convertible bonds – calculations and journal entries
Prepare a revised statement of cash flows, after recording your correcting journal entries. Include a note reconciling profit before tax with cash generated from operations.	7	Preparation of revised SOCF correctly incorporating adjustments. Clearly setting out workings.
Explain briefly why the revised statement of cash flows shows a net cash outflow from operating activities despite an increase in revenue.	4	Tailoring explanation to the scenario, avoiding generic comments.
Available	31	
Maximum	**30**	

Briefing note to Manager

(1) **Incorrect financial reporting treatments and appropriate adjustments to the draft extracts required**

Investment property

The fair value of the investment property should reflect the market conditions at the reporting date. The valuation of £12 million should not be used as a fair value because the sale transaction appears to have been made with a buyer who was not knowledgeable of local market conditions and therefore not a market participant. The valuation of £9 million would better reflect market conditions. Therefore an adjustment is required to the financial statements to reflect the fair value of £9 million, which reduces profit by £3 million.

The revaluation will not impact on cash flow from operating activities. However the company has not adjusted the rental income to show this as part of cash flows from investing activities which will decrease cash flow from operating activities and increase cash flow from investing activities.

Correcting journal:

		£'000	£'000
DEBIT	Investment income	3,000	
CREDIT	Investment property		3,000

Share options

The treatment of the option scheme is incorrect. IFRS 2, *Share-based Payment* should have been applied as follows:

The fair value of the options at the grant date should be treated as an expense in profit or loss and spread over the vesting period, which is from the grant date until the date the scheme conditions vest.

The scheme conditions are not market-based. The fact that the share price has increased since the grant date is ignored when determining the charge to profit or loss. The continuing employment condition should be based on the best estimates at the statement of financial position date, which in this case is for 6 managers to leave and therefore only 94 to be employed at the vesting date.

The charge to profit or loss is therefore £1.081m (10,000 × 94 × £4.60 × 1/3 × 9/12). In addition this sum is also credited in the statement of financial position to equity. IFRS 2 does not state where in equity this entry should arise, and many companies add it to retained earnings.

		£'000	£'000
DEBIT	Operating profit	1,081	
CREDIT	Equity		1,081

Revenue recognition

In accordance with IFRS 15, *Revenue from Contracts with Customers,* revenue should be recognised for the sale of goods when the entity satisfies the relevant performance obligation, which is when control is passed to the customer (IFRS 15: para. 32). This would normally occur on the passing of possession of the goods

(ie, physical delivery). In the case of the Pick and Collect sales, however, control is transferred when the customers collect their goods. This means that it is not appropriate to recognise the £10 million for goods sold and not collected, because the performance obligation in respect of those goods has not been satisfied. The timing of those customers' payments is not relevant to the timing of recognition, although credit control is clearly a matter of concern.

Revenue would, therefore, appear to be overstated by £10 million. However, I do not have enough information to propose an adjustment as I would need further information regarding the gross profit percentage on these goods.

Lease of equipment

The treatment of the lease is incorrect. IFRS 16, *Leases* requires all leases (except those of 12 months or less or of low-value assets) to be recognised in the statement of financial position. A right-of-use asset must be recognised consisting of the present value of future lease payments (initial value of the lease liability). The right-of-use asset will be depreciated over the shorter of the lease term and the useful life of the asset, that is over four years. The interest rate implicit in the lease is 7% and therefore the right-of-use asset and the lease liability should be recognised in the SOFP at £16 million (£4.72m × 3.387 = £16m). A finance cost of (£16m × 7%) × 3/12 = £0.28m and depreciation of £16m/4 × 3/12 = £1m will be recognised in profit or loss. The charge to operating profit of £1.2 million will be reversed out of the statement of profit or loss and debited to provisions.

This adjustment will also affect the statement of cash flows. The interest element will be added back to cash flow from operating activities. However, no interest paid will be shown in respect of the lease as no payment has yet been made. The repayment of the capital element should be shown as part of financing activities.

		£'000	**£'000**
DEBIT	Right-of-use asset	16,000	
CREDIT	Lease liability		16,000

Being recognition of lease in respect of the equipment

		£'000	**£'000**
DEBIT	Depreciation	1,000	
CREDIT	Right-of-use asset		1,000

Being depreciation of right-of-use asset over the lower of lease term and useful life (4 years)

		£'000	**£'000**
DEBIT	Lease interest	280	
CREDIT	Lease liability		280

Being recording of 3 months' interest

		£'000	**£'000**
DEBIT	Provisions	1,200	
CREDIT	Operating profit		1,200

Being reversal of provision for rental incorrectly made

Lease of new depots

The current treatment is not correct. Under IFRS 16, *Leases* all leases must be recognised in the statement of financial position, other than leases for 12 months or less, or leases of low-value assets. BathKitz must recognise a lease liability for the present value of future lease payments made over the lease term and a right-of-use asset. The right-of-use asset will be depreciated over the shorter of the lease term and the useful life of the asset, that is over four years.

The interest rate implicit in the lease is 7% and therefore the right-of-use asset and the lease liability should be recognised in the SOFP at £33.87 million (£10 million × 3.387 = £33.87m). A finance cost of (£33.87m × 7%) × 3/12 = £0.593m and depreciation of £33.87m/4 × 3/12 = £2.117m will be recognised in profit or loss.

This adjustment will also affect the statement of cash flows. The interest element will be added back to cash flow from operating activities. However, no interest paid will be shown in respect of the lease as no payment has yet been made. The repayment of the capital element should be shown as part of financing activities.

		£'000	£'000
DEBIT	Right-of-use asset	33,870	
CREDIT	Lease liability		33,870

Being recognition of lease in respect of the depots

		£'000	£'000
DEBIT	Depreciation	2,117	
CREDIT	Right-of-use asset		2,117

Being depreciation of right-of-use asset over the lower of lease term and useful life (4 years)

		£'000	£'000
DEBIT	Lease interest	593	
CREDIT	Lease liability		593

Being recording of three months' interest

Bonds

The convertible bond is a compound financial instrument per IAS 32, *Financial Instruments: Presentation*. IAS 32 para. 28 requires separation of the equity and liability components. This has not been done in the financial statement extracts of BathKitz.

The liability component should be measured first at the present value of the capital and interest payments. The discount rate used should be the prevailing market interest rate for an instrument with the same terms and conditions except for the ability to convert to shares. At the date of issue the value of the liability is therefore:

	Cash flow £'000	DF @ 7%		£'000
30.09.20X4	1,000	1/1.07	0.935	935
30.09.20X5	1,000	$1/1.07^2$	0.873	873
30.09.20X6	21,000	$1/1.07^3$	0.816	17,136
				18,944

The equity component is then the residual amount being the difference between the liability and the value of the bond:

£20m – £18.944m = £1.056m

In the cash flow statement, the finance charge is added back and is replaced by the coupon interest in the cash flow from operating activities. The proceeds from the issue of the bonds is shown in cash flows from financing activities.

Journals

		£'000	£'000
DEBIT	Bond	1,056	
CREDIT	Equity		1,056
DEBIT	Interest costs (18,944 × 7%)	1,326	
CREDIT	Bond		1,326
DEBIT	Bond	1,000	
CREDIT	Interest cost		1,000

(2) **Draft statement of cash flows for the year ended 30 September 20X4**

	£'000
Cash flows from operating activities	
Profit before taxation (see W1)	35,542
Adjustments for:	
Depreciation (10,631 + (3,117(W1)))	13,748
Increase in provisions	2,050
Gain on investment property (4,000 – 3,000)	(1,000)
Investment income (rental income – see below)	(1,200)
Share option expense – non cash investment	1,081
Interest expense (3,500 + 873 – 1,000 + 1,326)	4,699
	54,920
Increase in trade receivables	(53,978)
Increase in inventories	(23,090)
Increase in payables	27,400
Cash generated from operations	5,252
Interest paid (see W2)	(3,500)
Income taxes paid	(12,000)
Net cash used in operating activities	(10,248)
Cash flows from investing activities	
Rental income	1,200
Cash flows from financing activities	
Dividends paid	(5,000)
Proceeds from issuing bonds	20,000
Net cash from financing activities	15,000
Net increase in cash and cash equivalents	5,952
Cash and cash equivalents at beginning of period	12,670
Cash and cash equivalents at end of period	18,622

WORKINGS

(1) **Adjusted profit**

	£'000
Profit per the question	42,739
1. Investment gain	(3,000)
2. Share option	(1,081)
3. Depreciation on ROU assets (1,000 + 2,117)	(3,117)
Reverse rent charge	1,200
Lease interest (280 + 593)	(873)
4. Bond – actual coupon interest	(1,326)
Revised finance cost	1,000
Revised profit before tax	35,542

(2) **Interest paid**

	£'000
Revised charge	4,699
Less lease interest	(873)
Less finance charge for bond	(1,326)
Add coupon interest on bond	1,000
Cash flow statement – interest paid	3,500

(3) **Why the revised statement of cash flows shows a net cash outflow from operating activities despite an increase in revenue**

Revenue has increased but this is not feeding through to an increase in cash for the following reasons:

Comparison of 'like for like revenue' – ie, excluding Pick and Collect sales

Year ended 30 September	**20X4**	**20X3**
	£'000	**£'000**
Trade counter sales	804,550	737,334
Total trade discounts (242,110 – (54,560 × 10%))	(236,654)	(184,334)
Revenue	567,896	553,000

Managers have the ability to negotiate discounts locally – the percentage of discounts to gross revenue has increased from 25% to 29%. As managers are motivated with the share option scheme to meet agreed growth targets in revenue, this could have resulted in higher discounts being offered and a fall in operating profit. This will ultimately have an impact on the company's cash flow position.

Revenue has increased because of the new revenue stream. However there are inevitably upfront costs associated with this stream which may result in higher cash flows in the future. Also customers are taking longer to pay which will worsen cash flow.

Year ended 30 September	20X4 Receivables days	20X3 Receivables days
Trade counter sales		
(£134.5m – £39m)/£567.896m × 365	61 days	53 days
'Pick and Collect' sales		
(£39m/(£54.56m × 90%) × 365) × 3/12	72 days	N/A

As discussed above in part (1), the revenue recognition policy on Pick and Collect is not in accordance with IFRS 15 and revenue is overstated – customers are also taking longer to pay which has affected cash flow.

2 Elephant Ltd

Marking guide

Requirement	Marks	Skills
Matter 1 – Accrued income and expense accruals (1) Identify and explain why accrued income and expense accruals are areas of significant audit risk for the audit of Elephant for the year ended 31 December 2018. Use the data analytics software to identify specific key transactions which require further investigation. Include any additional information that you require from Elephant's management.	4 5	**Accrued income** • Size vs materiality • Round sums • Estimate and judgment • Management bias • Size of amount related to contract A10D37 • Disclosure **Expense accruals** • Incentive to misstate • Size vs materiality • Finance overstretched • Erroneous narrative • Round sums • Fewer than 2017 • Possible duplication of rent accrual
(2) Set out and explain the key audit procedures you would carry out in respect of accrued income and expense accruals.	4 4	Appropriate audit procedures Accrued income • 1 mark per relevant procedure/enquiry Expense accruals • 1 mark per relevant procedure/enquiry

Requirement	Marks	Skills
Matter 2 – Loans Set out and explain the appropriate financial reporting treatment for both the pension scheme loan and the loan from NEL Bank. Include any additional information and explanations that you require from Elephant's management. Journals are not required.	7	**Pension loan** New liability recognised if the terms are substantially different Previous liability derecognised Any difference carrying amount extinguished to consideration paid recognised in P/L Examination of transaction NOM059954 and identification of fees credited to 35043 Implications – overstatement of liabilities and understatement of finance costs
	7	**NEL bank loan** Preparation of analysis from the account code 79010 Round sum nature represents actual bank payments – incorrect split of interest and capital. Further information needed to confirm Calculate approximate interest rate Examine pattern of interest payments conclude change in terms possible Treatment depends on modification terms whether to derecognise Confirm impairment due to change in credit risk Request Frank's workings for the journal and the terms of the loan
Issue 3 – Interest rate cap Set out and explain the appropriate financial reporting treatment for the year ending 31 December 2019 for the illustrative example interest rate cap prepared by Frank Wright. Include journals.	6	**Interest rate cap** Derivative asset recognised on purchase of cap Change in the intrinsic value of the cap will be recognised in OCI/cash flow hedge reserve Time-period related hedged item, so initial time value amortised to SOFP as finance cost over the hedging period Change in fair value reflected in SOFP at year end

Requirement	Marks	Skills
	3	Journals
Available marks	**55**	
Maximum marks	**40**	

(1) **Accrued income**

All the amounts in posting are round sums suggesting that they may be estimates leading to potential for management bias and risk of misstatement.

The total value of £300,000 for accrued income is a significant item at 10 times materiality.

The amount of £120,000 relates to longer term contract A10D37. This contract is not complete at the year end. Therefore, the amount of revenue that should be recognised should be determined in accordance with IFRS 15. This determination is likely to involve management estimates and judgments related to performance obligations and the allocation of total transaction price thereto. Such estimates and judgements involve subjectivity and may be subject to management bias.

Given that the contract is expected to run for 8 months and commenced on 3 October 2018, approximately 37.5% of the contract period falls into the year ended 31 December 2018. Recognising revenue of £120,000 represents nearly 65% of the maximum transaction value of the contract. It may be appropriate to recognise a larger amount of revenue than that arrived at using simple time based apportionment as IFRS 15 requires identification of performance obligations. For example, if the customer survey were considered a separate performance obligation and a higher proportion of total transaction price was able to be allocated to it.

Nonetheless, it superficially appears that Andrea is recognising a significant portion (nearly 65%) of the overall transaction price to the first three months of the contract. This may indicate that revenue is overstated.

The total contract price is not a fixed amount and this could be reduced by Ayer following the initial customer survey stage – this gives further evidence that the revenue has been incorrectly recognised since £120,000 is almost the entire amount of the total contract price of £125,000 under the alternative terms. This matter requires further investigation.

The recognition of revenue related to contract A10D37 is likely to give rise to a contract asset under IFRS 15. There is a risk that this may not be disclosed appropriately.

Expense Accruals

The amounts recorded as expense accruals may be understated in order to overstate profit; alternatively they may be overstated to understate profit and minimise taxation. As Elephant is a private company the incentive for management to understate profit in order to minimise taxation may be considered to be the

greater. However, Frank stated that the Elephant board expects an increase in profit which may suggest pressure to overstate profit.

The overall amount of the expense accruals that Andrea intends to recognise are over 10 times the value of materiality and it is therefore a significant balance.

Frank is currently absent due to illness. We do not know for how long this has been the case, but Andrea's comments suggest that the finance department at Elephant are overstretched which may lead to errors.

There is an amount of £7,000 to be posted to Account number 71070 – Training, Staff with the narrative 2018 Accruals – Pension. It appears that this may be an error and could be a further sign of the pressure under which Andrea is working.

A number of the amounts Andrea intends to accrue are round sum figures (unlike the 2017 expense accruals that can be seen being reversed in Account code 34030 in the DAS). This suggests that the 2018 expense accruals may be estimates rather than based on invoices received post year end or purchase orders. As such these amounts are likely to be subject to a higher risk of misstatement.

Although the total value of 2018 expense accruals is similar to that for 2017, the number of expense accounts to which accruals are to be posted is considerably smaller. This may indicate that the expense accruals that Andrea intends to post are incomplete leading to possible understatement and therefore overstatement of profit.

Specific transactions from DAS

By examining Account code 34030 – Accruals Control A/C in the audit software, three large transactions can be identified all created on 7 December 2018. Two of these result in a debit and credit to 34030 of £328,125. These two transactions appear to be a reversal of the 2017 expense accruals and then the subsequent reversal of this transaction.

Subsequently, another transaction with the narrative '2017 accruals revers – Accruals' is posted resulting in a debit to account 34030 of £216,075. The difference between this amount and the previous cancelled reversal relates to the absence of rent accrual to account 72000 of £112,050 in the latest transaction. The net result of these three transactions is that the 2017 expense accruals are reversed apart from the rent accrual, which has not been reversed and remains in place at the year end.

Given the transaction Andrea intends to post includes a further rent accrual in relation to 2018 of £115,000, this suggests that this may be a duplication which will overstate expenses and liabilities.

(b) **Accrued income**

- Request a copy of contract A10D37 and review terms to determine the nature of performance obligations, total transaction price etc.
- Identify whether first stage of the contract is complete and accepted by customer and if so whether option to reduce total contract length has been exercised.
- Verify that amount recognised in respect of contract A10D37 is consistent with IFRS 15.
- Using information obtained apply IFRS 15 to calculate own estimate of revenue related to 2018 and compare to Andrea's estimate.
- Enquire as to the basis on which all amounts accrued were arrived at and request supporting documentation.
- For contracts not invoiced at the year end, agree to invoices raised after the year end or contract transaction value and acceptance by customer.
- Review sample of invoices raised post year end and verify that any related to contracts completed and accepted prior to 31 December 2018 are included in the figure of £200,000 to be posted by Andrea.
- Obtain management forecast for expected costs to fulfil all obligations under the contract and compare to transaction price to determine whether an onerous contract under IAS 37.

Expense accruals

- Confirm the amounts to be accrued for 2018 by agreeing to supporting documentation eg, invoices received after the year end or purchase orders.
- Confirm from supporting documents that amounts accrued relate to period prior to 2018 year end.
- Examine a sample of invoices received after the year end, identify whether related to year ended 31 December 2018 and verify whether included in Andrea's proposed posting.
- Enquire as to whether any expense accruals are estimated, obtain basis for any estimates and consider for reasonableness.
- Enquire as to the reason for leaving 2017 rent accrual in place and establish whether Andrea's entry will duplicate this.
- Examine rental agreements and payments and calculate own estimate for 2018 rent accrual.
- Enquire as to the reason for the smaller number of expense accruals compared to 2017.

(2) **Pension scheme loan – Account code 35043**

Where a new loan is agreed between borrower and an existing lender the appropriate accounting depends on whether the original liability should be derecognised and a new liability recognised, or whether the original liability should be treated as modified.

A new liability should be recognised if the terms of the new liability are substantially different from the old terms. This is the case where the present value of the cash flows under the new agreement discounted at the original effective interest rate is 10% or more different from the present value of the remaining cash flows under the original terms.

The outstanding Pension loan to Elephant is being increased by more than 100%, so it is highly likely that this should be considered substantially different from the previous terms and the original loan derecognised and a new, larger pension loan liability recognised.

In relation to the derecognition of the original loan the difference, if any, between the carrying amount extinguished and the consideration paid should be recognised in profit or loss and any fees related to the loan's extinguishment should be recognised as part of that gain or loss.

Examining Account code 35041 Pension Loan 2 provides no evidence of any difference between consideration and carrying amount being recognised in profit or loss, nor any evidence of transaction costs directly related to the extinguishment. This accounting treatment is correct only if the loan was extinguished in return for its carrying amount and in the absence of any fees. The entries to extinguish the loan are a debit to Account code 35041 Pension Loan 2 and a credit to 35043 Pension Loan 3 for the same amount indicating that the carrying amount of the loan was extinguished in return for an equal fair value of the new loan.

The new larger pension loan should be initially recognised at fair value which is the value of the consideration received by Elephant. In this case this is the amount of the loan extended. IFRS 9 states that for loans held at amortised cost, as will be the case here, transaction costs are normally deducted from the consideration received. However, because this new loan arises as a result of an exchange, any transaction fees are recognised in profit or loss, in accordance with Paragraph B3.3.6A of the Application Guidance to IFRS 9.

From an examination of Account code 35043 Pension Loan 3 using the data analytics software, we can identify transaction NOM059954 crediting Pension loan 3 with £121,459 with the narrative 'Transfer of Pension loan 2 to Pension loan 3'. On examination of the double entry for this transaction it can be seen that this amount is, in fact, made up of three items:

	£
Transfer from pension loan 2	104,905
Valuation fee from IP Collier	4,554
Fees due for pension loan 3	12,000

These amounts combined with the cash received into 20010 – Bank, Current Account of £243,541 match the total for the new Pension Loan of £365,000.

From these entries, it would appear that fees relating to the loan have been included in the fair value of the new loan rather than deducted in accordance with IFRS 9. If this is the case it is likely that effective interest rate (EIR) for the new pension loan has been calculated using an overstated value for the fair value of the initial loan.

Interest should be reported based on the EIR which is the rate that perfectly discounts all estimated future cash payments of the loan through its expected life to its initial carrying value. Hence any error in the amount initially recognised for the new pension loan will lead to a misstatement in the EIR.

If the fees described above totalling £16,554 satisfy the meaning of transaction costs under IFRS 9 related to the new loan, then the accounting treatment applied by Elephant appears to be incorrect. The consequence of this will be to recognise these fees as part of the loan principal, rather than part of the finance costs and result in the EIR being understated. This in turn will lead to an overstatement of liabilities and an understatement of finance costs over the life of the loan.

It may also be the case that some portion of the fees is attributable to the extinguishment of the original Pension Loan 2 recorded in account 35041. If this is the case the fees should have been taken into account in determining any gain or loss on the extinguishment of that loan.

NEL Bank Loan – Account code 35042

Jane was correct to raise this as an issue at the planning stage and from the pattern of payments there appears to have been a refinancing of this loan too. I have prepared an analysis of the transactions posted to this account code of the interest payments as follows:

Account code	**Interest 76010 Debit**	**Loan 35042 Debit**	**Bank 20010 Credit**
December	2109	9040	11149
January	2041	9108	11149
February	1972	9176	11148*
March		5500	5500
April		5500	5500
May		5500	5500
June		5500	5500
July		5500	5500
August		5500	5500
September		7000	7000
October		7000	7000
November		7000	7000
December	16107	–16107	
	22229	65217	87446
Prior year			280557
Current year			215339

*Rounding difference

The annual interest charge is therefore £22,229, which approximates to an annual interest rate of 9% based on the average loan balance outstanding during the year. The nominal journals to post the interest have been recorded from the bank account and therefore, despite the round sum nature of the amounts, would suggest that these are the actual amounts paid to NEL Bank. This would need to be confirmed with the client.

From February, the client has not separated the interest from the capital element of the payment – this is not attributed just to one user – Tanya, Frank, Andrea and John have all posted journals to this account.

From the pattern of payments above it is clear that there has been a change in the arrangement with the bank and I would need information to determine whether this is a modification of an existing loan leading to derecognition. If the modification has not resulted in derecognition, Elephant will need to assess whether there has been a significant increase in credit risks since initial recognition.

Frank has made an adjustment – see NOM064007 for £16,107 on 6 December 2018 to correct the interest charge. I would need to review Frank's workings and the arrangement with the bank to provide further advice.

(3) **Interest rate cap**

As the hedged item is the variable rate component of the future interest payments to NEL, this is a cash flow hedge. In accordance with IFRS 9 only the intrinsic value of the cap has been designated as the hedging instrument.

A cap is in essence an interest rate option. As with any option its value can be decomposed into two components: time value and intrinsic value. The way in which changes to each of these are recognised differs under IFRS 9.

Any change in the intrinsic value of the cap will be recognised in other comprehensive income and then in cash flow hedge reserve in equity. This amount is released to the profit or loss over the period of the hedging relationship. Such changes will offset the additional interest cost arising from UK benchmark interest rates increasing above 1.75%.

In his illustrative example, Frank is assuming that the UK benchmark rate remains below 1.75% for the whole period from the purchase of the cap until 31 December 2019 at which the fair value is given as £1,600. This means that at both these points there is no intrinsic value in the cap and the change in fair value from £2,950 to £1,600 represents a change in the time value of the options making up the cap.

Floating variable rate debt such as the NEL loan is a time-period related hedged item under IFRS 9. Therefore, the initial time value in the purchase price of the cap is amortised to profit or loss on a systematic basis over the period of the hedge. The time value of an option at expiry is always zero. Therefore, over the life of an option, such as the cap purchased by Elephant, the time value on purchase will be spread over the life of the hedge as a finance cost in the statement of profit or loss.

The decrease in time value over the period of the hedge (from £2,950 to zero) is amortised on the basis of time. The remaining life of the loan from 1 March 2019 to 1 May 2020 is 14 months and 10 months of this relate to the year ended 31 December 2019. Therefore, 10/14ths (71.43%) of the initial time value of the cap should be recognised in the statement of profit or loss for the year to 31 December 2018 as a finance cost.

At the year end, 31 December 2019, the benchmark interest rate is still below 1.75% and the fair value of the cap has been estimated to have fallen to £1,600. Since the option still has no intrinsic value, the fall in fair value represents a decrease in time value. However, the total decrease in time value over the period of the hedge (from £2,950 to zero) is amortised on the basis of time.

Journals:

1 March 2019

Purchase of cap

The following journal is required to initially recognise the purchase of the cap:

	£	£
DEBIT SOFP – Derivative asset (Interest rate cap)	2,950	
CREDIT SOFP Cash		2,950

The premium agreed represents the fair value of the cap

31 December 2019

Recognition of cost of hedge and fall in fair value

Fall in time value (fair value) (2,950 – 1,600 = £1,350)

DEBIT OCI – Cost of hedging reserve	1,350	
CREDIT SOFP – Derivative asset (Interest rate cap)		1,350

Amortisation of time value over time (2,950 × 10/14 = 2,107)

DEBIT SOPL – Finance costs	2,107	
CREDIT OCI – Cost of hedging reserve		2,107

APPENDIX TO THE ANSWER: QUESTION 2

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.)

(1) Select the Accruals Control A/C within liabilities in Account View.

Asset	1.84M (↑47.9%)	Liability	876K (↓0.9%)	Equity	360K (↓1903.3%)

Liability

ACCOUNT	PY BALANCE	CY BALANCE	DIFFERENCE		
31010 - Payables Control Acc...	148,109	151,941	3,832	↑3 %	☐
31025 - HP Creditors	3,942	0	-3,942	↓100 %	☐
32010 - Social Security Liability	37,292	30,250	-7,042	↓19 %	☐
32020 - Tax liability	-53,818	-10,894	42,924	↓80 %	☐
33010 - Sales Tax Output Cont...	5,784,774	6,171,262	386,488	↑7 %	☐
33020 - Sales Tax Input Contr...	-2,857,669	-3,026,917	-169,248	↑6 %	☐
33030 - Sales Tax Payments/R...	-2,900,550	-3,076,902	-176,352	↑6 %	☐
34030 - Accruals Control A/C	326,943	106,153	-220,790	↓68 %	☑
35041 - Pension Loan 2	114,112	0	-114,112	↓100 %	☐
35042 - Loan payable	280,557	215,339	-65,217	↓23 %	☐
35043 - Pension Loan 3	0	315,501	315,501	↑100 %	☐
31800 - Other loans	0	0	0	0 %	☐
34500 - Other Accruals	0	0	0	0 %	☐
TOTAL SELECTED	**326,943**	**106,153**	**-220,790**	**↓68 %**	

Click on ☰ to examine transactions.

Liability Transactions

Transaction Id	Description	Debit	Credit	Account Codes	Effective Dates	User Ids	Document Types	Created Dates
NOM059639	2017 accruals revers - Accruals	216,075	0	34030	01/12/2018	FWRIGHT	NOM - Nominal Journal	07/12/2018 17:16:03
NOM059642	2017 accruals revers - Accruals	0	328,125	34030	01/12/2018	FWRIGHT	NOM - Nominal Journal	07/12/2018 08:04:01
NOM059643	2017 accruals revers - Accruals	328,125	0	34030	01/12/2018	FWRIGHT	NOM - Nominal Journal	07/12/2018 11:08:29
NOM061774	RE 2017 accruals - Being 2017 accrual reversal re D Batey	0	1,182	34030	31/05/2018	FWRIGHT	NOM - Nominal Journal	06/06/2018 19:56:16
SRC006968	Year End Accruals Posting	5,897	0	34030	29/11/2018	FWRIGHT	SRC - Sales Receipt	05/12/2018 16:30:26

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Indicates three large transactions created on the same day with the same narrative '2017 accruals revers – Accruals'. The underlying entries for each can be investigated in turn by clicking in the Transaction Id.

Transaction 'NOM059643'

Transaction Id	Account Code	Amount	Effective Date	Document Type	Journal Description	User Id	Line Description	Entered Date
NOM059643	34030	328,125	01/12/2018	NOM - Nominal Journal	2017 accruals revers - Accruals	FWRIGHT	008493_099	07/12/2018
NOM059643	73030	-4	01/12/2018	NOM - Nominal Journal	2017 accruals revers - Office telephones	FWRIGHT	008489_099	07/12/2018
NOM059643	73030	-41	01/12/2018	NOM - Nominal Journal	2017 accruals revers - Office telephones	FWRIGHT	008493_099	07/12/2018
NOM059643	73030	-41	01/12/2018	NOM - Nominal Journal	2017 accruals revers - Office telephones	FWRIGHT	008468_099	07/12/2018
NOM059643	73030	-76	01/12/2018	NOM - Nominal Journal	2017 accruals revers - Office telephones	FWRIGHT	008468_099	07/12/2018
NOM059643	72050	-93	01/12/2018	NOM - Nominal Journal	2017 accruals revers - Heat & light	FWRIGHT	008493_099	07/12/2018
NOM059643	62125	-94	01/12/2018	NOM - Nominal Journal	2017 accruals revers - Sales NI	FWRIGHT	008493_099	07/12/2018
NOM059643	72050	-150	01/12/2018	NOM - Nominal Journal	2017 accruals revers - Heat & light	FWRIGHT	008493_099	07/12/2018
NOM059643	72050	-200	01/12/2018	NOM - Nominal Journal	2017 accruals revers - Heat & light	FWRIGHT	008493_099	07/12/2018
NOM059643	73030	-205	01/12/2018	NOM - Nominal Journal	2017 accruals revers - Office telephones	FWRIGHT	008489_099	07/12/2018
NOM059643	71005	-465	01/12/2018	NOM - Nominal Journal	2017 accruals revers - Admin Ni	FWRIGHT	008493_099	07/12/2018
NOM059643	71090	-590	01/12/2018	NOM - Nominal Journal	2017 accruals revers - Artwork Manager	FWRIGHT	008493_099	07/12/2018
NOM059643	73035	-666	01/12/2018	NOM - Nominal Journal	2017 accruals revers - Mobile phones	FWRIGHT	008489_099	07/12/2018
NOM059643	73035	-673	01/12/2018	NOM - Nominal Journal	2017 accruals revers - Mobile phones	FWRIGHT	008489_099	07/12/2018
NOM059643	73035	-699	01/12/2018	NOM - Nominal Journal	2017 accruals revers - Mobile phones	FWRIGHT	008489_099	07/12/2018
NOM059643	71090	-800	01/12/2018	NOM - Nominal Journal	2017 accruals revers - Artwork Manager	FWRIGHT	008493_099	07/12/2018
NOM059643	72050	-800	01/12/2018	NOM - Nominal Journal	2017 accruals revers - Heat & light	FWRIGHT	008493_099	07/12/2018
NOM059643	62120	-940	01/12/2018	NOM - Nominal Journal	2017 accruals revers - Sales	FWRIGHT	008493_099	07/12/2018
NOM059643	77020	-1,125	01/12/2018	NOM - Nominal Journal	2017 accruals revers - Prov of a director	FWRIGHT	008489_099	07/12/2018
NOM059643	62105	-2,374	01/12/2018	NOM - Nominal Journal	2017 accruals revers - Studio	FWRIGHT	008493_099	07/12/2018
NOM059643	77020	-2,500	01/12/2018	NOM - Nominal Journal	2017 accruals revers - Accountancy T Talbot	FWRIGHT	008489_099	07/12/2018
NOM059643	71000	-4,645	01/12/2018	NOM - Nominal Journal	2017 accruals revers - Admin	FWRIGHT	008493_099	07/12/2018
NOM059643	61010	-6,545	01/12/2018	NOM - Nominal Journal	2017 accruals revers - Purchases	FWRIGHT	008493_099	07/12/2018
NOM059643	71060	-6,836	01/12/2018	NOM - Nominal Journal	2017 accruals revers - staff pension	FWRIGHT	008493_099	07/12/2018
NOM059643	77030	-8,000	01/12/2018	NOM - Nominal Journal	2017 accruals revers - Audit	FWRIGHT	008489_099	07/12/2018
NOM059643	71025	-15,784	01/12/2018	NOM - Nominal Journal	2017 accruals revers - Compensation	FWRIGHT	008493_099	07/12/2018
NOM059643	62100	-23,738	01/12/2018	NOM - Nominal Journal	2017 accruals revers - Studio	FWRIGHT	008493_099	07/12/2018
NOM059643	72000	-112,050	01/12/2018	NOM - Nominal Journal	2017 accruals revers - rents	FWRIGHT	008493_099	07/12/2018
NOM059643	77035	-137,989	01/12/2018	NOM - Nominal Journal	2017 accruals revers - Consult	FWRIGHT	008489_099	07/12/2018

This posting was the initial reversing of the 2017 accruals. This was then itself reversed.

Transaction 'NOM059639'

Transaction Id	Account Code	Amount	Effective Date	Document Type	Journal Description	User Id	Line Description	Entered Date
NOM059639	34030	216,075	01/12/2018	NOM - Nominal Journal	2017 accruals revers - Accruals	FWRIGHT	008468_099	07/12/2018
NOM059639	73030	-4	01/12/2018	NOM - Nominal Journal	2017 accruals revers - Office telephones	FWRIGHT	008468_099	07/12/2018
NOM059639	73030	-41	01/12/2018	NOM - Nominal Journal	2017 accruals revers - Office telephones	FWRIGHT	008468_099	07/12/2018
NOM059639	73030	-41	01/12/2018	NOM - Nominal Journal	2017 accruals revers - Office telephones	FWRIGHT	008468_099	07/12/2018
NOM059639	73030	-76	01/12/2018	NOM - Nominal Journal	2017 accruals revers - Office telephones	FWRIGHT	008468_099	07/12/2018
NOM059639	72050	-93	01/12/2018	NOM - Nominal Journal	2017 accruals revers - Heat & light	FWRIGHT	008468_099	07/12/2018
NOM059639	62125	-94	01/12/2018	NOM - Nominal Journal	2017 accruals revers - Sales NI	FWRIGHT	008468_099	07/12/2018
NOM059639	72050	-150	01/12/2018	NOM - Nominal Journal	2017 accruals revers - Heat & light	FWRIGHT	008468_099	07/12/2018
NOM059639	72050	-200	01/12/2018	NOM - Nominal Journal	2017 accruals revers - Heat & light	FWRIGHT	008468_099	07/12/2018
NOM059639	73030	-205	01/12/2018	NOM - Nominal Journal	2017 accruals revers - Office telephones	FWRIGHT	008468_099	07/12/2018
NOM059639	71005	-465	01/12/2018	NOM - Nominal Journal	2017 accruals revers - Admin Ni	FWRIGHT	008468_099	07/12/2018
NOM059639	71090	-590	01/12/2018	NOM - Nominal Journal	2017 accruals revers - Artwork Manager	FWRIGHT	008468_099	07/12/2018
NOM059639	73035	-666	01/12/2018	NOM - Nominal Journal	2017 accruals revers - Mobile phones	FWRIGHT	008469_099	07/12/2018
NOM059639	73035	-673	01/12/2018	NOM - Nominal Journal	2017 accruals revers - Mobile phones	FWRIGHT	008469_099	07/12/2018
NOM059639	73035	-699	01/12/2018	NOM - Nominal Journal	2017 accruals revers - Mobile phones	FWRIGHT	008469_099	07/12/2018
NOM059639	71090	-800	01/12/2018	NOM - Nominal Journal	2017 accruals revers - Artwork Manager	FWRIGHT	008468_099	07/12/2018
NOM059639	72050	-800	01/12/2018	NOM - Nominal Journal	2017 accruals revers - Heat & light	FWRIGHT	008468_099	07/12/2018
NOM059639	62120	-940	01/12/2018	NOM - Nominal Journal	2017 accruals revers - Sales	FWRIGHT	008468_099	07/12/2018
NOM059639	77020	-1,125	01/12/2018	NOM - Nominal Journal	2017 accruals revers - Prov of a director	FWRIGHT	008469_099	07/12/2018
NOM059639	62105	-2,374	01/12/2018	NOM - Nominal Journal	2017 accruals revers - Studio	FWRIGHT	008468_099	07/12/2018
NOM059639	77020	-2,500	01/12/2018	NOM - Nominal Journal	2017 accruals revers - Accountancy T Talbot	FWRIGHT	008469_099	07/12/2018
NOM059639	71000	-4,645	01/12/2018	NOM - Nominal Journal	2017 accruals revers - Admin	FWRIGHT	008468_099	07/12/2018
NOM059639	61010	-6,545	01/12/2018	NOM - Nominal Journal	2017 accruals revers - Purchases	FWRIGHT	008468_099	07/12/2018
NOM059639	71070	-6,836	01/12/2018	NOM - Nominal Journal	2017 accruals revers - staff pension	FWRIGHT	008468_099	07/12/2018
NOM059639	77030	-8,000	01/12/2018	NOM - Nominal Journal	2017 accruals revers - Audit	FWRIGHT	008469_099	07/12/2018
NOM059639	71025	-15,784	01/12/2018	NOM - Nominal Journal	2017 accruals revers - Compensation	FWRIGHT	008468_099	07/12/2018
NOM059639	62100	-23,738	01/12/2018	NOM - Nominal Journal	2017 accruals revers - Studio	FWRIGHT	008468_099	07/12/2018
NOM059639	77035	-137,989	01/12/2018	NOM - Nominal Journal	2017 accruals revers - Consult	FWRIGHT	008469_099	07/12/2018

Then this further transaction was posted to reverse the 2017 accruals with a lower total of £216,075 debited to 34030 Accruals Control A/C.

By comparing the entries to the expense accounts with the previous larger transaction the difference can be identified as an accrual of £112,050 to account 72000 – Rent Charge which is not reversed in the second transaction below. Thus, the net effect of these transactions is that the 2017 rent accrual is left in place.

(2) Pension loan

Note: The data relevant to the Pension Loans shown below was available for examination in the 11 month data provided as Advance Information. Being familiar with these entries before the mock examination would clearly be beneficial.

Select Account number 35041 – Pension Loan 2 within liabilities in Account View.

Asset	1.84M (↑47.9%)	Liability	876K (↓0.9%)	Equity	360K (↓1903.3%)

Liability

ACCOUNT	PY BALANCE	CY BALANCE	DIFFERENCE		
31010 - Payables Control Acco...	148,109	151,941	3,832	↑3 %	
31025 - HP Creditors	3,942	0	-3,942	↓100 %	
32010 - Social Security Liability	37,292	30,250	-7,042	↓19 %	
32020 - Tax liability	-53,818	-10,894	42,924	↓80 %	
33010 - Sales Tax Output Cont...	5,784,774	6,171,262	386,488	↑7 %	
33020 - Sales Tax Input Contro...	-2,857,669	-3,026,917	-169,248	↑6 %	
33030 - Sales Tax Payments/R...	-2,900,550	-3,076,902	-176,352	↑6 %	
34030 - Accruals Control A/C	326,943	106,153	-220,790	↓68 %	
35041 - Pension Loan 2	114,112	0	-114,112	↓100 %	✓
35042 - Loan payable	280,557	215,339	-65,217	↓23 %	
35043 - Pension Loan 3	0	315,501	315,501	↑100 %	
31800 - Other loans	0	0	0	0 %	
34500 - Other Accruals	0	0	0	0 %	

Click on ☰ to examine transactions.

Liability Transactions

Transaction Id	Description	Debit	Credit	Account Codes	Effective Dates	User Ids	Document Types	Created Dates
NOM059052	TDG Pension Loan - Pension Loan	4,597	0	35041	21/12/2018	FWRIGHT	NOM - Nominal Journal	27/12/2018 07:11:31
NOM059585	TDG Pension Loan - Pension Loan	4,611	0	35041	23/01/2018	FWRIGHT	NOM - Nominal Journal	29/01/2018 18:32:52
NOM059954	Pension Loan 3 - Transfer of Pension loan2 to pension loan 3	104,905	0	35041	27/01/2018	FWRIGHT	NOM - Nominal Journal	02/02/2018 06:58:36
NOM059989	TDG Pension Loan - Pension Loan	4,624	0	35041	20/02/2018	TPOTTS	NOM - Nominal Journal	26/02/2018 13:33:55
NOM060015	TDG Pension Loan - Pension Loan/STO refunded	0	4,624	35041	20/02/2018	JSMITH	NOM - Nominal Journal	26/02/2018 09:10:40

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This shows the transfer of £104,905 to Pension Loan 3 thus extinguishing the liability. Clicking on the Transaction Id shows the entries related to the transaction.

Transaction 'NOM059954'

Transaction Id	Account Code	Amount	Effective Date	Document Type	Journal Description	User Id	Line Description	Entered Date
NOM059954	35041	104,905	27/01/2018	NOM - Nominal Journal	Pension Loan 3 - Transfer of Pension loan2 to pension loan 3	FWRIGHT	012254_004	02/02/2018
NOM059954	77010	12,000	27/01/2018	NOM - Nominal Journal	Pension Loan 3 - Fees due for pension loan 3	FWRIGHT	012254_004	02/02/2018
NOM059954	77035	4,554	27/01/2018	NOM - Nominal Journal	Pension Loan 3 - Valuation fee from Coller IP	FWRIGHT	012254_004	02/02/2018
NOM059954	35043	-4,554	27/01/2018	NOM - Nominal Journal	Pension Loan 3 - Valuation fee from Coller IP	FWRIGHT	012254_004	02/02/2018
NOM059954	35043	-12,000	27/01/2018	NOM - Nominal Journal	Pension Loan 3 - Fees due for pension loan 3	FWRIGHT	012254_004	02/02/2018
NOM059954	35043	-104,905	27/01/2018	NOM - Nominal Journal	Pension Loan 3 - Transfer of Pension loan2 to pension loan 3	FWRIGHT	012254_004	02/02/2018

Show 10 lines

Showing 1 to 6 of 6 lines

This reveals fees credited to Pension Loan 3.

Select 35043 – Pension Loan 3 in Account View.

Asset	1.84M (↑ 47.9%)	Liability	876K (↓ 0.9%)	Equity	360K (↓ 1903.3%)

Liability

ACCOUNT	PY BALANCE	CY BALANCE	DIFFERENCE	
31010 - Payables Control Acco...	148,109	151,941	3,832	↑ 3 %
31025 - HP Creditors	3,942	0	-3,942	↓ 100 %
32010 - Social Security Liability	37,292	30,250	-7,042	↓ 19 %
32020 - Tax liability	-53,818	-10,894	42,924	↓ 80 %
33010 - Sales Tax Output Cont...	5,784,774	6,171,262	386,488	↑ 7 %
33020 - Sales Tax Input Contro...	-2,857,669	-3,026,917	-169,248	↑ 6 %
33030 - Sales Tax Payments/R...	-2,900,550	-3,076,902	-176,352	↑ 6 %
34030 - Accruals Control A/C	326,943	106,153	-220,790	↓ 68 %
35041 - Pension Loan 2	114,112	0	-114,112	↓ 100 %
35042 - Loan payable	280,557	215,339	-65,217	↓ 23 %
35043 - Pension Loan 3	0	315,501	315,501	↑ 100 %
31800 - Other loans	0	0	0	0 %
34500 - Other Accruals	0	0	0	0 %

Click on ☰ to examine transactions.

Liability Transactions

Transaction Id	Description	Debit	Credit	Account Codes	Effective Dates	User Ids	Document Types	Created Dates
NOM059702	Pension Loan - Receipt of Pension Loan	0	243,541	35043	27/01/2018	ABLOGGS	NOM - Nominal Journal	02/02/2018 13:25:10
NOM059954	Pension Loan 3 - Transfer of Pension loan2 to pension loan 3	0	121,459	35043	27/01/2018	FWRIGHT	NOM - Nominal Journal	02/02/2018 06:58:36
NOM059990	TDG Pension Loan 3 - TDG Pension loan 3	4,776	0	35043	20/02/2018	FWRIGHT	NOM - Nominal Journal	26/02/2018 12:14:22
NOM060359	TDG Pension Loan 3 - TDG Pension loan 3	4,814	0	35043	23/03/2018	JSMITH	NOM - Nominal Journal	29/03/2018 13:29:39
NOM060756	TDG Pension Loan - TDG Pension Loan	4,852	0	35043	25/04/2018	ABLOGGS	NOM - Nominal Journal	01/05/2018 17:07:34
NOM061146	TDG Pension Loan 3 - TDG Pension loan 3	4,890	0	35043	23/05/2018	FWRIGHT	NOM - Nominal Journal	29/05/2018 19:37:31
NOM061522	TDG Pension Loan - TDG Pension Loan	4,929	0	35043	22/06/2018	FWRIGHT	NOM - Nominal Journal	28/06/2018 10:25:16
NOM061893	TDG Pension Loan 3 - TDG Pension loan 3	4,968	0	35043	24/07/2018	JSMITH	NOM - Nominal Journal	30/07/2018 13:25:54
NOM062322	TDG Pension Loan - TDG Pension Loan	5,008	0	35043	23/08/2018	JSMITH	NOM - Nominal Journal	29/08/2018 11:20:48
NOM062748	TDG Pension Loan - TDG Pension Loan	5,047	0	35043	22/09/2018	JSMITH	NOM - Nominal Journal	28/09/2018 16:44:31
NOM063191	TDG Pension Loan 3 - TDG Pension loan 3	5,087	0	35043	23/10/2018	FWRIGHT	NOM - Nominal Journal	29/10/2018 11:45:51
NOM063667	TDG Pension Loan - TDG Pension Loan	5,127	0	35043	22/11/2018	FWRIGHT	NOM - Nominal Journal	28/11/2018 09:42:51

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Shows new funds received of £243,541 and transfer of Pension Loan 2 of £121,459 followed by monthly loan payments.

Clicking on the Transaction Id for the transfer reveals the fees credited to the account, (these may already have been identified by examining account 35041 as above).

Transaction 'NOM059954'

Transaction Id	Account Code	Amount	Effective Date	Document Type	Journal Description	User Id	Line Description	Entered Date
NOM059954	35041	104,905	27/01/2018	NOM - Nominal Journal	Pension Loan 3 - Transfer of Pension loan2 to pension loan 3	FWRIGHT	012254_004	02/02/2018
NOM059954	77010	12,000	27/01/2018	NOM - Nominal Journal	Pension Loan 3 - Fees due for pension loan 3	FWRIGHT	012254_004	02/02/2018
NOM059954	77035	4,554	27/01/2018	NOM - Nominal Journal	Pension Loan 3 - Valuation fee from Coller IP	FWRIGHT	012254_004	02/02/2018
NOM059954	35043	-4,554	27/01/2018	NOM - Nominal Journal	Pension Loan 3 - Valuation fee from Coller IP	FWRIGHT	012254_004	02/02/2018
NOM059954	35043	-12,000	27/01/2018	NOM - Nominal Journal	Pension Loan 3 - Fees due for pension loan 3	FWRIGHT	012254_004	02/02/2018
NOM059954	35043	-104,905	27/01/2018	NOM - Nominal Journal	Pension Loan 3 - Transfer of Pension loan2 to pension loan 3	FWRIGHT	012254_004	02/02/2018

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Showing 1 to 6 of 6 lines

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NEL Bank loan

Select the Loan Payable within liabilities in account view.

Asset	1.84M (↑ 47.9%)	Liability	876K (↓ 0.9%)	Equity	360K (↓ 1903.3%)

Liability

ACCOUNT	PY BALANCE	CY BALANCE	DIFFERENCE		
31010 - Payables Control Acco...	148,109	151,941	3,832	↑ 3 %	☐
31025 - HP Creditors	3,942	0	-3,942	↓ 100 %	☐
32010 - Social Security Liability	37,292	30,250	-7,042	↓ 19 %	☐
32020 - Tax liability	-53,818	-10,894	42,924	↓ 80 %	☐
33010 - Sales Tax Output Cont...	5,784,774	6,171,262	386,488	↑ 7 %	☐
33020 - Sales Tax Input Contro...	-2,857,669	-3,026,917	-169,248	↑ 6 %	☐
33030 - Sales Tax Payments/R...	-2,900,550	-3,076,902	-176,352	↑ 6 %	☐
34030 - Accruals Control A/C	326,943	106,153	-220,790	↓ 68 %	☐
35041 - Pension Loan 2	114,112	0	-114,112	↓ 100 %	☐
35042 - Loan payable	280,557	215,339	-65,217	↓ 23 %	☑
35043 - Pension Loan 3	0	315,501	315,501	↑ 100 %	☐
31800 - Other loans	0	0	0	0 %	☐
34500 - Other Accruals	0	0	0	0 %	☐

Click on ☰ to examine transactions.

Liability Transactions

Transaction Id	Description	Debit	Credit	Account Codes	Effective Dates	User Ids	Document Types	Created Dates
NOM059280	NEL Loan - NEL Loan	9,040	0	35042	02/01/2018	ABLOGGS	NOM - Nominal Journal	08/01/2018 08:08:17
NOM059707	NEL Loan - NEL Loan	9,108	0	35042	30/01/2018	JSMITH	NOM - Nominal Journal	05/02/2018 08:04:28
NOM060114	NEL Loan - NEL Loan	9,176	0	35042	28/02/2018	TPOTTS	NOM - Nominal Journal	06/03/2018 08:42:44
NOM060440	NEL Loan - NEL Loan	5,500	0	35042	30/03/2018	ABLOGGS	NOM - Nominal Journal	05/04/2018 19:58:26
NOM060840	NEL Loan - NEL Loan	5,500	0	35042	01/05/2018	FWRIGHT	NOM - Nominal Journal	07/05/2018 18:49:57
NOM061222	NEL Loan - NEL Loan	5,500	0	35042	30/05/2018	JSMITH	NOM - Nominal Journal	05/06/2018 18:12:02
NOM061628	NEGF Loan - NEL Loan	5,500	0	35042	30/06/2018	ABLOGGS	NOM - Nominal Journal	06/07/2018 06:58:26
NOM061988	NEGF Loan - NEL Loan	5,500	0	35042	01/08/2018	FWRIGHT	NOM - Nominal Journal	07/08/2018 08:50:26
NOM062425	NEGF Loan - NEL Loan	5,500	0	35042	30/08/2018	ABLOGGS	NOM - Nominal Journal	05/09/2018 16:26:35
NOM062919	NEGF Loan - NEL Loan	7,000	0	35042	02/10/2018	FWRIGHT	NOM - Nominal Journal	08/10/2018 18:01:32
NOM063308	NEGF Loan - NEL Loan	7,000	0	35042	30/10/2018	JSMITH	NOM - Nominal Journal	05/11/2018 18:04:40
NOM063708	NEGF Loan - NEL Loan	7,000	0	35042	30/11/2018	FWRIGHT	NOM - Nominal Journal	06/12/2018 08:35:28
NOM064007	NEL Loan - Correct NEL loan capital/interest Apr-Dec	0	16,107	35042	30/11/2018	FWRIGHT	NOM - Nominal Journal	06/12/2018 07:29:29

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This shows a change in loan payments during the year, suggesting some form of rescheduling has taken place.

Clicking on the Transaction Id for a payment in Jan or Feb shows capital repayment plus interest to SOPL.

Transaction 'NOM060114'

Transaction Id	Account Code	Amount	Effective Date	Document Type	Journal Description	User Id	Line Description	Entered Date
NOM060114	35042	9,176	28/02/2018	NOM - Nominal Journal	NEL Loan - NEL Loan	TPOTTS	012489_004	06/03/2018
NOM060114	76010	1,972	28/02/2018	NOM - Nominal Journal	NEL Loan - NEL Loan	TPOTTS	012489_004	06/03/2018
NOM060114	20010	-1,972	28/02/2018	NOM - Nominal Journal	NEL Loan - NEL Loan	TPOTTS	012489_004	06/03/2018
NOM060114	20010	-9,176	28/02/2018	NOM - Nominal Journal	NEL Loan - NEL Loan	TPOTTS	012489_004	06/03/2018

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Clicking on the Transaction Id for any payment from March shows the whole loan payment recognised as a repayment of loan.

Transaction 'NOM060440'

Transaction Id	Account Code	Amount	Effective Date	Document Type	Journal Description	User Id	Line Description	Entered Date
NOM060440	35042	5,500	30/03/2018	NOM - Nominal Journal	NEL Loan - NEL Loan	ABLOGGS	013235_004	05/04/2018
NOM060440	20010	-5,500	30/03/2018	NOM - Nominal Journal	NEL Loan - NEL Loan	ABLOGGS	013235_004	05/04/2018

Show 10 lines

Showing 1 to 2 of 2 lines

CANCEL

The transaction posted in December below appears to be a correction of the errors revealed above – failure to split total loan payments from March into loan interest and repayment of principal.

Transaction 'NOM064007'

Transaction Id	Account Code	Amount	Effective Date	Document Type	Journal Description	User Id	Line Description	Entered Date
NOM064007	76010	16,107	30/11/2018	NOM - Nominal Journal	NEL Loan - Correct NEL loan capital/interest Apr-Dec	FWRIGHT		06/12/2018
NOM064007	35042	-16,107	30/11/2018	NOM - Nominal Journal	NEL Loan - Correct NEL loan capital/interest Apr-Dec	FWRIGHT		06/12/2018

Show 10 lines

Showing 1 to 2 of 2 lines

3 **Wecare**

Marking guide

Requirement	Marks	Skills
For each of the two issues described in Liz's email (Exhibit 2), set out:		
(1) (a) An explanation of the appropriate financial reporting treatment in both the consolidated and individual companies' financial statements: • Mayfield Rd • Investment in Gull	15	Identify the impairment of Mayfield Road. Advise that the group impairment loss may be higher due to fair value adjustment. Determine that the goodwill on consolidation may be impaired. Distinguish costs which require provision. Determine that the subsidiary would no longer be consolidated and determine profit on disposal of the subsidiary. Recognise that this is a deemed disposal and account for it accordingly.
(b) The specific audit procedures we should carry out during our audit for the year ending 31 July 20X4.	6	Recommend relevant audit procedures to address financial reporting issues identified.
(2) (a) Using analytical procedures (financial statement analysis), identify and explain any other audit issues which you have noted from your review of the management accounts (Exhibit 3) and the other information provided.	8	Perform financial statement analysis to identify audit issues. Link information from different sources in the scenario.

Requirement	Marks	Skills
(b) For each audit issue, set out the key audit procedures we should perform.	5	Recommend relevant audit procedures to address audit issues identified.
(3) Explain the matters that the firm needs to consider in determining whether or not to accept the engagement to review the Wecare group companies' forecast financial statements.	7	Discuss the appropriate level of assurance that can be given in an engagement to review prospective information. Identify the need to understand the intended use of the prospective information, as discussed in ISAE 3400. Identify the independence threats that may be posed by accepting the engagement, and suggest relevant safeguards.
Total marks	**41**	
Maximum marks	**30**	

(1) (a) **An explanation of the appropriate financial reporting treatment in both the consolidated and individual companies' financial statements and specific audit procedures we should carry out**

Mayfield Road – Points for response to Liz

It is clear from the information provided that there has been an impairment in the value of the Mayfield Road property. The carrying amount of the property will need to be reduced to recoverable amount which is the higher of its fair value less costs to sell and its value in use. As there is no intention to continue to let the property, fair value less costs to sell is likely to be the higher. (Alternatively, as the property is to be disposed of it has no further value in use other than its disposal value.)

The estate agent's valuation would give rise to an impairment loss of £0.7 million in the financial statements of Twilight, assuming that it is appropriate to use the estate agent's valuation (will only be so if it is fair value less costs to sell). However, the recoverable amount should also take account of the direct costs of sale so the actual impairment loss may be higher. The loss should be charged as a cost to profit or loss giving rise to the entry:

DEBIT Impairment loss in profit or loss
CREDIT Carrying value of property

The carrying amount of the property may be higher in the group accounts as an increase in the value of property was recognised as a fair value adjustment when the company was acquired a year ago. To the extent that the fair value adjustment relates to Mayfield Road, a higher impairment loss should be recognised.

There is also the question of whether the decision to shut down one of the apartment buildings gives rise to any impairment of goodwill at the group level. Each apartment building is a separate cash generating unit (CGU), but it is unclear whether the goodwill has been or can be allocated between them. To the extent that it can be allocated then the element relating to Mayfield Road will be totally impaired as the decision has been made to cease this element of the business. This will give rise to an additional charge for impairment within group profit or loss.

If the goodwill cannot be allocated between the three apartment buildings then an impairment test will be required across all three CGUs combined to determine whether the remaining carrying value of the net assets and goodwill within the consolidated financial statements is supported by the net present value of the cash flows to be generated from the remaining two apartment buildings. To the extent that it is not, any impairment charge will be allocated first to the goodwill balance and then to the other assets.

Closing the Mayfield Road apartment building will also have other consequences and give rise to other costs. These are likely to include costs associated with relocating the remaining tenants who will have rights under their tenancy agreements which will need to be honoured or possibly renegotiated. There may also be staff redundancies and security and other costs associated with the vacant site in the period to disposal. As the decision is to be communicated to staff prior to year end, the redundancy costs should be provided under IAS 37 as should contractual amounts payable to the remaining tenants. Other operating costs will need careful consideration to determine whether they are part of a future operating loss (which should not be provided), reorganisation costs (which should be provided) or costs which should be taken into account in determining the impairment of the assets.

Where it is appropriate to recognise costs under IAS 37, these will involve an element of estimation and the correct entry will therefore be:

DEBIT	Reorganisation costs (shown separately in the statement of profit or loss as an exceptional item)
CREDIT	Provisions

In terms of classification, the question arises as to whether the Mayfield Road property should be classified as a 'held for sale' asset at the year end. In order to qualify it must be available for immediate sale and its sale must be highly probable, which requires among other things active marketing. The IFRS 5 conditions are that the carrying amount should be recovered principally through sale, it must be available for immediate sale in its present condition subject to such terms as are usual, and its sale must be highly probable (IFRS 5: paras. 6–7).

(If the asset is classified as held for sale, then the business may be regarded as a discontinued business as the definition of such a business is that it is a CGU which has either been disposed of (not the case) or held for sale (IFRS 5: App A). It will be disclosed as a discontinued business in both Twilight's accounts and those of the group. However, further information is required to determine this.)

(b) **Mayfield Road – Audit procedures**

- Obtain from the client their assessment of any impairment loss to be booked both in Twilight and at the group level. Recalculate the loss and ensure that it is based on the correct carrying values in both Twilight and at a group level.
- Obtain support for the estimated sale value attributed to the property and assess whether the basis of the valuation is appropriate.
- Consider the qualification of the valuer used by the estate agent and whether there is corroborative evidence as to value from any other sources such as recent similar property transactions or values from other estate agents/professional valuers.
- Consider the need to involve an auditor's expert in assessment of the valuation and its reasonableness.
- Consider the estimate of sales costs used in the impairment calculation and ensure that the costs are both reasonable and complete.
- Consider whether the goodwill on acquisition of Twilight can be allocated between the CGUs as it would seem likely that this should be possible. In making this assessment, consider evidence from prior year files and from client working papers and contractual documentation at the time of the acquisition.
- If the client has concluded that goodwill cannot be allocated we need to challenge this as it is a surprising conclusion given that the three buildings are on separate sites. If we are satisfied that this is the case, obtain cash flow projections for the continuing business and consider the extent to which they support the carrying value of the total assets and goodwill relating to that business within the group statement of financial position.
- Subject the cash flows used in the client calculations to independent scrutiny, considering the reasonableness of assumptions made and the sensitivity of the results to particular assumptions.
- Consider the extent to which the property is both available for sale at the year end and being actively marketed and conclude as to whether it should be classified as a held for sale asset. Evidence obtained may include copies of marketing materials, instructions given to estate agents and the extent of interest in the property to date. It may also include legal advice as to the position of the existing tenants and the extent to which vacant possession of the property can be obtained.
- Determine whether the client has made any provisions for reorganisation costs at year end. Where provisions have been made, obtain a detailed analysis and review evidence that decisions were communicated to staff and residents pre-year end and that the company could not realistically withdraw from its decision. Review

Board minutes for evidence of when the Board decision was made. Assess the reasonableness of any provisions made by reference to statutory and legal rights; communications and promises made; cost incurred in the past for similar exercises; estimates obtained; legal advice provided etc. Consider whether the provisions appear complete taking into account the plans and decisions made.

- Ensure that only reorganisation costs are provided and that other costs are either included in the assessment of impairment (if appropriate) or charged in future years.
- Consider the disclosure made within the financial statements to ensure that costs are appropriately classified and described.

Investment in Gull – points for Liz

The introduction of a new investor in Gull will result in a reduction in Wecare's interest in its subsidiary and a part disposal. As the new investor will have a 60% interest, it seems likely that Gull will no longer be a subsidiary but an associate (although a review of the detailed agreement and any control clauses is needed to confirm this). It is also possible that the arrangement will qualify as a jointly controlled entity.

In either case (JV or associate), Wecare will cease to consolidate Gull's results in the same way as it has done historically. Instead, using the equity method, it will include on a single line in the consolidated statement of profit or loss its share of Gull's profit and, in the consolidated statement of financial position, the group's interest in Gull will be shown as an investment.

Up to the date of disposal, Wecare should continue to consolidate 100% of Gull's results in the normal way.

This is a deemed disposal, rather than a regular disposal, as the new shares in Gull will be issued to Tend Ltd and the proceeds on issue go to Gull rather than the group.

On disposal, the gain to be recorded in the consolidated accounts is calculated as follows:

	£'000
Proceeds received	Nil
Add fair value of 40% interest retained	650
Deduct net assets of Gull immediately prior to the disposal	(233)
Profit on disposal	417

(The net assets at 31 May 20X4 are used in the above calculation of £233,000 but these may change before year end and when tax and other year-end adjustments are included.)

Hence a gain of the order of £0.4 million will be recognised and the 40% investment will be recorded at its fair value of £650,000. Wecare will then recognise only 40% of any future profit made by Gull.

In Gull's financial statements, it will recognise a share issue, recording £15,000 as share capital and £1.185 million as share premium, along with £1.2 million in cash.

If the transaction completes before the issue of the financial statements for the year ending 31 July 20X4, it must be disclosed as an event after the reporting period in the financial statements for both Gull and Wecare.

Investment in Gull – audit procedures

- Consider whether the transaction has been completed before the financial statements are signed. If so, review contracts and ensure that the event is disclosed accurately in the financial statements for both Gull and Wecare.
- To the extent that the transaction has not been completed but is key in projections used to determine compliance with bank covenants or to assess going concern (see below), the probability of it being completed will need to be assessed as it may be so significant that an uncertainty should be disclosed. To assess this, we will need to gain a good understanding of the progress of negotiations and due diligence, any issues raised and, where possible, seek the view of external advisors as to the likelihood of it completing.
- There is an incentive to manipulate the financial statements in light of the pending sale. We will need to apply professional scepticism to management estimates and assertions.

(2) **Other audit issues noted from the review and key audit procedures for each issue**

- Mark-up on intra-group recharges

  The mark up seems higher than might be expected at 24.4% of operating costs (although it is possible that some recharge of finance costs can be justified if financing has been passed on to the subsidiaries who have at least benefitted from making no payment for recharged costs until after year end). We need to consider whether this is reasonable and also look at the way costs are allocated between the two subsidiaries as Twilight's cost appears disproportionately high. This could be motivated by a desire to improve Gull's results in advance of the sale transaction.

  Audit procedures

  We will need to look at how charges compare to prior year and whether the basis is consistent. We will also need to review transfer pricing documentation in place.

- Finance costs in Gull

  Finance costs in Gull look too low – we would expect £800,000 @ 8% × 10 months/12 months = £53,333, whereas charge recorded is only for 4 months at £21,000. This looks like an error and will need to be investigated. As interest is payable monthly, the company may also be in default of its loan agreement. If this is the case, it could have much more

significant implications, such as the bank demanding the entire loan to be repaid immediately. This, in turn, would have going concern implications.

Audit procedures

Will need to confirm loan agreement terms and ascertain to what extent discussions have been held with the bank. To the extent that different terms have been agreed, we will need confirmation of this in writing from the bank.

- Completeness of consolidation adjustments

  There is a consolidation adjustment to increase the carrying amount of property but no depreciation on this has been booked at present.

  Audit procedures

  We will need to investigate whether any depreciation charge is necessary at the year end and also check by reference to prior year and our own consideration of the adjustments which would be expected that all relevant consolidation adjustments are made. Although we are told that the adjustment concerns Twilight's freehold land, some depreciation might still be required.

- Capitalisation of improvement and renovation works in Gull

  Additions to the property value in Gull are significant and there is a risk that repairs and general maintenance work have been capitalised which would be incorrect.

  Audit procedures

  We need to obtain details of the additions recorded and ensure by reference to the invoices and the physical work done that it is appropriate to capitalise these amounts.

- Receivables in Gull

  Receivables in Gull look unexpectedly high given that residents typically pay in advance. It may be that they represent advance bills. Two risks arise: firstly, that Gull is failing to collect fees from residents and potentially has a bad debt problem; secondly, that income is being recognised too early, artificially boosting results.

  Audit procedures

  – Consider age and collectability of year end receivable balances and the extent to which they have been paid post year end.
  – Review the income received to ensure that all and only amounts relating to pre year end services/periods have been recognised. This work will focus especially on any income billed in the month/quarter as some of this could relate to post year end periods.

- Motivation for fraud in Gull

  The future of Gull may depend on satisfactorily concluding contracts with its new investor so there is an incentive for management to make the company's results as attractive as possible. A number of the points above could be indicative of deliberate manipulation of results (although error or the absence of year end journals are also possible explanations).

  Audit procedures

  We will need to remain sceptical throughout the audit process and ensure that we are vigilant for any indications that results are being manipulated or judgement skewed.

- Classification of loans

  All loan balances are classified as long-term in the management accounts. From terms of loans it is clear that the following elements should be classified as short-term as at the year end:

  – Wecare – £400,000 due on 31 July 20X5 (assuming 20X4 payment made on time)

  – Twilight – £500,000 due on 31 March 20X5 + 4 months interest on £5m = £125,000

  – Gull – £160,000 due on 30 September 20X4 + interest for 9 months to July 20X5 unless paid pre-year end + any interest arrears – see above

  However, a failure to pay interest on the Gull loan (see above) may mean that further elements become due immediately and this should be taken into account. In addition, work will be required to ensure that any other terms/bank covenants are met as any failure to do so might affect the repayment dates and make the loans repayable immediately.

  Audit procedures

  Audit procedures on this will need to include a detailed review of the agreements and compliance with them along with recalculation of the elements shown as short-term.

- Going concern

  Going concern needs to be considered separately for each entity, but the group position may also be relevant as it would be possible for one entity to support or fund another.

  The group as a whole has net current assets of £733,000 but this is before taking into account the loan repayment due on 31 July 20X4 of £400,000 and annual interest also due on that date of £170,000, leaving a balance of £163,000. This will be reduced to a negative net current asset figure when the loan repayments due within the next year are taken into account.

Audit procedures

As a result it will be necessary to obtain detailed cash flow projections to ensure that there is evidence that the group and each company within it will be able to meet their debts as they fall due taking into account anticipated cash inflows during the year.

Gull has a particular issue as it clearly has insufficient cash at present to meet the repayment due on 30 September and may have triggered repayment of the whole loan through its failure to make interest payments. The cash inflow from the potential deal would be sufficient to resolve this issue but that is uncertain and there may be commitments associated with the deal such that the share issue proceeds are spent not on the repayment of loans but on future capital development.

Wecare does not have sufficient cash to meet the 31 July 20X4 debt repayments unless it collects its debt from the group companies (which will presumably be higher still by year end). Gull's ability to pay its balance due has to be in doubt.

We will need to include a review of support for key cash flows and sensitivity analysis as it does appear that there may be some uncertainty over the entities' ability to meet their debts as they fall due for at least one year from the date of signing.

Even if it is appropriate at group level, it may still be necessary for commitments of support/funding to be put in place between the entities such that each can meet their commitments.

If the projections rely on uncertain events such as an incomplete transaction, then it may be necessary to draw attention to this fundamental uncertainty in the accounts and potentially as an emphasis of matter paragraph in the auditor's report. If we conclude that a material uncertainty exists in relation to the use of the going concern basis of accounting (and adequate disclosure is made in the financial statements) we will include a Material Uncertainty Related to Going Concern section in our auditor's report.

(3) **The matters the firm needs to consider in determining whether or not to accept the engagement to review Wecare Group's forecast financial statements for the year ending 31 July 20X5**

It is important for the firm to consider the following matters before accepting the engagement:

- the level of assurance that can be given;
- the intended use of the information and the nature of the assumptions made; and
- ethical and independence issues.

The level of assurance that can be given

Because the forecast financial statements presuppose future events and actions, which may not occur, making it more difficult for us as auditors to obtain a satisfactory level of assurance, the firm must consider the level of assurance that we can give under the circumstances.

As a result of this, ISAE 3400 recommends a limited level of assurance to be given when reporting on the reasonableness of management's assumptions (ISAE 3400.9). In other words, it may be preferable for the review opinion to be expressed in a negative form. It should be noted that the firm would also offer reasonable assurance in the form of an opinion about the application of these assumptions, as this can be determined with more certainty.

The level of assurance that we feel can be satisfactorily provided, and the form of the opinion and report, should be agreed in advance with the client, and explained in the engagement letter.

The intended use of the information and the nature of the assumptions made

The firm must consider the following matters:

- The **intended use of the information**: In this case, the information is provided to the bank to enable it to assess Wecare Group's ability to make the scheduled loan repayments. If it appears that the information is inappropriate for this purpose, we should not accept the engagement.
- **Whether the information will be for general or limited distribution**: By reviewing and reporting on the forecast financial statements, the firm may owe a duty of care to those who then rely upon the information. If the forecast financial statements are to be distributed to other third parties, it will be important to include wording in the report restricting the firm's responsibility to the other third parties.
- The **nature of the assumptions**: that is, whether they are best estimate or hypothetical assumptions. This will affect the nature of the review procedures that we undertake.
- The **elements to be included in the information**: ideally the forecast information will consist of the same financial statements as the historical financial information prepared by Wecare, making our review more straightforward and comparable.
- The **period covered by the information**: The longer the future period covered, the more speculative the information and the less assurance we will be able to provide. In this case, it appears that we are reviewing information relating to the next 12-month accounting period only. The level of assurance will need to be reviewed should the bank require any other information relating to further future periods.

(ISAE 3400.10)

In addition, the firm must also consider practical matters, such as the time available to them, the experience of the staff member compiling the information, any limitations on their work, and the degree of secrecy required beyond the normal duty of confidentiality.

Ethical and independence issues

As in any assurance engagement, we must ensure that we are, and appear to be, independent. A number of potential independence threats arise here, so the firm must implement safeguards to reduce them to an acceptable level:

(1) **Self-review threat**: Because the forecast contains underlying information and the assumptions that derive from, or will have an impact on, the statutory audited financial statements, a self-review threat will arise if the external audit team were to perform the review engagement. To mitigate this threat, a separate team should be used to carry out the engagement, reviewed by a separate partner. The firm must evaluate whether we have sufficient resources to do this.

(2) **Self-interest threat**: Although this is likely to be a one-off engagement, any additional engagement with Wecare increases the amount of revenue we earn from this client. The firm should review the proportion of revenue that arises from Wecare Group on a periodic basis. In addition, it is important to ensure that the fees for this work are fixed and agreed in advance with the client. Any contingent fee arrangements for an assurance engagement of this type are prohibited.

(3) **Advocacy/management threat**: Advocacy threat arises when the auditor is seen to promote the client's position to the detriment of his/her objectivity. In reviewing the forecast prepared for the bank, we must ensure that group management retains full responsibility for the forecast. We should set out the respective responsibilities of the client and the auditor in the engagement letter.

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