Financial reporting questions

1 Sagefoot plc

Marking guide

	Marks
Explanation of reporting treatment of remuneration schemes	6
(Recognition that the directors' share option scheme is an equity-settled share-based payment scheme.	
Recognition that the share appreciation rights for senior employees are a cash-settled share-based payment scheme.)	
Quantification of required adjustments	4
Explanation of the impact of the change in terms	2
Financial treatment of unusual transactions (the acquisition, the sale or return transaction, the deposit and the rights issue)	8
Quantification of adjustments	3
Earnings per share	8
Maximum available	31
Total	25

Memorandum

To: Rob Lovelace
From: Interim Finance Director
Date: 4 November 20X2

Financial statements for the year ended 30 September 20X2

As requested, I have considered various issues relating to the financial statements for the year ended 30 September 20X2. I set out my comments below. I have considered applicable IFRSs and other guidance.

Remuneration schemes

Directors' share option scheme

This is an equity-settled share-based payment scheme. The options have been issued as part of the directors' remuneration and the expense should be recognised in profit or loss. A corresponding amount should be recognised in equity, normally in a separate reserve. IFRS 2 *Share-based Payment* states that the transaction should be measured at fair value. As it is not possible to measure the fair value of the directors' services, the transaction is measured by reference to the fair value of the equity instruments granted. IFRS 2 normally requires fair value to be measured at the grant date.

Two conditions must be satisfied before the shares can vest. The first is a 'non market-based' condition that the directors have to remain with the company until the vesting date. The second condition is a 'market-based' condition: the share price must reach a specified level by the vesting date. Neither condition has yet been met, but the market-based condition should have already been taken into account when the fair value of each option was estimated and no further adjustment for it is necessary in arriving at the amount to be recognised in profit or loss. IFRS 2 states that the expense is recognised over the vesting period and is based on the best available estimate of the number of equity instruments expected to vest. This estimate is revised if the number of equity instruments expected to be issued changes (for example, if further directors leave the company before the end of the vesting period).

Therefore the expense should be based on the latest estimate that six directors will serve throughout the full three year period. The expense to be recognised in profit or loss for the year ended 30 September 20X2 (and also credited to equity) is £200,000 (6 × 100,000 × £1.00 × 1/3).

Share appreciation rights for senior employees

This is a cash-settled share-based payment scheme. As before, an expense should be recognised in profit or loss for the year, but in this case the company must recognise a liability for the cash that will eventually be paid to the employees.

IFRS 2 requires the expense to be measured as the fair value of the liability (in this case, the fair value of the right to receive cash). The fair value is re-measured at the end of each reporting period (for changes in both market-based and non market-based conditions) and any changes in fair value are recognised in profit or loss.

Otherwise, the financial reporting treatment is the same as for an equity-settled share-based payment scheme. The amount to be recognised is based on the latest estimate of the equity instruments expected to vest: 80%, or 160 employees, will remain in employment for the full six year period. The expense is recognised over the vesting period of six years.

Therefore the expense to be recognised in profit or loss for the year ended 30 September 20X2 (and the amount recognised as a liability) is £200,000 (160 × 10,000 × £1.00 × 1/6 × 9/12).

Modifications to an equity-settled share-based payment scheme

There are two main ways in which the directors' scheme could be modified to make it more favourable: the exercise price of the option could be reduced; or the vesting conditions could be altered.

If the exercise price of the option is reduced, the fair value of the equity instruments granted will increase. Therefore the company would need to recognise an additional expense to reflect the increased remuneration. The increase is spread over the period between the modification date and the vesting date.

If the vesting conditions are altered (to remove a condition or to make it more likely that a condition will be met) the remuneration expense is calculated based on the number of options expected to vest under the new conditions.

Significant transactions during the year

Acquisition of Foxpath

IFRS 3 (Revised) *Business Combinations* states that the cost of a business combination should be measured at the fair value of the consideration given. In this case the consideration is in the form of equity shares in Sagefoot and their fair value can be taken to be their market price on the date of the combination: 1 April 20X2.

Part of the consideration is a contingent consideration. Additional shares in Sagefoot will only be issued if the reported profits of Foxpath exceed £2m for the year ended 30 September 20X4. IFRS 3 (Revised) requires this to be recognised and measured at fair value at the acquisition date, regardless of whether it is probable that the additional amount will be due. If the profit forecasts are reliable, Foxpath should exceed the target. Profits for the year ended 30 September 20X4 should be £2.08m (£1.85m × 1.06 × 1.06), but the extra consideration will be recognised in any event.

Therefore the total cost of the combination is £11.5m (2,500,000 × £4.60) and this amount is used as consideration in the calculation of the goodwill arising on the combination.

Sale and return transaction

The treatment of the 2,000 copies of the novel which have been sold is straightforward. The revenue of £25,980 should be recognised with a matching cost of sale of £14,500 resulting in a profit of £11,480.

The issue regarding the books remaining at the period end is whether they should be recorded as inventory and a liability recognised. The treatment will depend on the substance of the transaction and whether the risks and rewards of ownership have been transferred to Sagefoot or are retained by the publisher. The 1,450 (5,000 – 2,000 – 750 – 800) copies which Sagefoot does not expect to sell and which have not been damaged should not be recorded as an asset or liability of Sagefoot. Sagefoot has not paid for these and does not have the rewards of ownership as it cannot set its own price. In addition it does not have the risks of ownership as the unsold items can be returned. No liability should be recognised in respect of these as there is no obligation to pay for them.

The 750 books which Sagefoot expects to sell may be recognised as an asset with a matching liability in spite of the right of return. Although the right exists in commercial terms, the company does not expect to exercise this right in respect of these particular items.

The treatment of the damaged books depends on the precise terms of the returns policy as Sagefoot is not able to return the books in the same condition as they were supplied. If Sagefoot is required to retain

this inventory a liability should be recognised of £5,800. Depending on the extent of the damage this inventory may need to be written down. Net realisable value may be affected by Sagefoot's ability to sell these books at a discount rather than the cover price.

Deposit

The deposits taken of £112,500 (25,000 × £9 × 50%) represent deferred income at the period end and should not be recognised as revenue in this accounting period. This should be recognised as revenue in the next accounting period when the customers have paid the balance for the book and have received their copies. In this year's accounts, the deferred income is recognised as a current liability.

Rights issue

The rights issue is treated as a non-adjusting event after the reporting period. Details of the rights issue and its financial effect must be disclosed in the notes to the financial statements as required by both IAS 10 *Events After the Reporting Period* and IAS 33 *Earnings per Share*.

The rights issue affects the calculation of the earnings per share for the year ended 30 September 20X2 (see below).

Earnings per share

Basic earnings per share

This can be calculated as $\frac{11,900,000}{7,833,333}$ = 152p

Basic earnings are as follows:

	£'000
Per draft consolidated financial statements	12,300
Directors' share option scheme (see above)	(200)
Senior employees' remuneration scheme (see above)	(200)
Adjusted post-tax profit for the year	11,900

The weighted average number of shares outstanding for the year is calculated below:

		Shares
1 October 20X1 to 31 March 20X2	(6,000,000 × 4.70/4.20 × 6/12)	3,357,143
1 April 20X2 to 30 September 20X2	(8,000,000 × 4.70/4.20 × 6/12)	4,476,190
		7,833,333

Note: Because the rights issue contains a bonus element, the weighted average number of shares must be adjusted (IAS 33 paragraph 64). The theoretical ex-rights price is £4.20 ((4 × £4.70 + £2.20) ÷ 5).

Diluted earnings per share

This can be calculated as $\frac{11,976,000}{10,433,333}$ = 115p

The full calculation is shown below:

	Earnings	No of shares	EPS
	£'000		£
Basic	11,900	7,833,333	1.52
Options:			
Number of shares under option		1,500,000	
Equivalent number at market price (1,500,000 × 2.70/4.50)		(900,000)	
	11,900	8,433,333	1.41
Convertible bonds:			
(948,418 × 8%) (Note 4)	76	2,000,000	
Diluted	11,976	10,433,333	1.15

Notes

(1) The rights issue is not included in the calculation, apart from the bonus element. The additional shares were issued after the year end and therefore were not potential ordinary shares during the year to 30 September 20X2.

(2) The directors' share options are not included in the calculation as the market-based condition was not met at 30 September 20X2.

(3) The additional 500,000 contingently issuable shares are not included in the calculation. Although it is probable that the shares will be issued, at 30 September 20X2 the condition had not yet been met.

(4) Interest saved on conversion of the bonds would normally be adjusted net of current income tax.

Please contact me if you require any further information.

Interim Finance Director

2 Tosca Group

Marking guide

			Marks
2.1	Preparation of statement of financial position, including share capital, share premium and other figures not affected by the adjustments (marks for adjustments and calculations shown separately below, and in detail on the related workings)	3	
	Impairment loss – Cavaradossi	4	
	Investment in associate	3	
	Retained earnings	5	
	Non-controlling interest	1	
	Fair value	1	
	Sale and repurchase	2	
	Group profit on disposal	3	
	Goodwill	1	
	Total available	23	
	Maximum		19
2.2	Cash flow hedge	2	
	Impairment review	2	
	Sale and repurchase and other points	4	
	Total available	8	
	Maximum		6
Total			25

Notes for meeting with finance director

2.1 **Tosca Group**

Consolidated statement of financial position as at 31 October 20X8

	£m
Non-current assets	
Property, plant and equipment (635 + (W4) 8)	643
Goodwill (20 – 8 (W5))	12
Investment in associate (W7)	342
Held to maturity investment	62.5
	1,059.5
Current assets	
Inventories	550
Trade receivables	240
Financial asset (futures contract) (W3)	2
Cash and cash equivalents (230 + 300 proceeds on disposal)	530
	1,322
	2,381.5
Equity attributable to owners of the parent	
Share capital of £1	500
Share premium	100
Retained earnings (W9)	780.1
	1,380.1
Non-controlling interests (W8)	101.4
	1,481.5
Non-current liabilities (440 + (W4) 10)	450
Current liabilities	450
	900
	2,381.5

2.2 **Explanations**

(a) **Cash flow hedge**

The loss on the forecast sale should not be accounted for as the sale has not yet taken place. However, the gain on the future should be accounted for under IAS 39. Hedge accounting can

be applied because the hedge has fallen within the required 80 – 125% effectiveness range (2/1.9 = 105%). **(2 marks)**

The double entry required is:

DEBIT	Financial asset (future)	£2m	
CREDIT	Other comprehensive income (with effective portion)		£1.9m
CREDIT	Profit or loss (with ineffective portion)		£0.1m

(Here both credits can be posted to retained earnings as we are preparing a statement of financial position.) **(2 marks for calculating adjustment)**

(b) **Impairment review**

The carrying value of Cavaradossi's net assets in the group accounts (including the fair value adjustment and the grossed up value of goodwill) must be compared with the recoverable amount. Working 6 shows that an impairment loss of £10m has arisen. The impairment of a cash generating unit is allocated first to any goodwill in that unit, so in this case the impairment is allocated wholly to goodwill and as only the group's portion of goodwill is recognised in the consolidated statement of financial position, only £8m of the loss is recognised in the group financial statements. **(1 mark)**

(c) **Sale and repurchase**

The concept of substance over form needs to be applied to determine the correct accounting treatment of this disposal.

The legal form is that a sale has taken place and Puccini Bank is now the legal owner of the land.

However, in substance, the commercial effect of the arrangement is that of a secured loan. Tosca continues to bear all the significant benefits and risks relating to the land, retains control of its development and bears all resulting gains and losses. In substance, the bank receives a lender's return on a secured loan.

Risks

The following terms of the agreement indicate that Tosca retains the risks of ownership of the land:

- Tosca has to pay all the outgoings of the land during Puccini Bank's ownership.
- Tosca has to pay interest to Puccini Bank (at Puccini Bank's base lending rate plus 2%) thus incurring the holding and financing costs of ownership.
- If Tosca does not exercise the repurchase option and Puccini Bank sells the land to a third party at a loss, Tosca will have to compensate Puccini Bank for this loss through settlement of the memorandum account. Thus Tosca retains the risk of any fall in value in the land.

Benefits

The following terms of the agreement indicate that Tosca retains the benefits of ownership of the land:

- Tosca retains the right to develop the land during Puccini Bank's ownership.
- Tosca has the option to repurchase the land at the original sales price plus interest (less annual fees) so retains the benefit of any increase in value of the land.
- If Puccini Bank sells the land to a third party at a profit, Tosca will receive this profit via the settlement of the memorandum account.

In conclusion, the substance of the transaction is that of a loan not a sale. Therefore, the land should be reinstated as a non-current asset in the statement of financial position at £8m, the profit on disposal of £2m (£10m – £8m) reversed through profit or loss and retained earnings and a loan recorded in non-current liabilities. (See Working 4.) **(1 mark)**

As the transaction took place on the last day of the year, no fees, interest or expenses on development of the land have occurred yet. However, in the year ended 31 October 20X9, the

5% fees paid to Puccini Bank should be deducted from the loan, the interest payable to Puccini Bank should be added to the loan and recorded as a finance cost and finally, any outgoings on development of the land should be recorded as an expense. **(1 mark)**

(d) **Part disposal of Scarpia**

IFRS 10 *Consolidated Financial Statements* outlines the treatment of partial disposals of subsidiaries. In this case control is lost but as significant influence is retained, Scarpia will be treated as an associate in the group accounts. **(1 mark)**

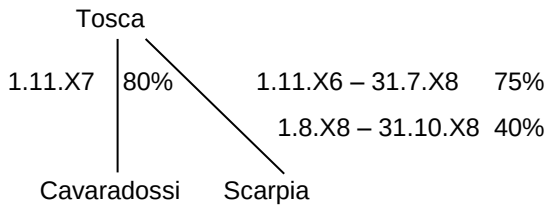
Where a parent loses control of a subsidiary, IFRS 10 requires that:

- assets, liabilities and the non-controlling interest must be derecognised
- any interest retained is recognised at fair value at the date of loss of control
- a gain or loss on loss of control is recognised in profit or loss (see Working 10).

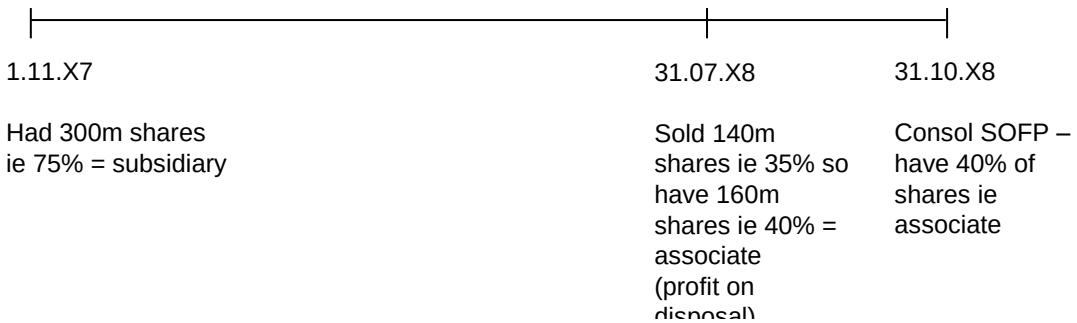
In the consolidated statement of financial position Scarpia must be equity accounted by reference to the year-end holding. The carrying amount of the associate is based on the fair value of the interest as included within the gain calculation. (See Working 7.)

WORKINGS

(1) **Group structure**



Scarpia for the current year:



(2) **Fair value adjustments**

Cavaradossi

	Acq'n date £m	**Movement** £m	**At year end** £m
PPE (450 – 250 – 50 – 120)	30	(5)*	25
	↓	↓	↓
	Goodwill	Retained earnings	SOFP & NCI

* Extra depreciation = 30 × 1/6

Scarpia

	Acq'n date £m	**Movement** £m	**At year end** £m
PPE (700 – 400 – 40 – 260)	0	0	0

(3) **Futures contract**

The double entry required is:

DEBIT	Financial asset (future)	£2m	
CREDIT	Other comprehensive income (with effective portion)		£1.9m
CREDIT	Profit or loss (with ineffective portion)		£0.1m

(Here both credits can be posted to retained earnings as we are preparing a statement of financial position.) **(1 mark)**

(4) **Sale and repurchase (Tosca)**

In substance, this is not a true sale (see answer to part 2.2 for more detailed explanation). The adjustment required is:

DEBIT	Property, plant and equipment	£8m	
DEBIT	P/L/Retained earnings (to cancel profit on disposal)	£2m	
CREDIT	Loan		£10m

(2 marks)

(5) **Goodwill in Cavaradossi**

	£m
Consideration transferred	380
Non-controlling interest (450 × 20%)	90
	470
Net assets acquired	(450)
Goodwill (as per draft SOFP)	20
Impairment loss (W6) (10 × 80%)	(8)
	12

Goodwill in Scarpia

	£m	
Consideration transferred	550	
Non-controlling interest (700 × 25%)	175	
	725	
Fair value of net assets acquired	(700)	
Goodwill	25	**(1 mark)**

(6) **Impairment loss on Cavaradossi**

	£m	
Notional goodwill (20 × 100%/80%)	25	
Net assets (480 + (W3) 2)	482	
Fair value adjustments (W2)	25	
Carrying amount	532	**(2 marks)**
Recoverable amount (520 + (W3) 2)	522	
Impairment loss (532 – 522)	10	
Allocate to:		
(1) Goodwill	10	
(2) Other assets pro rata	0	
Group share of goodwill impairment (10 × 80%)	8	**(2 marks)**

(7) **Investment in associate (Scarpia)**

	£m	
Fair value at date control lost	340	**1**
Group share of post-acquisition profit (20m × 3/12) × 40%	2	**1**
	342	**(Mark for treating associate)**

(8) **Non-controlling interests (Cavaradossi)**

	£m	
Per question	101	
Share of cash flow hedge adjustment (20% × 2 (W3))	0.4	
NCI	101.4	**1**

(9) **Retained earnings**

	Tosca	Scarpia 40%	Scarpia 35% sold	
	£m	£m	£m	
Per question/at disposal (310 – (3/12 × 20))	696.5	310	305	**1**
Sale & repurchase (W4)	(2)			½
Group profit on disposal of Scarpia (W10)	56.2			½
Pre-acquisition (W1)		(260)	(260)	
		50	45	**1**
Share of Cavaradossi cash flow hedge adj (80% × 2 (W3))	1.6			½
Share of Scarpia post acquisition				
(50 × 40%)	20			½
(45 × 35% sold)	15.8			½
Impairment loss (W6)	(8)			½
	780.1			

(10) **Group profit on disposal of Scarpia**

	£m	£m	
Fair value of consideration received		300	½
Fair value of 40% investment retained		340	½
Less share of consolidated carrying value when control lost:			
Net assets ((750 – (20 × 3/12)) × 75%)	558.8		**1**
Goodwill (W5)	25.0		**1**
		(583.8)	
		56.2	

3 Timber Products plc

Marking guide

		Marks
(a)	Accounting treatments:	
	Redeemable preference shares	2
	Convertible preference shares	2
	Loan agreement	2
	Sale and repurchase	2
	Consignment	2
(b)	Journals:	
	Redeemable preference shares	3
	Convertible preference shares	2
	Loan agreement	1
	Sale and repurchase	2
	Adjusted statement of financial position	2
(c)	Earnings per share:	
	Basic	3
	Diluted	2
Maximum available		25
Total		25

REPORT

To: Finance Director
From: Accountant
Date: XX/X/XXXX
Subject: Accounting adjustments required

(a) **Accounting treatments**

Accounting treatment of redeemable preference shares

It appears that Timber Products plc is required to pay the annual preference dividend and to redeem the shares on their due date. It also appears that the holders of these shares have no residual interest in the company's net assets. IAS 32 *Financial Instruments: Presentation* defines a financial liability as an instrument that creates an obligation for the entity to transfer cash. As the holder of the option has the right to redeem, this creates an obligation for the company to settle in cash and hence the preference shares should be treated as a financial liability rather than equity.

The shares and share premium will have to be reclassified as debt. The fair value is the sum raised of 2,000,000 shares × £1.20 per share, less the issue costs of £100,000 = £2.3m. The issue costs should not be expensed to profit or loss for the year, but rather deducted from the carrying value of the debt.

The treatment of the dividend must reflect the classification of the instrument in the statement of financial position. Therefore the dividend paid on 30 September 20X6 will have to be added back to equity and expensed to profit or loss as a finance charge of £2.3m × 6.7% = £154,100.

(2 marks)

Accounting treatment of convertible preference shares

These shares effectively comprise two elements: a debt element with a fair value of £500,000 and carrying an effective interest rate of 6.7% and an equity element of £2,500,000.

The debt element of the shares will be reclassified as a non-current liability in the statement of financial position.

IAS 39 *Financial Instruments: Recognition and Measurement* requires the debt element (a financial liability) to be measured at amortised cost. The dividend of £120,000 paid on 30 September 20X6

will have to be added back to equity. The finance charge to profit or loss will be based on the carrying amount of the liability, £500,000 × 6.7% = £33,500. **(2 marks)**

Loan agreement

The net present value of the cash flows is approximately zero when discounted at 9% (£5,000,000 – (350,000 × 0.917) – (500,000 × 0.842) – (5,514,000 × 0.772)) = £1,242 (deemed a rounding error and close to zero).

This confirms that the effective rate of interest on this loan is 9% per annum.

The principal plus the 9% interest of £450,000 less the actual coupon payment of £350,000 results in a year-end balance of £5,100,000. Of this, £41,000 will be a current liability. The remaining £5.059m will be a non-current liability. **(2 marks)**

Sale and repurchase of inventory

In accordance with IAS 18 *Revenue* the transaction would be regarded as a financing transaction because Timber Products plc has not transferred the risks and rewards of ownership of the timber. It has in fact borrowed money on the security of the timber. The timber will therefore appear as inventory in the statement of financial position, and the loan will appear as a liability. Each year there will be an interest element charged to profit or loss and added to the liability.

The inventories will be shown at their cost of £4.9m and the loss on disposal of £1.8m must be reversed.

A loan of £3.1m must be created to reflect the cash received on the initial sale.

The repayment of £5.0m on the repurchase of the inventory, or the settlement of the loan, has a net present value of £5.0m × 0.621 = £3.1m (rounded) at 10%, so the interest rate implicit in this loan is 10% per annum.

The statement of profit or loss and other comprehensive income will show interest for the year of £310,000 (£3.1m × 10%) and the associated non-current liability will be £3,410,000 (a finance charge will be added on an annual basis for each of the five years up to the repayment of the £5.0m agreed). **(2 marks)**

Consignment inventory

The problem here is to determine whether the 'outstanding' inventory of £10m – 6m = £4m (£3m cost price) has been sold. If it has, the inventory should not be recognised in the statement of financial position of Timber Products plc.

A significant factor supporting a sale is that retailers have never returned any goods to Timber Products plc. It may be that, in view of the company's long-established position, they are commercially compelled to purchase the goods.

Furthermore, Timber Products plc does not really bear all of the risks associated with the inventory. The inventory is insured against loss or damage and the cost of that insurance is passed on to the customer.

A further factor in support of a sale is that retailers are required to pay the price as at the date of delivery, not at the time of payment. The fact that the price is fixed upon taking delivery of the inventory implies that both parties regard this as a fairly significant commitment and, more importantly, that the buyer takes on the risks of change in the value of the inventory from the date it is delivered to its premises.

Thus the risks and rewards are largely with the buyer, and the inventory should therefore be recorded in the buyer's statements of financial position.

All of this tends to suggest that the entries in the financial statements should be left as they are. **(2 marks)**

(b) **Journal entries**

Redeemable preference shares

	£'000	£'000
Share capital	2,000.0	
Share premium	400.0	
7% redeemable preference shares		2,400.0

Being transfer of share capital and share premium to show fair value of debt instrument

	£'000	£'000
7% redeemable preference shares	100.0	
Finance costs		100.0

Being transfer of issue costs from finance charges in profit or loss to fair value of debt instrument

	£'000	£'000
7% redeemable preference shares	140.0	
Retained earnings (Equity)		140.0

Being transfer of dividend paid

	£'000	£'000
Finance charge to profit or loss	154.1	
7% redeemable preference shares		154.1

Being accrual of finance charge **(3 marks)**

Convertible preference shares

	£'000	£'000
4% convertible preference shares	500.0	
Debt element of 4% convertible preference shares		500.0

Being transfer of debt element from equity to non-current liabilities

4% convertible preference shares	120.0	
Retained earnings (Equity)		120.0

Being transfer of dividend paid

Finance charge to profit or loss	33.5	
4% convertible preference shares		33.5

Being accrual of finance charge

(2 marks)

Loan agreement

	£'000	£'000
Finance charge to profit or loss	450.0	
Loan		350.0
Accrued loan interest		100.0

Being accrued finance charge

(1 mark)

Sale and repurchase of inventory

	£'000	£'000
Inventory	4,900.0	
Loan secured on inventory		3,100.0
Profit or loss		1,800.0

Being cancellation of 'sale' of inventory and recognition of associated liability

	£'000	£'000
Finance charge to profit or loss	310.0	
Loan secured on inventory		310.0

Being accrual of finance charge on loan **(2 marks)**

Adjusted financial statements

(Taking financial statements per question and adjusting for above journals)

Timber Products plc

Adjusted draft statement of financial position as at 30 September 20X6

	£'000	£'000
Property, plant and equipment		35,000.0
Current assets		
Inventory	34,900.0	
Receivables	20,000.0	
Cash	9,650.0	
		64,550.0
		99,550.0
Equity		
Ordinary shares (£1)		32,000.0
4% convertible preference shares (equity element)		2,500.0
Share premium		20,000.0
Retained earnings		26,212.4
		80,712.4
Non-current liabilities		
Loans	5,059.0	
7% redeemable preference shares	2,314.1	
4% convertible preference shares	413.5	
Loan secured on inventory	3,410.0	
		11,196.6
Current liabilities		7,641.0
		99,550.0

(2 marks)

(c) **Earnings per share**

The draft financial statements show earnings after tax for the year of £8,000,000. These have to be adjusted as follows:

Transfer of issue costs from finance charges	+£100,000
Interest recognised on preference shares	– (£154,100 + 33,500)
Accrual of interest on loan	– £450,000
Cancellation of 'loss' on 'sale' of inventory	+£1,800,000
Accrual of interest on loan secured on inventory	– £310,000
Adjusted profit	£8,952,400

Basic earnings per share = $\frac{8,952,400}{32,000,000}$ = 28.0 pence **(3 marks)**

Diluted earnings per share = $\frac{8,952,400+33,500}{32,000,000+3,000,000}$ = 25.7 pence

(2 marks)

4 Hollinwell plc

Marking guide

			Marks
4.1	Comments on financial performance and cash flow		
	For each ratio calculation up to a maximum of 5	1	
	For each valid comment	½	
	Total available	33½	
	Maximum		13
4.2	Usefulness of EBITDA		
	For each valid comment	½	
	Total available	3½	
	Maximum		2
Total			15

4.1 **REPORT**

To: The Chairman
From: Business Analyst
Date: X/XX/XXXX
Subject: Analysis of Hollinwell plc

Examples of relevant additional ratios

	20X6	20X5
Gross profit %	20.1%	20.9%
Operating cost %	8.6%	9.9%
Interest cover	3.8 times	3.1 times
Operating cost % (exc. change in depn)	9.8%	9.9%
Operating margin (exc. change in depn)	10.3%	11.0%
Revenue per employee	£23,863	£22,306
Operating profit per employee	£2,735	£2,455
EBITDA/Revenue	26.5%	25.6%
Cash from ops to profit from ops	2.8 times	1.9 times
Cash interest cover	9.6 times	4.5 times
Effective rate of taxation	22.6%	32.5%

(Credit will be given for other ratios; the basis of the calculation should be given.)

Note: Ratio calculations could be included in an Appendix.

Introduction

The financial statements and ratios provided by the directors appear to show strong net profit growth and improved cash inflows between 20X5 and 20X6. Profit after tax has increased by almost 35% on modest revenue growth of 3.4%. Cash inflows are strong. Increased investment has been made in capital expenditure and gearing has reduced significantly.

Profitability

The ROCE has increased to 9.8% from 9.3%. This is significantly below the ROCE of Stannage plc (14.7%). This may be due to the operating structure of the two businesses. Stannage plc has outsourced the manufacture of key components and this will probably have a favourable effect on capital employed compared to Hollinwell plc which has its own manufacturing capability and has invested heavily in capital expenditure during the current year.

Hollinwell plc's profitability has benefited from the year on year reduction in the depreciation expense arising from the reassessment of the useful lives and residual values of certain assets. Without this change, the profit from operations would have reduced by £90,000 (3,200 – 2,970 – 320) and the ROCE would have probably reduced (the effect on capital employed of the change is far less significant than that on PBIT).

The change in depreciation expense involves the exercise of judgement by management. A sceptical interpretation may be that it represents an easy way to increase profitability. However, IAS 8 and IAS 16 provide guidance on the annual reviews required and their subsequent treatment and disclosure. The disclosures quantify the effect on the financial statements and improve comparability.

Revenue has increased by 3.4% year on year. Hollinwell plc has initiated an aggressive pricing policy. This would indicate that sales volume growth would be greater than the growth in sales revenue. In addition, sales mix between products will also affect the year on year analysis.

Stannage plc's revenue growth is only 0.3% and this may have been adversely affected by Hollinwell plc's policy for increasing sales volumes.

Revenue per employee has increased by 7% to £23,863. Average employee numbers have fallen by 3.3%. There appears to have been an improvement in efficiency which may be attributable to the significant capital expenditure in 20X6. The full benefits from this expenditure may not have yet been fully realised. The performance in 20X7 may benefit further from the expenditure.

The revenue per employee of Stannage plc is greater than that of Hollinwell plc. This reflects the fact that Hollinwell plc manufactures its own product whereas Stannage plc outsources production.

The gross profit margin has reduced from 20.9% to 20.1%. This will have been affected by the pricing policy which may have adversely affected the current year. Set against this will be any efficiencies that the new management team have generated through capital expenditure. The changes to the depreciation expense will not have affected gross margin as they are confined to the operating expenses classification.

Operating expenses have fallen by 10% and now represent 8.6% of revenue (20X5 – 9.9%). However, if depreciation expenses had been calculated consistently year on year then the operating expenses would have increased by 2%. On an 'adjusted' basis operating expenses as a percentage of revenue have remained almost the same as the previous year (9.8% vs. 9.9%).

Operating profits have increased by 7.7% but as noted above this is wholly attributable to the depreciation expense change. Excluding this, the operating margin has fallen from 11.0% to 10.3%. Underlying performance shows a reduction in operating profitability. The key factor affecting operating profitability is the reduction in gross margin. The operating margins are below those of Stannage plc.

Interest cover has increased from 3.1 times to 3.8 times. The strong cash flows have repaid some of the borrowings which have reduced the interest expense. The ratio does benefit from the depreciation expense reducing. However, it remains at comfortable levels.

The effective rate of taxation has fallen from 32.5% to 22.6%. This has a beneficial effect on post-tax profits. This requires some explanation. If the effective rate had stayed stable then the taxation charge would have been £230,000 higher.

The overall increase in net profit of £470,000 looks admirable. It will be affected by many factors. However, the two key factors appear to be the positive changes from the reduction in the depreciation expense (£320,000) and the reduction in the effective rate of taxation (£230,000). Hence, it appears that underlying performance has not improved.

Profit per employee has increased from £2,455 to £2,735. The reduction in employee numbers is a factor in this change. However, the depreciation expense changes have a more marked effect.

EBITDA has increased significantly. This excludes the depreciation effects including the additional depreciation from the new capital expenditure. EBITDA/Revenue is 26.5% and is comparable to that of Stannage plc (27%). Hollinwell plc may have a higher depreciation expense than Stannage plc as it is more capital intensive.

Cash flow

The net gearing has reduced dramatically from 41.2% to 33.2%. This is attributable to the strong operating cash flows. These have reduced net debt by £1.2m (700 + 500) even after a substantial investment in tangible non-current assets that is 50% greater than the related depreciation expense. The cash flows are objective. They do not need adjustment for comparability arising from the change in accounting estimates for depreciation.

Operating cash flows have increased significantly. Of particular note is the positive effect from reductions in working capital which reversed the negative trend from the previous year. Reductions

in working capital have improved operating cash flows by almost £1.7m. It may be difficult to generate similar benefits in future years.

Inventory turnover has increased significantly. This may be a result of increasing sales volumes by pricing the products more competitively.

The trade receivables collection period has reduced but still remains at over 90 days. There may be further opportunity to release working capital and enhance cash flows by improving credit control further.

Improvements have also been made to the trade payables payment period. However, further improvements may be limited without damaging relationships with suppliers.

The cash from operations to profit from operations ratio has increased to 2.8 times which is greater than last year and the similar ratio for Stannage plc. In calculating the ratios there may be some one-off benefits from working capital management. However, the new management team appear to have focused on improving operating cash flow.

The result of these cash flow improvements has also fed through to the cash return on capital employed which has improved year on year (28.0% against 17.6%) and against that of Stannage plc (22.4%). The cash return on capital employed is greater than ROCE as it excludes capital expenditure and the latter includes depreciation.

Capital expenditure (£6.5m) has been increased year on year (from £3m). Management have invested heavily. This is probably an attempt to modernise the manufacturing process and reduce production costs. The full benefits of this investment may not yet have been realised.

No dividends have been declared in either year. This may reflect the performance and the need to retain cash generated for reinvestment in PPE.

Conclusion

The new management of Hollinwell plc have stabilised the business with a view to turning it around. They appear to have focused on short term cash generation. They have closely managed working capital and extracted cash for capital investment. This has also reduced gearing and the business appears more stable. While the depreciation expense has been reduced this does not appear to be an attempt to hide poor management performance.

Further matters for investigation

- An analysis of the depreciation methods against those of Stannage plc and other companies in the engineering sector.
- Comparison of the working capital (liquidity) ratios with those for Stannage plc and other companies in the sector.
- Details of the fall in the effective tax rate. In particular does it relate to one-off events or does it represent the long-term effective rate?
- Further details on the pricing policy to analyse the revenue growth between volume and price.
- A statement of financial position to analyse efficiency with respect to non-current assets.
- Details of the capital expenditure to analyse the investment made between new production facilities and technology improvements.
- Review the financial statements for other key management judgements that may have changed during the year.

4.2 EBITDA is often considered as a good indicator of profit from operations (underlying performance). It is independent of the capital structure of the entity and is unaffected by the accounting policies for non-current assets. When considering EBITDA for Hollinwell plc, it is not affected by the changes in the estimates for the useful lives and the residual values of certain assets. In this respect it is useful in assessing Hollinwell plc's performance. It should be remembered that in the long-term earnings must cover interest, tax, depreciation and amortisation. However, in the short-term it is a useful performance measure.

EBITDA is also often used as an approximation for cash generated from operations. However, it does not take into account changes in working capital. In the case of Hollinwell plc its use is limited for approximating cash flows since during 20X5 and 20X6 there have been significant changes, both adverse and favourable, to working capital.

5 Typoprinters Ltd

Marking guide

			Marks
5.1	Comments on performance and financial position		
	For each supporting ratio calculation up to a maximum of 8	8	
	For each valid comment to a maximum of 12	12	
	Total available	20	
	Maximum		12
5.2	Usefulness/limitations of segment reporting		
	For each valid comment to a maximum of 6		
	Total available	6	
	Maximum		3
Total			15

5.1 **Analysis**

Examples of additional relevant ratios

	Typo-printers Ltd	First Impressions Ltd
Return on capital employed	24.9%	21.0%
Return on shareholders' funds (equity)	18.0%	20.5%
Net asset turnover	1.08	1.24
Non-current asset turnover	1.13	1.33
Current ratio	1.26	2.35
Quick ratio	0.75	2.18
Inventory turnover – days	38.20	3.35
Trade receivables collection period – days	37.69	30.63
Gearing	13.4%	59.1%
Interest cover	23.44	5.65
Revenue per employee – £'000	£34.07	£54.04

Performance

Return on capital employed in Typoprinters Ltd (TP) is higher than First Impressions Ltd (FI). However, TP premises are stated at cost and since the company has owned them for over 40 years the market value will probably have increased. If the premises were measured at fair value and depreciation based on this amount, the profits of the company would be lower and capital employed higher. This would result in a lower ROCE which may be more comparable with that of FI, which does not own property but pays what is assumed to be a market rent.

The return on shareholders' funds is higher in FI. This is due to FI being a more highly geared company – see below.

Although revenue is higher in TP than FI in 20X6, it is suggested that TP is losing customers, and therefore it is probable that its revenue has fallen compared to the previous year.

FI may have increasing revenue as it attracts new customers; it has only been in the new market for a few years.

TP has a higher gross profit percentage than FI but the make-up of cost of sales is different:

- TP has more materials cost – due to its product being 'hard' copy requiring paper and ink rather than 'electronic'.
- FI has more labour costs – it employs fewer people than TP but its staff are more skilled.
- The overheads are similar – TP is in an expensive city centre, but has owned its premises for a number of years; FI rents premises, but is in a cheaper location. TP premises are probably undervalued (see above). As discussed, if the premises were measured at fair value it would result in a higher depreciation charge, which would increase the overheads in cost of sales.

Distribution costs are greater in TP – probably due to nature (hard copy) of the product; costs are lower in FI as the product is 'electronic'.

Advertising costs are higher in FI – FI probably spends more as it operates in a new market and TP spends less as it relies on repeat business.

The operating margin percentage is higher in TP than FI, but by less than the gross profit percentage. Thus FI is slightly more efficient with regards to its operating expenses. Its total operating expenses are 7.9% of revenue as compared to TPs which are 9.5% of revenue. This is mainly the result of TP's heavy expenditure on distribution.

Finance costs are higher in FI, which is the result of more debt. This level of interest is not a problem as the interest cover in FI is 5.65, which is comfortable.

The interest cover in TP is 23.44, which indicates that gearing could be higher, providing TP with an opportunity to raise additional financing through borrowings, especially since the return on shareholders' funds is less in TP than FI. Increased debt finance in TP, if invested well, will result in increased profits even after the additional finance costs are taken into account. Thus it would contribute to an increased return on shareholders' funds.

Tax is proportionately less in FI than TP and this may be the result of its recent capital expenditure compared to TP.

	ROCE	=	Net margin %	×	Net asset turnover
TP	24.9%	=	23%	×	1.08 (difference due to rounding)
FI	21.0%	=	17%	×	1.24 (difference due to rounding)

The non-current asset turnover ratio is slightly higher in FI with £1.33 revenue generated for each £1 non-current assets as compared to TP's £1.13 for each £1. TP's ratio would be even less if its property were carried at fair value, as previously discussed.

The age of machinery held by each company is also relevant:

- TP has old machinery, some of which could be fully depreciated, which results in a low non-current assets balance and so higher non-current asset turnover.
- FI has new machinery with higher carrying amounts which reduces its non-current asset turnover ratio compared to TP.

Revenue per employee is higher in FI, who employ fewer but more skilled staff. This ratio is likely to be higher in high technology companies compared to manufacturing companies.

Position

Gearing in FI is considerably higher than that of TP at 59%; based on the interest cover and the return on shareholders' funds this appears to be an acceptable level of debt.

The gearing in TP seems very low – as already discussed, there is capacity to gear up.

The current ratio in FI is an acceptable figure, taking the comments below into consideration.

The current ratio in TP is low, taking the comments below into consideration.

The quick ratio in FI is similar to the current ratio as FI does not carry much inventory.

The quick ratio in TP is low which shows the importance to the company of being able to manage inventory control, as well as receivables and payables.

Inventory days in TP is good at 38 days but in absolute terms inventory is high because material costs are a high proportion of cost of sales.

Inventory days in FI are not important as material cost is a low proportion of cost of sales.

Trade receivable days in each company look good, assuming that the credit period is one month, although FI is better by seven days.

The trade payables days in TP is 45 days – the significance of this depends upon the credit terms. Assuming that these are one month, then this may indicate cash flow problems in TP, which may lead to difficulties with suppliers.

If trade payables are within the credit terms, this shows good financial management as the period is greater than trade receivable days.

The trade payables for FI are 28 days. Assuming that the credit terms are 1 month, then this may indicate that FI is paying unnecessarily quickly. However, there may be cash discounts for prompt payment.

Trade payable days are less than trade receivables days but there is no indication from other information that is a problem.

The working capital cycle in TP is 31 days (38 + 38 – 45), which appears to be good, subject to the comments above.

The working capital cycle in FI is six days (3 + 31 – 28), which is highly efficient, and means that the company does not need to hold much cash. However, this is a high-risk strategy if too much reliance is placed on customers paying on time.

The profit for the period is greater in TP than in FI but the EBITDA is greater in FI than TP.

This is the result of more depreciation in FI as FI has newer plant and machinery which, given it is computer equipment, is likely to be depreciated over a short useful life. The depreciation on property and the old equipment in TP is likely to amount to a lower annual charge.

EBITDA is a measure of the cash flow generated from operations and the superior performance by FI supports the analysis of the working capital above.

5.2 Segment reporting

Investors are interested in risk and return.

This is easier to assess if companies provide information about the segments, geographical and product, in which they operate.

Segment information may help assess:

- opportunities for growth
- future prospects.

The segment information provided should be of high quality as it is consistent with the financial statements with regards to:

- accounting policies
- the revenue must agree with the statement of profit or loss.

However, the segment information is subjective and depends on management judgement because management:

- effectively select which segments are reported
- allocate shared expenses
- allocate shared assets and liabilities
- set inter-segment selling prices.

6 Merton plc

Marking guide

	Marks
Comments on performance, liquidity and investor ratios	
For each ratio calculation up to a maximum of 5	1
For each valid comment	½
For each matter requiring further investigation	½
Maximum available	29½
Total	20

Analysis

Examples of additional relevant ratios

	20X7	20X6
Operating cost %	17.7%	11.2%
Operating margin	17.6%	26.8%
Interest cover	61.8 times	30.5 times
Operating cost % (exc. £2m settlement)	13.0%	11.2%
Operating margin (exc. £2m settlement)	22.4%	26.8%
P/E ratio	8.0	7.6
Dividend cover	1.0 times	2.8 times
Dividend yield	11.9%	4.7%
Dividend cover – normalised	2.0 times	2.8 times
Dividend yield – normalised	6.2%	4.7%
Return on capital employed (ROCE)	34.6%	61.9%
Non-current asset turnover	1.70 times	2.13 times
Net asset turnover	1.96 times	2.31 times
Quick ratio (exc. HFS assets)	0.81 times	0.3 times
Trade payables payment period	43.6 days	28.5 days

Note: Ratio calculations could be included in an Appendix.

Introduction

The financial statements and ratios provided show deterioration in performance. The pre tax profits from continuing operations have decreased by 41% and revenue from continuing operations is over 12% lower.

The discontinued operations have been separately disclosed and Merton plc has withdrawn from this sector to concentrate on its core CD market and its two growth markets.

Profitability

Revenue from continuing operations has reduced by over 12%. This can be analysed as between the three divisions as follows.

- CD division – significant decrease of almost £10m. This could be attributed to the delay in the release of the new album from the major artist. However, the expected levels of sales from the album would be required to assess whether this is the only reason. A move away from CDs towards website downloads would be another likely explanation.
- Growth of almost 30% in the website downloads division. Major investment has been made over the last two years and the growth reflects the returns from this investment. The settlement with Eyemusic Ltd does not appear to have adversely affected this division.
- Whilst the licensing division is the smallest division it also appears to have growth potential. The growth rate is 17.9%. This will probably be a split of organic growth from the existing copyrights and growth from the acquisition of new copyrights. Analysts may be interested in this split.

The website has increased its number of registered users by 22%. This is lower than the revenue growth rate for the division and the revenue per user is growing faster at £58 per registered user. The basis of

the registered user numbers is often an interesting calculation. It would be useful to understand how many of these users are active and how many are inactive (registered but not active downloaders from the site).

The discontinued operations have been separated out. This allows the continuing operations to be analysed more closely. However, the gross margin has fallen by 2.6%. This may be due to a change in the mix of revenue streams or from changes in the margins of the different product offerings. This cannot be determined from the information provided. In addition, there may be some operational gearing effect and whilst revenue has fallen some fixed costs, such as production, may not have been reduced.

The operating expenses increase can be explained by the £2m payment to Eyemusic Ltd. Otherwise the absolute level of operating expenses has remained almost static. The operating cost % adjusted for the £2m payment has increased to 13.0% (17.7% unadjusted) from 11.2%. This may be indicative of the costs being primarily fixed in nature.

Operating margins have reduced to an 'adjusted' level of 22.4% from 26.8%. It would appear that Merton plc has high operational gearing and the delay in the album release has had a major year on year effect.

The interest cover is very comfortable (61.8 times). This reflects the low levels of net debt and gearing (3%). Cash flow and debt levels do not appear to be a problem. Cash resources have benefited from the disposal proceeds of the classical music division. These proceeds are being returned to shareholders. This will increase net debt but there appears to be plenty of capacity to increase net debt and to pay the associated interest.

The ROCE has reduced to 34.6% from 61.9%. This is primarily due to reductions in continuing profitability. The revaluation of intangible assets will also have an adverse effect by increasing equity. The ROCE appears very attractive to investors. However, it is not unexpected from media companies as the key assets and factors in business success are often intangible and not recognised in financial statements.

Liquidity

The net gearing has reduced dramatically from 16.6% to 3.0%. One major influence on this is the proceeds from the sale of the classical music division. This ratio may increase when the special dividend is paid. However, when combined with the interest cover this does not appear significant.

The current ratio (excluding the held for sale asset) has improved to 0.99 times from 0.49 times. Inventory is not a major asset and turns very rapidly as would be expected, as it is likely that only the CD division needs to hold any significant inventory. Therefore the quick ratios (0.81 compared to 0.3 times) show similar trends.

The most significant impact on these ratios has arisen from trade payables. The payment period has increased from 28.5 days to 43.6 days. No obvious reasons for this are available and it requires further investigation. It could have adverse effects on the relationships within the supply chain.

Investor ratios

The market share price of each share has fallen. Its movement compared to the movement in the media sector should be reviewed to understand its comparative performance.

The PE ratio is almost unchanged (8.0 times vs. 7.6 times). Investors have probably been reassured by the growth in the two smaller segments. However, the legal and production problems have held the PE ratio to modest levels. A comparison against the sector would probably identify that it is low. An investigation of the factors resulting in a lack of confidence in the company is required.

The dividend has been declared since year end. The investors' perspective on this needs investigating. The ongoing dividend yield after adjustment for the special element is 6.2% (up from 4.7%). This should reassure the investors.

The dividend cover excluding the special element is 2.0 times (unadjusted 1.0 times). This is a low level of cover but probably reflects the management's confidence in the future having identified two growth areas.

Conclusion

Merton plc has refocused on three major divisions. The CD division has been adversely affected by the lack of new releases. The downloads division has settled its non-recurring contractual issues and together with the licensing division, it is now in a position to continue to grow. However, it is essential to deliver new major albums. Investors' confidence will need to be restored by delivering these on time.

Further matters for investigation – not discussed above

- An analysis of the basis for the revaluation of the intangible assets. This would include the credentials of those who have completed the valuation.
- Comparison of the ratios with those for other companies in the sector.
- Segmental analysis of gross margin, operating performance, capital expenditure etc for each of the continuing divisions to assess performance and development opportunities for each sector.
- Details of the contractual arrangements with artists to assess future potential.
- Details of the number of units sold, downloaded or licensed so that the impact of pricing and volume changes on revenue can be analysed.
- Details of future CD releases from major artists expected in 20X7 and beyond. This will provide reassurance to investors and analysts.
- A cash flow statement to confirm the movements in liquidity and the investments made in copyright licences. The cash flow statement should analyse cash flows between continuing and discontinued operations.
- Further details of the settlement with Eyemusic Ltd to assess whether operational aspects of the settlement will affect the development of this sector. This analysis could be supported by an assessment of whether other claims could be received or made.
- Future dividend policy now that one division has been disposed of and a substantial amount of the net proceeds has been returned to shareholders by way of a special dividend.

7 Mayfield Ltd

Marking guide

	Marks
Pension plan	
Explanation	2
Deferred tax issue	1
Calculations and presentation of workings	6
Choice of treatment not possible – rebuttal of suggestion	2
Financial statement presentation	3
Interest free loan	
Classification	2
Calculation of fair value	3
Explanation of why it is expensed	2
Investments	
Treatment of gain	3
Explanation and application of tainting rule	3
Rebuttal of proposed treatment	3
Finance income	1
Property held for sale	
Explanation of IFRS 5 requirements	2
Reason why treatment was incorrect	3
Correct treatment	3
Maximum available	39
Total	30

Background comments

This scenario based question is set within the media sector. The current investors in the business are seeking an exit and they have installed an aggressive new management team to prepare Mayfield for sale.

The question concentrates on financial reporting issues but there are also ethical issues arising from the motivation to maximise performance and the exit price. The candidate takes the role of a financial controller who is completing the preparation of the annual financial statements. There are four complex financial reporting issues that need resolution and you have received direct instructions from the CEO.

The requirements of the question are open ended. A briefing paper is required to be prepared. The briefing paper needs to identify the options available to the company. The professional skills of the candidate will be tested as the briefing paper needs to be professionally prepared but also needs to demonstrate that the candidate will not be intimidated into suggesting inappropriate solutions.

The solution below provides significant detail, but it is sufficient for a good quality answer, that would obtain a clear pass mark, to provide concise explanations of the following key issues:

- An explanation of the required treatment which Mayfield must use in accounting for the defined benefit pension plan of the recently acquired subsidiary.
- An assessment of the correct accounting treatment for the interest free loan granted to a company which is a marketing partner together with a rebuttal of the CEO's suggestion.
- An assessment of the appropriate accounting treatment for the strategic investment in a competitor company.
- An explanation of the required accounting treatment for the property held for sale.

To: Chief Executive Officer
From: Financial Controller
Date: 15 November 20X6

Subject: Briefing paper – outstanding financial reporting issues for the year ended 30 September 20X6

I have reviewed the four outstanding issues relating to the year ended 30 September 20X6. In formulating the suggested accounting treatments, I have considered the various IFRS and the ethical guidance from the Institute of Chartered Accountants in England & Wales of which I am a member.

Burbage Ltd – Pension scheme

Before the acquisition of Burbage Ltd, Mayfield Ltd or its subsidiaries have not previously operated any defined benefit pension schemes. In such a case, IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* would not consider this to be a change in accounting policy (IAS 8.16(b)) and the requirements of IAS 19 *Employee Benefits* should be considered in selecting the most appropriate accounting policies for the treatment of the scheme.

When a business combination is undertaken, IAS 19 requires the acquirer to recognise the net pension asset at the fair value of the plan assets less the present value of the scheme obligation. Therefore at the date of acquisition the pension asset should be £1,000,000 (£2,000,000 less £1,000,000) and the deferred taxation provision is £230,000 (23% × £1,000,000) as the tax base is nil and a taxable temporary difference of £1,000,000 is created. The net amount recognised in the financial statements has increased from £753,600 (1,000,000 less 246,400) to £770,000 (1,000,000 less 230,000). The initial goodwill arising on consolidation will decrease by a corresponding amount of £16,400.

The movement on the present value of the obligation and the fair value of the plan assets can be summarised as follows.

	£
Present value of obligation at 1 October 20X5	1,000,000
Interest cost on obligation (6% × 1,000,000)	60,000
Current service cost	400,000
Benefits paid	(250,000)
Gain on remeasurement of obligation (balancing figure)	(60,000)
Present value of obligation at 30 September 20X6	1,150,000

Fair value of plan assets at 1 October 20X5	2,000,000
Interest on plan assets (6% × 2,000,000)	120,000
Contributions	100,000
Benefits paid	(250,000)
Gain on remeasurement of plan assets (balancing figure)	280,000
Fair value of plan assets at 30 September 20X6	2,250,000

The CEO is suggesting that there is a choice in the way the £340,000 remeasurement gain is recognised. However, since the 2011 revision of IAS 19 *Employee Benefits,* there is only one permitted treatment: immediate recognition in other comprehensive income in the year in which the gain arises (20X6).

The statement of profit or loss and other comprehensive income and statement of financial position impacts can be summarised (all figures in £) as:

Statement of profit or loss and other comprehensive income 20X6 (extracts)

In profit or loss	
Current service cost	400,000
Interest expense	60,000
Interest income	(120,000)
Gain recognised	0
	340,000
Gain recognised	(340,000)

Statement of financial position as at 30 September 20X6 (extracts)

Fair value of plan assets	2,250,000
PV of plan liabilities	(1,150,000)
	1,100,000
Deferred tax provision (23%)	253,000
Brought forward – at acquisition	246,400
Loss recognised in OCI (340 × 23%)	78,200
(Gain)/Loss recognised in profit or loss (balancing figure)	(71,600)
Carried forward	253,000

Interest free loan

The interest free loan should be classified as a 'loan or receivable' financial asset. Its measurement on initial recognition should be at fair value (plus issue costs, if any) in accordance with IAS 39 *Financial Instruments: Recognition and Measurement*.

The fair value of the loan can be determined by discounting the future cash flows to present value, using the prevailing market interest rate for a similar instrument with a similar credit rating. The rate of interest on equivalent debt is 10%.

The present value on 1 July 20X6 is £826,446 ($(1/1.1^2)$ 1,000,000). This amount below £1,000,000 should be recognised as an expense as it does not qualify for recognition as an intangible asset given that the benefits from advancing the loan do not meet the recognition criteria as an intangible asset and have not been achieved.

The difference between the initial amount of the loan and the final amount repaid is recognised as interest income over the life of the loan. In the three-month period the amount of interest income recognised will be £19,929 ($826,446 \times ((1.1^{0.25}) - 1)$) and this amount is added to the carrying amount of the asset. No deferred tax adjustment is required as the carrying amount and tax base are the same.

The £20,000 cannot be recognised as an asset as training is specifically excluded by IAS 38 *Intangible Assets* from inclusion on the statement of financial position.

The loan should be reviewed at the reporting date to ensure that there is no evidence that Freetext will default when the loan is due for repayment. If there is any sign of default, then an impairment review would be required and the loan would be written down to its recoverable amount.

Classification of investments

The sale of the portfolio of investments classified as held to maturity generates a gain of £280,000 (£400,000 less £120,000). It would be inappropriate to offset the gain against interest expenses, as this does not represent the substance of the transaction. IAS 1 *Presentation of Financial Statements* only allows offsetting where it is required or permitted by a standard. Items may be offset where this represents the substance of the transaction. However, the interest expense was unaffected by the proceeds of the disposal and so the gain does not reflect the substance of the transaction.

In fact, the nature and amount of the gain should be disclosed separately. Income arising from the disposal of investments is one of the transactions requiring separate disclosure identified in IAS 1 (IAS 1.98).

When an entity sells held to maturity investments in more than insignificant amounts, other than as a result of a non-recurring isolated event beyond the entity's control, then the held to maturity classification becomes tainted (IAS 39.9 and IAS 39.52). No investments can be classified as held to maturity for the current or next two financial reporting years. The requirement applies to the entity and not the entity's management. Even though the new management may not have had the intention to hold the investment to maturity, the requirement applies to the intention of the entity. The tainting rule therefore applies, assuming that these investments are material enough to qualify as being significant.

It is possible, depending on the terms of the redemption of the preference shares that they could have been classified as held to maturity, however, due to the application of the tainting rule, these shares are no longer able to be classified as held to maturity.

The implication is that the CEO wishes to see this new investment classified as at 'fair value through profit or loss', and is apparently prepared to breach ethics and create backdated documentation to support this classification.

However, this is not possible under the current version of IAS 39. To qualify for this classification (IAS 39 paragraph 9) the investment must either be held for trading, which is unlikely as it is a 'strategic investment', or derivative, which it is not, or if it is designated as such on initial recognition. It could only be so designated if it meets the strict and exceptional criteria in IAS 39 paragraph 9, which it does not, or if it is a hybrid contract containing a derivative, which it is not.

However, it could be designated as either 'loans and receivables' (LAR) or 'available for sale' (AFS). The classification will have a direct effect on the financial statements.

The 'loans and receivables' classification is a possible treatment in accordance with the definition in IAS 39 paragraph 9, as it is a non-derivative financial asset with fixed or determinable payments that is not quoted in an active market (the investee is a private limited company).

As such it would be shown on the statement of financial position at an amortised cost of £500,000 with the dividends of 7% × £500,000 = £35,000 recognised in profit or loss as finance income.

If the redeemable preference shares are classified as 'available for sale' they will be initially measured at fair value being £500,000. On 30 September 20X6 they will be remeasured to fair value of £600,000 (500,000 × £1.20).

The finance income of £35,000 referred to above is still recorded in profit or loss (IAS 39.55b) (in the current year assuming that the instrument is not an equity instrument) and the remainder of the gain of £65,000 is recognised through other comprehensive income. This is usually in a separate reserve described as AFS reserve.

As the tax base is the same as historic cost, a taxable temporary difference of £100,000 is created and a deferred taxation provision of £23,000 (£100,000 × 23%) needs to be created. The expense is recorded pro rata in profit or loss and other comprehensive income.

Furthermore, I am aware of discussions that have taken place about creating backdated information to favourably categorise the investments. It is appropriate to advise you that I am bound by the ethical rules of ICAEW to bring such matters to the attention of my superiors, should I believe that an inappropriate course of action is being pursued by Mayfield.

The financial asset should be classified as AFS. If the investment is sold in 20X7, the gain previously recognised in other comprehensive income is reclassified to profit or loss. This is known as a reclassification adjustment.

Classification of asset held for sale

The held for sale criteria in IFRS 5 *Non-current Assets Held for Sale and Discontinued Operations* are very strict, and often the decision to sell an asset or disposal group is made well before they are met.

The property appears to have been incorrectly classified as 'held for sale'. Although the company had always intended to sell the property, IFRS 5 states that in order to qualify as 'held for sale' an asset must be available for immediate sale in its present condition. Because repairs were needed before the property could be sold and these were not completed until after the reporting period end, this was clearly not the case at 30 September 20X6.

In addition, even if the property had been correctly classified, it has been valued incorrectly. IFRS 5 requires assets held for sale to be valued at the lower of their carrying amount or fair value less costs to sell. The property should have been valued at its carrying amount of £8m, not at the eventual sale proceeds of £12m.

The property must be included within property, plant and equipment and must be depreciated. Therefore its carrying amount at 30 September 20X6 is £7.6m (£8m less depreciation of £400,000). The gain of £4m that the company has previously recognised should be reversed.

Although the property cannot be classified as 'held for sale' in the financial statements for the year ended 30 September 20X6, it will qualify for the classification after the end of the reporting period. Therefore details of the sale should be disclosed in the notes to the financial statements.

8 Breightmet plc

Marking guide

Marks

Requirement		Skills
(a) Available-for-sale financial assets	4	Identify the correct accounting treatment for gains and losses on available-for-sale financial assets. Recognise that the unrealised loss due to a fall in market value must normally go to other comprehensive income. Use professional judgement in considering whether an impairment has occurred.
(b) Convertible bonds	6	Recognise that convertible bonds contain both an equity and a liability component, and that the equity component is the balancing figure after calculating the liability component and deducting it from the fair value of the instrument as a whole. Identify the correct treatment for the finance costs. Apply the IAS 32 rules identified to record the accounting treatment. Consider effect on gearing.
(c) Redeemable preference shares	4	Identify that these are in substance a liability, and that the dividends are a finance cost rather than an appropriation of profit. Record the correct accounting treatment.
(d) Repayable bank loan	7	Recognise that the early repayment option, if exercised, changes the amount of the financial liability because it changes the expected cash flows. Use professional judgement to determine that the discussions with the bank do not create a legal obligation to repay the loan within the next twelve months, and therefore do not create a current liability.
(e) Employee loans	7	Recognise that the face value of the interest-free loan to the employees is not the same as the fair value, and that the fair value of the loan may be determined by considering other market transactions in the same instrument. Identify the difference between the fair value and the face value of the interest-free loan to the employees as being the cost to the employer, to be treated as compensation under IAS 19. Apply the IAS 39 rules in accounting for the loan at amortised cost using the effective interest method.
(f) Loan to Phinferb	6	Explain the IAS 39 treatment of impairments and apply to the scenario.
(g) Adjusted profit	6	Accurately record the effect of the above adjustments.
Total marks	**40**	
Maximum marks part (a)	3	
Maximum marks part (b)	4	
Maximum marks part (c)	3	
Maximum marks part (d)	5	
Maximum marks part (e)	5	
Maximum marks part (f)	5	
Maximum marks part (g)	5	
Maximum marks	**30**	

Memorandum

To: Julie Bradshaw
From: Kirsty Farnworth
Date: 15 November 20X5
Subject: Financial instruments

Available-for-sale financial assets

Gains and losses on remeasuring available-for-sale financial assets should be recognised in a separate component of equity and presented as Other Comprehensive Income. This gain or loss is calculated and recognised each reporting period when the asset is marked to market. This is the fundamental accounting treatment for such assets under IAS 39 *Financial Instruments: Recognition and Measurement*.

In Breightmet's draft figures the unrealised loss on the available-for-sale assets of £20m (£80m – £60m) due to a fall in the market value has been recognised in profit or loss as a finance cost. This is incorrect and should be transferred to equity and presented as Other Comprehensive Income. The correcting journal is:

DEBIT	Equity	£20m	
CREDIT	Finance costs		£20m

However, IAS 39 also states that if a loss on an available-for-sale asset is an impairment, then any loss recognised in Other Comprehensive Income should be reclassified as an impairment and recognised in profit or loss. The impairment accounting treatment requires objective evidence of impairment. The fall in market value is not of itself objective evidence of impairment since a general market decline does not imply that any particular investment has specific problems. However, a prolonged or significant decline is presumed to indicate an impairment.

In the case of Breightmet, there is insufficient information to determine whether an impairment has occurred. If further evidence were made available which showed that an impairment had occurred then a reclassifying entry would be required in addition to the journal above:

DEBIT	Impairment expense	£20m	
CREDIT	Equity		£20m

The reclassification would be presented in Other Comprehensive Income.

The accounting treatment described is mandatory. However, careful judgement is required in assessing whether there is objective evidence of impairment.

Convertible bonds

It is incorrect to record the convertible bonds as purely equity and to treat the interest as a dividend to be recorded in the statement of changes in equity. Such bonds contain both a liability and an equity element. They are called compound financial instruments. In such cases, IAS 32 *Financial Instruments: Presentation* requires the component parts of the instrument to be classified separately, according to the substance of the contractual arrangement and the definitions of a financial liability and an equity instrument. This method is called 'split accounting'.

The following method should be used for calculating the split.

(1) Calculate the value for the liability component.

(2) Deduct this from the fair value of the instrument as a whole to leave a residual value for the equity component.

The reasoning behind the approach is that the liability component, or the valuation of the obligation, is assumed to be more easily determinable than valuing the embedded option to convert the liability into equity. The liability component is valued as the present value of the cash flows which Breightmet would be obliged to make if the instrument were a simple non-convertible loan. The discount rate used to calculate the present value is the interest rate applicable to a similar non-convertible instrument. The value of the equity component is simply the balancing or residual amount since the value of the convertible loan is effectively assumed to equal the sum of the value of a similar non-convertible loan plus the value of the embedded equity option to convert.

In addition the interest payable should be shown as a finance cost and not as a dividend. This is because the payments made in relation to the instrument until conversion are payments for a financial liability. They are expenses rather than appropriations of profit.

The sum of the carrying amounts assigned to liability and equity will always be equal to the carrying amount that would be ascribed to the instrument as a whole.

The correct treatment will have the effect of increasing gearing by increasing liabilities and reducing equity. The accounting treatment is not optional and does not depend on an assessment of expectations of conversion. Given that Breightmet does not have an unconditional right to avoid making payments, either as interest or in repaying capital, there is a fundamental obligation. This is the reason why there must be a liability component in the accounting.

The calculations are as follows:

1 October 20X4:

	£m	£m
Proceeds (3,000,000 × £100)		300
Financial liability:		
PV of principal (300 × $1/1.07^5$)	(214)	
PV of interest (300 × 5% × 4.100)	(62)	
		(276)
Equity component		24

Journal to correct classification:

DEBIT	Equity	£276m	
CREDIT	Financial liability		£276m

30 September 20X5:

Financial liability:

	£m
1/10/20X4	276
Finance cost (7% × 276)	19
Coupon paid (5% × 300)	(15)
30/9/20X5	280

Journal to correct:

DEBIT	Finance costs	£19m	
CREDIT	Financial liability		£4m
CREDIT	Retained earnings*		£15m

*To reclassify interest incorrectly treated as dividends.

Redeemable preference shares

These have incorrectly been treated as equity. Following the substance of the transaction, they should be treated as a financial liability:

DEBIT	Equity	£500m	
CREDIT	Financial liability		£500m

The dividends should be treated as a 'finance cost' not an appropriation of profit:

DEBIT	Finance costs (£500m × 8%)	£40m	
CREDIT	Retained earnings		£40m

Repayment of bank loan

The loan from Kearsley bank is to be repaid in ten years' time, but the terms of the loan state that Breightmet can pay it off in seven years. The issue arises as to whether the early repayment option is likely to be exercised.

If, when the loan was taken out on 1 October 20X4 the option of early repayment was not expected to be exercised, then at 30 September 20X5 the normal terms apply. The loan would be stated at £40 million in the statement of financial position, and the effective interest would be 8% × £40 million = £3.2 million, the interest paid.

If at 1 October 20X4 it was expected that the early repayment option would be exercised, then the effective interest rate would be 9.1%, and the effective interest 9.1% × £40 million = £3.64 million. The cash paid would still be £3.2 million, and the difference of £0.44m would be added to the carrying amount of the financial liability in the statement of financial position, giving £40.44 million.

IAS 39 *Financial Instruments: Recognition and Measurement* requires that the carrying amount of a financial asset or liability should be adjusted to reflect actual cash flows or revised estimates of cash flows. This means that, even if it was thought at the outset that early repayment would not take place, if expectations then change, the carrying amount must be revised to reflect future estimated cash flows using the effective interest rate.

The directors of Breightmet are currently in discussion with the bank regarding repayment in the next financial year. However, these discussions do not create a legal obligation to repay the loan within twelve months, and Breightmet has an unconditional right to defer settlement for longer than twelve months. Accordingly, it would not be correct to show the loan as a current liability on the basis of the discussions with the bank.

Loans to employees

IAS 39 *Financial Instruments: Recognition and Measurement* requires financial assets (except those at FVTPL) to be measured on initial recognition at fair value plus transaction costs. Usually the fair value of the consideration given represents the fair value of the asset. However, this is not necessarily the case with an interest-free loan. An interest free loan to an employee is not costless to the employer, and the face value may not be the same as the fair value.

To arrive at the fair value of the loan, Breightmet needs to consider other market transactions in the same instrument. The market rate of interest for a two year loan on the date of issue (1 October 20X4) and the date of repayment (30 September 20X6) is 6% pa, and this is the rate that should be used in valuing the instrument. The fair value may be estimated as the present value of future receipts using the market interest rate. There will be a difference between the face value and the fair value of the instrument, calculated as follows:

	£m
Face value of loan at 1 October 20X4	200
Fair value of loan at 1 October 20X4: (£200m/$(1.06)^2$)	178
Difference	22

The difference of £22 million is the extra cost to the employer of not charging a market rate of interest. It will be treated as employee compensation under IAS 19 *Employee Benefits*. This employee compensation must be charged over the two year period to the statement of profit or loss and other comprehensive income, through profit or loss for the year.

Breightmet wishes to classify the loan under IAS 39 as 'loans and receivables'. It must therefore be measured at 30 September 20X5 at amortised cost using the effective interest method. The effective

interest rate is 6%, so the value of the loan in the statement of financial position is: £178m × 1.06 = £188.68m. Interest will be credited to profit or loss for the year of: £178m × 6% = £10.68m.

The double entry is as follows:

At 1 October 20X4

DEBIT	Loan	£178m	
DEBIT	Employee compensation	£22m	
CREDIT	Cash		£200m

At 30 September 20X5

DEBIT	Loan	£10.68m	
CREDIT	Profit or loss - interest		£10.68m

Loan to Phinferb Ltd

IAS 39 *Financial Instruments: Recognition and Measurement* states that at each reporting date, an entity should assess whether there is any objective evidence that a financial asset or group of assets measured at amortised cost is impaired. Indications of impairment include significant financial difficulty of the issuer; the probability that the borrower will enter bankruptcy; or a default in interest or principal payments.

Where there is objective evidence of impairment, the entity should determine the amount of any impairment loss, which should be recognised immediately in profit or loss. Only losses relating to past events can be recognised. Two conditions must be met before an impairment loss is recognised:

- there is objective evidence of impairment as a result of one or more events that occurred after the initial recognition of the asset; and
- the impact on the estimated future cash flows of the asset can be reliably estimated.

For financial assets carried at amortised cost the impairment loss is the difference between the asset's carrying amount and its recoverable amount. The asset's recoverable amount is the present value of estimated future cash flows, discounted at the financial instrument's original effective interest rate.

The financial difficulties and reorganisation of Phinferb are objective evidence of impairment. The impairment loss is the difference between the carrying amount of the loan at 30 September 20X5 and the present value of the estimated future cash flows, £100,000 on 30 September 20X7, discounted at the original effective interest rate of 8%.

This is £85,730 (100,000 × 0.8573). Therefore the impairment loss is £114,270 (200,000 – 85,730) and this is recognised immediately in profit or loss.

Adjusted profit before tax

Adjusting for the items incorrectly recorded or not recorded, and assuming the loan from Kearsley bank is not repaid early the profit before tax of Breightmet may be restated as follows.

	£'000
Per draft financial statements	800,000
Loss on AFSFA transferred to OCI	20,000
Deduct finance cost on convertible bonds	(19,000)
Deduct finance cost on preference shares	(40,000)
Interest on loan from Kearsley bank	(3,200)
Employee compensation (loan to employees)	(22,000)
Interest on employee loan	10,680
Impairment loss on loan to Phinferb	(114)
Adjusted profit before tax	746,366

If the loan from Kearsley bank is expected to be redeemed after seven years, the effective interest for the year will be £3.64m instead of £3.2m, giving an adjusted profit before tax of £745,926,000.

9 Puckoon plc

Marking guide

Requirement	Marks	Skills
Advise on the appropriateness of financial reporting treatment	22	Appropriate style replying to chief executive linking own workings to summary.
		Evaluate option as derivative appreciating understanding of net settlement.
		Determine impact of business transactions on specific elements of financial statements.
		Evaluate the effectiveness of the hedge.
	8	Calculate and present pension figures.
		Determine that the investment in Edgington is classified as at FVTPL.
		Conclude when accounting treatment is correct.
Set out journal entries to correct extract from draft statement of profit or loss and other comprehensive income	3	
Prepare a table showing proposed adjustments	3	Prepare table in a clear form.
Total marks	36	
Maximum marks	30	

BRIEFING NOTES

To: Terry Milligan
From: Aasha Penesar
Subject: Financial Reporting issues

I attach, as requested, my comments on the financial reporting issues raised in your email of 2 November. My comments are based on the draft financial statements and the notes of my predecessor as financial controller.

As a result of the changes made operating profit has increased from £1.6m to £5.602m and finance charges have decreased from £970,000 to £951,500 (see appendix for calculations).

(1) **Wheat option**

The option to purchase wheat on 1 January 20Y0 represents a derivative per IAS 39. This is because:

- the initial cost of the option of £500,000 is low compared to the potential cost of the underlying asset in the form of the wheat of £12m
- the value of the option changes in response to the change in price of wheat
- the option will be settled at a future date.

However, although uncertain, if the contract has (eg on the basis of past practice) been used partially or entirely in the business and thus physical delivery taken, then this would be scoped out of IAS 39 and not treated as a derivative. Any form of intended 'net settlement' would imply it is not for usage and would therefore be treated as a derivative according to IAS 39.

Assuming it is treated according to IAS 39, the initial cost of the option should be included within the value of the derivative and taken to the statement of financial position. It is therefore necessary to remove this expense from administrative costs.

DEBIT	Financial asset	£500,000	
CREDIT	Administrative costs		£500,000

As a derivative the option should be measured at fair value at the statement of financial position date and the change in fair value should be recognised in profit or loss.

At 30 September 20X9 the option's value is £2.5m (100,000 × (£145-£120)). The option should be measured at fair value, and the increase in value of £2m is taken to profit or loss.

DEBIT	Financial asset	£2m	
CREDIT	Profit or loss		£2m

(2) **Agricultural equipment**

The accounting treatment in relation to this contract is incorrect. Even though there is a highly probable chance of taking up the option to purchase the equipment, Puckoon does not have an asset of equipment at 30 September 20X9. This is because Puckoon does not have control of the equipment in the form of the risks and rewards of ownership.

Therefore the capitalisation of the equipment, recognition of a liability and depreciation should all be reversed.

DEBIT	Payable	£2m	
CREDIT	PPE		£1.7m
CREDIT	Depreciation expense		£300,000

The forward contract to buy dollars on 1 December 20X9 represents a cash flow hedge. The forward contract represents a hedge of a highly probable forecast transaction. The contract costs of £25,000 should be treated as a financial asset and therefore:

DEBIT	Financial asset	£25,000	
CREDIT	Profit or loss		£25,000

Per IAS 39 the hedge should be reviewed for effectiveness. The hedging instrument (the forward contract) needs to be in the range of 80 – 125% of the value of the hedged asset (the equipment). At the date the forward contract is signed the hedge instrument could be regarded as 93.3% effective ($2.8m/$3m) and so the IAS 39 hedging rules can be applied. However, as the value of the hedge instrument is less than the hedged item, the amount that an entity can designate as a hedge may be all, or a proportion of, the value of the equipment (the hedged item). In this respect, if it was designated that only $2.8m of the planned purchase was hedged, then the hedge effectiveness would prospectively be 100%.

The forward contract is initially measured at fair value of £1.931m ($2.8m/1.45) plus the transaction costs of £25,000 making a total of £1.956m.

At 30 September the forward contract should be measured at fair value using the exchange rate at that date. Transaction costs are now excluded.

The fair value of the contract is as follows:

Value at 30 September 20X9 ($2.8m/1.25) £2.24m, giving a gain of £284,000 (£2.24m – £1.956m). (**Note:** More properly the forward rate should be determined at the year end.)

The future expected cash flows in relation to the equipment are as follows:

At 1 January 20X9 ($3m/1.5) = £2m.

At 30 September 20X9 ($3m/1.25) = £2.4m, giving a potential extra cost of £400,000.

The movement on the hedge is 71% of the movement on the expected cash flow (£284,000/£400,000) and as such it is ineffective per IAS 39 if the whole of the $3m purchase had been designated as a hedge.

Therefore the gain on the forward contract should be recognised in profit or loss.

DEBIT	Financial asset	£284,000	
CREDIT	Profit or loss		£284,000

However if only $2.8m of the equipment had been designated as a hedged item then the exchange difference would be £373,333 (ie £400,000 × 2.8/3.0).

Effectiveness would then be 76.1% (£284,000/£373,333). The hedge would still be ineffective as it falls outside the 80 – 125% range.

Another alternative method of assessing hedge effectiveness is to look at the total value of the hedging loan against the total value of the assets being hedged.

Tutorial note:

IAS 39 does not set out a single method for assessing hedge effectiveness hence there is some discretion in these calculations.

(3) **Staff issues**

By advising staff that a bonus would be payable via the newsletter Puckoon has created a constructive obligation in relation to a past event. The provision should be based on the expected estimate of the bonus cost.

If Puckoon expect to make 40 staff redundant then the provision should be based on 210 staff being employed at 31 December. Therefore a provision should be created in the sum of £201,600 (210/250 × £6m × 4%).

DEBIT	Profit or loss	£201,600	
CREDIT	Provision		£201,600

A further provision in respect of employers' national insurance will also be required of around 12.8% × £201,600 = £25,805. A total provision therefore of £227,405.

The above assumes that all employees will be entitled to 4% and meet the requirements for individual performance.

No provision should be made for the expected redundancy costs of £1.1m. This is because at 30 September no formal announcement has been made, and therefore no constructive obligation exists.

DEBIT	Provision for redundancy costs	£1,100,000	
CREDIT	Profit or loss		£1,100,000

Pension scheme

The directors are not correct. The contributions to the scheme are not recognised in profit or loss but are treated as a debit to plan assets. The accounting entries relating to the contributions are:

DEBIT	Plan assets	£85,000	
CREDIT	Puckoon cash		£85,000

According to IAS 19 *Employee Benefits* (revised 2011), gains or losses on remeasurement of the net defined benefit asset/liability (actuarial gains or losses) must be recognised in other comprehensive income in the year in which they arise.

The full accounting treatment is as follows:

Amounts recognised in the statement of financial position

	30 September 20X9	**1 October 20X8**
	£'000	£'000
Present value of obligation	1,200	1,000
Fair value of plan assets	(1,125)	(950)
Net liability	75	50

Expense recognised in profit or loss for the year ended 30 September 20X9

	£'000
Current service cost	100.0
Net interest on the net defined benefit obligation: (5% × 50)	2.5
Net expense	102.5

Amount recognised in other comprehensive income for the year ended 30 September 20X9

	£'000
Actuarial loss on obligation	(145.0)
Return on plan assets (excluding amounts in net interest)	137.5
Net remeasurement loss	(7.5)

Change in the present value of the obligation

	£'000
Present value of obligation at 1 October 20X8	1,000
Interest cost on obligation (5% × 1,000)	50
Current service cost	100
Benefits paid	(95)
Loss on remeasurement through other comprehensive income (residual)	145
Present value of obligation at 30 September 20X9	1,200

Change in the fair value of plan assets

	£'000
Fair value of plan assets at 1 October 20X8	950.0
Interest on plan assets (5% × 950)	47.5
Contributions	85.0
Benefits paid	(95.0)
Gain on remeasurement through other comprehensive income (residual)	137.5
Fair value of plan assets at 30 September 20X9	1,125

(4) **Equity investments**

The investments in both Bentine plc and Secombe Inc are categorised as available for sale. This is because there was no intention to sell the shares when they were acquired and hence they are not 'held for trading'. Also they do not fulfil the conditions as being eligible to be designated as at FVTPL. Therefore they should not be treated as at fair value through profit or loss.

The investments should initially be recognised at fair value and deal costs should be capitalised.

For Bentine plc the investment should therefore be initially measured as £459,000, and the deal costs should be reversed out of profit or loss.

DEBIT	Financial asset investment	£9,000	
CREDIT	Profit or loss, finance costs		£9,000

Because Secombe is based overseas it should be treated as a non monetary asset per IAS 21 and translated using the actual rate of exchange at the acquisition date of £1=$1.42. Therefore the existing treatment is correct except for the reversal of the deal costs.

DEBIT	Financial asset investment	£7,000	
CREDIT	Profit or loss, finance costs		£7,000

Therefore the initial measurement of Secombe is £258,408 (251,408 + 7,000) in non-current assets.

Both investments should be measured at fair value at 30 September 20X9. In respect of Secombe Inc the exchange rate at 30 September should be used, despite the fact that the investment is a non-monetary asset, to best reflect the changes in the underlying value of the investment.

Although a spread price is given for the share values at 30 September, the lower (sale) price should be used in both cases. Sales commissions should be ignored.

Therefore Bentine plc should be measured at £8 each, giving a gain of £341,000 (£800,000 – £459,000) which should be taken to other comprehensive income.

DEBIT	Financial asset investment	£341,000	
CREDIT	Other comprehensive income		£341,000

Secombe Inc should be valued at $10.60 a share, using the rate of £1=$1.25, to give a value of £254,400 ($318,000/1.25).

Therefore a loss of £4,008 (£258,408 – 254,400) arises. This too should be taken to other comprehensive income, unless there is evidence that it represents an impairment, in which case the loss would be taken to profit or loss.

DEBIT	Other comprehensive income	£4,008	
CREDIT	Financial asset investment		£4,008

Although Bentine plc and Secombe Inc are both suppliers, the fact that Puckoon has less than a 5% stake in both companies is unlikely to warrant either of them being classified as related party transactions, as neither investment would be deemed to be an associate.

The shares in Edgington plc appear to satisfy the criterion for held for trading and thus were appropriately classified as at fair value through profit or loss financial asset. This is because it was purchased with the specific aim of being sold at a short-term profit. The acquisition costs of £5,000 should therefore be expensed, but it is probably more appropriate to charge them as operating costs rather than financing.

DEBIT	Profit or loss, admin costs	£5,000	
CREDIT	Profit or loss, finance costs		£5,000

At 30 September 20X9 the investment should be remeasured to fair value at the sale price of £13.50 a share, giving a total value of £337,500.

Although the shares were classified as at fair value through profit or loss on recognition, the treatment may change after the reporting date, because there is now an intention to hold them for their investment potential. Following a 2008 amendment to IAS 39, the shares may be reclassified from fair value through profit or loss to available-for-sale financial assets. We should bear this possibility in mind in the future.

The gain on remeasurement in the current year should be taken to profit or loss. Although no guidance is given in IAS 39, it would appear to be most appropriate to treat this as operating income.

DEBIT	Financial asset investment	£125,000	
CREDIT	Profit or loss		£125,000

Please contact me if you require any further information.

Appendix

Impact on profit of changes () = debit

	Operating profit	**Finance costs**
	£'000	£'000
Draft	1,600	(970)
Wheat option cost	500	
Restate fair value of option	2,000	
Depreciation removed	300	
Forward contract costs	25	
Forward contract gain	284	
Bonus provision	(227)	
Redundancy provision	1,100	
Pension: current service cost	(100)	
Pension: net remeasurement loss (to OCI)		
Pension: net interest on net defined benefit liability		(2.5)
Bentine deal costs		9
Secombe deal costs		7
Edgington deal costs	(5)	5
Restatement of Edgington	125	
Revised figure	5,602	(951.5)

Audit and integrated questions

1 Move-it Ltd

Marking guide

			Marks
(a)	Audit strategy and going concern status		
	Initial analysis – ½ marks per point, up to 6 points maximum	3	
	Issue and explanation – 1½ marks per issue, up to 6 issues	9	
	Maximum		12
(b)	Audit plan and going concern		
	1 mark per procedure:		
	Management's approach to assessing going concern	1	
	Review after date sales	1	
	Check order books	1	
	Review after date cash	1	
	Review trend of overhead expenses	1	
	Check remaining within overdraft limit	1	
	Review profit forecasts and cash flows for after date period	1	
	Check company has met leasing commitments after date	1	
	Check after date budgets against actual performance	1	
	Review after date board minutes	1	
	Challenge assumptions over state of housing market	1	
	Review possible impact of sale of warehouse, look at market values	1	
	Obtain written representations	1	
	Any other relevant procedures		
	(ensure that they are procedures – what to do and what to look for)	2	
			15
Maximum available			27
Total			25

(a) An initial analysis of the available information:

	20X6	20X7	20X8
Change in sales from prior year	–	+5%	–10.8%
GP%	10	10	5
Admin. costs as a proportion of revenue	3.1%	3.1%	3.5%
Interest cover	8.7×	8.6×	0.9×
Receivables days	60	59	90
Payables days	30	30	41

Circumstances giving rise to going concern doubts:

Fall in revenue

The loss of two customers may only be a short term issue; however the potential loss of a major source of income, from the domestic customers, may be more worrying in the longer term, representing a major structural change in the company's market.

Fall in gross profit margins

This is a problem, particularly as administrative expenses have not fallen in line with revenue and interest charges are increasing. Future profitability may be in doubt unless these costs can be kept under control or the decline in revenue proves to be only temporary.

Losses

The fact that the company has gone into a loss making position for the first time is likely to affect investors' and lenders' confidence in the business even if the absolute loss is not great. Such a position will make it harder to raise capital in the future, especially when combined with a

worsening liquidity position. The renewal of the bank borrowing facilities in the near future may well involve difficult negotiations.

Trade receivables

An increase in the length of time being taken to collect receivables could represent a real strain on the company's cash flow taken with increased fixed commitments re leasing payments and high interest charges.

Trade payables

The amount of time taken to pay creditors has increased. Whilst this may ease any cash flow problems it could alienate suppliers, risking future relationships and adversely affecting supplies and trading conditions.

Financial commitments

The company has entered into leasing arrangements with three year commitments – there are cash flow implications here as well as the probability of penalties should payments not be made. Also, the poor interest cover is a worry as the company will be required to keep within the terms of its bank arrangements, especially significant as facilities are due to be renegotiated.

(b) The audit procedures required in relation to going concern will depend on when the financial statements are to be signed off. For example, a key issue will be the renewal of the company's overdraft facility – a significant area of risk and uncertainty will have been removed if the negotiations with the bank have been concluded before sign off. Risk would also be reduced if a warehouse has been sold, providing a useful injection of cash.

Audit procedures

- Review the approach and procedures Move-it's management takes to establish for themselves that the company is a going concern and that the financial statements should be prepared on that basis. Review any working papers, minutes etc to establish the reasonableness of their approach.
- Review after date sales – establish whether the negative trend of sales in each of the company's market areas has continued or has improved.
- Check order books and whether the directors' expectations of securing two major new customers look realistic. Review correspondence and board meeting minutes etc as appropriate.
- Review after date cash received – establish whether the poor collection record is continuing and whether there are any significant irrecoverable receivables.
- Review the trend of overhead expenditure – establish whether any action is being taken to control costs better.
- Review the bank records to ensure that the company has met its commitments in the post year-end period and is within its overdraft facility.
- Obtain cash flow and profit forecasts – discuss the assumptions with the directors and perform sensitivity analysis, particularly flexing interest costs and payment periods in relation to trade receivables and payables.
- Verify whether lease and other contractual commitments are being met.
- Check budgets for the after date period against actual performance to form a view as to the likely accuracy of the forecasts.
- Review board and other minutes to look for indicators of improving or worsening conditions.
- Challenge any assumptions the management are making in relation to the domestic housing market and its impact on domestic removals. Look for external evidence, such as published statistics on monthly numbers of house sales completed, to support management's views.
- Review the anticipated impact of the sale of the warehouse on income streams and cash injections. Check the market for warehouses and the value given to them by the company (the use of auditors' experts may be required here).

- Obtain written representations from management on the likelihood of the company operating for the 12 months from the date of approval of the financial statements.

2 Pure Foods Ltd

Marking guide

				Marks
2.1	(a)	Impact on statutory audit	2	
		Competence of firm to do work	2	
		Liability of firm for report	2	
		Exact nature of assignment/engagement letter	2	
		Total available	8	
		Maximum		7
	(b)	Up to 2 marks per assertion		8
2.2		Generic risks – ½ per point (max 6)	3	
		Specific risks for Ebygum:		
		Security re integrity of system and over business standing data	1	
		Inventory	1	
		Returns/refunds	1	
		New venture requiring competent staff	1	
		Contingency planning	1	
		On line order and security of customer data	1	
		Audit trail	1	
		Any other relevant specific risks	1	
		Total available	11	
		Maximum		10
Total				25

2.1 **Pure Foods Ltd**

(a) The audit engagement partner should consider:

- How the new engagement might impact on the statutory audit.
  - Will the objectivity of the audit be affected (for example, the impact of the additional fees arising from the new engagement on the total fee income from Pure Foods Ltd)?
  - Will the extra fees from the additional work take the total above the acceptable level?
  - What staff will be involved in the assignment (the audit staff or another team)? This includes considering the effect on auditor independence.
  - Whether taking on the extra assignment will increase the knowledge of the business and the client in a way that would improve the conduct of the statutory audit (eg improve the quality of the risk assessment).
- Whether the firm is competent to carry out the somewhat specialist assignment.
  - The new assignment needs to be carried out by competent staff to ensure that the work is of the appropriate quality to minimise the risk of being sued for negligence.
  - The partner might consider it necessary to use the work of auditor's experts.
  - Should existing members of the audit team be used – they will have knowledge of the client and its business but they may be too close to be objective and make inappropriate assumptions.
- The potential liability of the firm for the report.
  - Need to consider to whom he/she is accepting liability in relation to this report.
  - Unless otherwise stated, liability is unlikely to be limited to shareholders.
  - Liability could extend to all users of the annual report.

  - Should consider whether it is possible to limit liability and disclaim liability to certain parties.
  - Must decide whether the risk of the assignment is worth it (risk v fees v benefits of doing the work).
- The exact nature of the assignment.
  - What is the nature of the assignment? This needs to be clarified.
  - What level of assurance is required?
  - What are the criteria by which the directors expect the firm to assess the assertions?
  - 'Truth and fairness' and the concept of materiality do not automatically apply to this assignment, so the partner needs to agree the requirements and degree of assurance to be given with the directors.
  - Is the assignment an 'agreed upon procedures' engagement rather than an assurance engagement (the former is more straightforward)?
  - The engagement letter should establish these issues.

(b) In relation to the four assertions, the auditor must firstly establish how the client justifies them. The auditor must also determine whether the company's corporate responsibility report is to comply with recognised standards (for example, the GRI or the Accounting for Sustainability Connected Reporting Framework). Where the report asserts compliance with a set of standards, the auditor must review the disclosures to determine whether they are in compliance with the standards.

All the ingredients, both from the UK and abroad, are organically produced and free from GM products.

- A complex assertion because the ingredients come from a variety of countries where organic principles may be different or differently interpreted. A starting point will be a list of suppliers and the countries of origin of ingredients.
- The use of the word 'all' could provide problems as it does not allow for a margin of error.
- We would need to establish who the suppliers were during the year, where the ingredients originated, whether those countries had appropriate organic standards and whether the suppliers were certified by the standard setters.
- In the EU, it may be a matter of ensuring that suppliers comply with EU-wide standards and are certified by approved organic control bodies.
- Organic and 'free from GM' usually go hand in hand, but you would need to ensure that the countries' standards included 'free from GM'.
- Evidence could include:
  - Assertions from suppliers.
  - Checking certification of suppliers with EU/national standard setters.
  - Reviewing the methods of production used by suppliers – not easy to relate back to the period under review with any degree of certainty.

Fair prices are paid to overseas producers (including fair wages).

- The auditor needs a comprehensive list of overseas suppliers and their countries (as above).
- The definition of 'fair' could cause problems due to its subjectivity and lack of clarity.
- The assertion may be verifiable against a recognised standard such as the Fairtrade Mark used by the Fairtrade Foundation. Difficulties would arise if suppliers were not officially party to such a scheme.
- If Pure Foods Ltd is a member of an organisation with definable and enforceable standards, it may be possible to check against the standards that they are being met.

The company's processing plant in the UK is carbon neutral.

- Difficult for a non-expert to assess – may need to employ an auditor's expert (and obtain the necessary evidence that the expert is independent, experienced, competent and has an identifiable positive track record in making these kind of judgements).
- Need to establish how the client measures its carbon footprint.
- Client's measurement methods should be checked against what is considered an appropriate standard – some standards may be obtainable from government sources, or the GRI.
- The end result is likely to be a matter of assessing the validity of the bases for, and checking the calculations of, the carbon output from the client's processes and then checking that these have been appropriately offset.

Packaging makes use of recycled materials and is itself recyclable.

- Need to establish what packaging the firm uses and what is meant by 'makes use of' (does this mean that all the packaging is recyclable or just that some of it is?). This assertion would need to be clarified and perhaps quantified.
- The suppliers of the packaging could be contacted and asked to make assertions that the products purchased by Pure Foods Ltd are made from recycled material.
- Need to establish whether any further processing is done by Pure Foods Ltd which might render the packaging unrecyclable.
- Whether the packaging itself is recyclable can be checked to appropriate UK and EU guidelines.

2.2 **Ebygum Ltd**

The more a business is engaged in e-commerce, the greater the risk associated with it. Ebygum's involvement in e-commerce includes the provision of information, customers initiating transactions, and automatic update of systems that initiate expenditure – so it is at the riskier end of the spectrum of e-commerce activities.

Generic risks of e-commerce include the following:

- cyber-security risks (viruses, hackers, frauds)
- loss of transaction integrity and risk of reputational damage in the event of failures
- possible lack of sufficient audit trail
- risk of non-compliance with regulations (eg data protection, taxation)
- contractual issues relating to agreements made over the Internet
- risk of system crashes and losses from resulting business interruption
- lack of proper support and appropriately trained staff when entering a new area
- over-reliance on e-commerce when placing significant business systems on the web without appropriate back-ups and controls.

Specific risks for Ebygum Ltd include:

- Security issues are important, particularly in the area of purchases and inventory control. Business sensitive areas such as inventory re-order levels and the database of approved suppliers must be secure, but allow appropriate updating as required by authorised personnel.
- Inventory control will be a key area – although the system operates automatically, it will need to be controlled and monitored so that appropriate business decisions can be made (eg are we continuing to buy from the best suppliers, should base inventory levels be changed as circumstances change?).
- The system for dealing with returns and refunds must be considered and must be secure. As the inventory is held in remote locations how will the process work – who will accept the returned inventory and initiate refunds?

- As this is a new endeavour for Ebygum Ltd, it will be important to ensure that the staff have developed and will continue to develop appropriate skills to operate and support the new processes.
- The risk of system failure and appropriate contingency planning will need to be addressed – this will become increasingly important as the proportion of business obtained using e-commerce increases.
- Cyber-security will be a key risk area as transaction integrity is particularly important for Ebygum Ltd, where sensitive data relating to customers is provided, and monetary transactions take place on line.
- As this is the first year that an online business model has been adopted, there is a risk that the audit trail for certain account balances and transactions may be lost. This is likely to be the case where the online records are not automatically integrated with internal systems.

3 Childplay plc

Marking guide

		Marks
3.1	Fraudulent financial reporting	
	1 mark per risk (½ for the risk, ½ for the explanation)	8
	Misappropriation of assets	
	1 mark per risk (½ for the risk, ½ for the explanation)	7
3.2	Inherent risk	
	½ marks per point (including an explanation)	5
	Control risk	
	½ marks per point (including an explanation)	5
Total		25

3.1 Fraud risk divides into two categories:

- Fraudulent financial reporting.
- Misstatement arising from misappropriation of assets.

The conditions for fraud have two key elements: opportunity and incentives.

In relation to the **risk of fraudulent financial reporting** within Childplay, the following need to be considered by the auditors:

- **Opportunities**
  - Significant related-party transactions – the managing director's brother-in-law has designed and installed the inventory control system, a key asset of the company and an essential part of the system for financial reporting. The potential for fraud is higher than if such services were provided at arm's length.
  - Domination of management by a single person or small group – the managing director appears to be a very dominant person.
  - Complex or unstable organisation structure – establishing a new management structure can often lead to instability for a period of time; this could be the case in Childplay, thereby providing opportunity for fraud.
  - Deficient internal controls – it is possible that the inventory system has deficiencies and therefore inventory could be misstated; the assertion that it is now running smoothly needs to be investigated.
  - Assets, liabilities, revenues or expenses are based on significant estimates – this factor could be of major significance in the case of Childplay as estimates would be involved in assessing inventory provisions and they could be affected by the poor trading conditions.
  - Bringing forward the publication of the financial statements would reduce the amount of time the auditors have to gather evidence after the reporting period.
- **Incentives**
  - Financial stability and profitability – for Childplay these may well be threatened due to difficult market conditions.
  - Pressure for management to meet the expectations of third parties – the desire to raise capital would increase fraud risk in relation to Childplay.

- Personal financial situation of management threatened by the entity's financial performance – the new regional management of Childplay have a performance related pay package dependent on financial performance. If they have direct influence on the reporting process the opportunity for fraud and fraud risk increases.
- Excessive pressure on operational management to meet financial targets – in addition to the issue above, Childplay's regional management will probably be under pressure to perform well financially due to the overriding desire to expand and raise capital.
- Low morale amongst sales staff and staff shortages increases the risk for overriding internal control processes.

In relation to the **risk of misstatement arising from misappropriation of assets** within Childplay, the following need to be considered by the auditors:

- **Incentives**
  - Personal financial obligations – we are not aware of any issues here but with any group of employees this risk always exists, so the auditor needs to keep this in mind as a possibility.
  - Adverse relationships between the entity and its employees with access to cash or other assets susceptible to theft – due to the low morale of staff because of the cost cutting exercise over the Christmas period this is a potential risk. In this situation there is both access to cash and the merchandise is easily stolen.
- **Opportunities**
  - In the retailing environment of Childplay there are likely to be relatively high levels of cash on hand.
  - Inventory items are small in size (easily stolen) and, at the right price, readily sold on.
  - The ease with which inventory can be written off and supposedly passed on to charities without much formal control provides an ideal opportunity for inventory to be misappropriated.
  - A new, and perhaps unreliable, inventory control system can provide opportunities for staff to cover up misappropriations by blaming the system.
  - There are known deficiencies in the internal control over inventories and the ability to write off and dispose of obsolete inventory locally. Such a lax approach can adversely influence staff's attitude and their desire to safeguard the company's assets.

3.2 **Inherent risk** is the susceptibility of an assertion about a class of transaction, account balance or disclosure to misstatement that could be material, before consideration of any related controls.

- In the case of Childplay, the **inherent risk factors that affect the company as a whole** are the following:
  - The apparent dominance of the managing director may adversely affect the integrity and attitude to risk of the other directors and management.
  - The changes in the management structure can increase risk with management and staff being unaccustomed to new processes.
  - As the company appears to be in a difficult market with increasing pressures for success, this will create unusual pressures on management.
  - The desire for a tight reporting deadline will also put additional pressure on staff, increasing the likelihood of errors.
  - New systems (especially key systems such as Childplay's inventory control system) can introduce additional pressures and risks before employees become familiar with them.

- **Inherent risk factors that affect individual account balances and transactions** in Childplay are the following:
  - Assets are at risk of being lost or stolen – cash and inventory in the case of Childplay.
  - The new system and its poor implementation could adversely affect the inventory balance. Experience has indicated problems in this area.
  - This type of retail chain has a high volume of transactions which can lead to higher than normal risks.
  - Low staff morale in the shops could adversely affect the sales and receivables transactions streams as staff will tend to perform badly.

Control risk is the risk that misstatements in account balances transactions or disclosures will not be prevented, or detected and corrected on a timely basis by the entity's internal control.

Control risk factors affecting Childplay depend upon the control environment and the control activities being undertaken in respect of financial reporting.

In the case of Childplay the implications of the information obtained to date about control risk are as follows:

Control activities

- A new inventory system has been installed. This increases control risk. The auditor will need to carry out tests of controls in order to assess the effectiveness of the control activities it undertakes (for example, physical controls to access, backup facilities and application controls over information processing).
- Cutting staffing levels could have a negative effect on the implementation of controls (for example, segregation of duties may be more difficult to achieve).
- Controls around the disposal of obsolete inventory appear to be very limited, being left to the discretion of local management. No application controls appear to be in place, and authorisation seems to be inconsistent. This increases the control risk with regards to the disposal of inventory, as well as increasing fraud risk in general.

Control environment

- Insisting on tight deadlines for reporting also indicates that proper controls are not at the top of the management's agenda, pointing to a deficient control environment.
- A number of specific events during the year combine to increase control risk:
  - Installation of new inventory control system
  - Management restructure
  - Aggressive expansion plans
- Establishing purely sales and profitability targets as measures of success for regional managers may point to a culture of overlooking integrity and ethical values. This also increases control risk.

4 Nucleus Ltd

Marking guide

			Marks
4.1	Scheme assets	2½	
	Scheme liabilities	2½	
	Actuarial assumptions	2½	
	Items charged to profit and OCI	1½	
			9
4.2	1½ marks per business risk (½ per risk, 1 per explanation):		
	Market risk	1½	
	Foreign exchange risk	1½	
	Credit risk	1½	
	Settlement risk	1½	
	Liquidity risk	1½	
	Operational risk	1½	
	Interest rate risk	1½	
	Legal risk	1½	
	Total available	12	
	Maximum		9
4.3	Economy (inputs)	3	
	Efficiency (outputs)	3	
	Effectiveness (impacts)	3	
	Total available	9	
	Maximum		7
Total			25

4.1 The main areas to audit are:

- scheme assets
- scheme liabilities
- the actuarial assumptions
- the items charged to profit for the year
- the items charged to other comprehensive income for the year.

Scheme assets

- Obtain a list of the scheme assets showing the various shares, bonds and properties that the scheme holds. Ensure that there is a reconciliation of their valuation at the beginning and end of the year – verify the reconciliation to supporting documentation.
- Obtain direct confirmation of the scheme assets from the investment custodian or from documentary evidence directly (such as share certificates, title deeds etc).
- Check valuation of assets to appropriate evidence (eg similar shares quoted on the stock market, professional valuations – it is likely that the use of auditor's experts is required here, particularly in relation to the property valuations).
- Check the movements of assets to appropriate documentation (eg purchase/sale documents).
- Some of the above detailed procedures may be performed by the scheme auditors.

Scheme liabilities

- Liabilities will be based on the actuary's assessment.
- Need to apply ISA (UK) 620 (Revised June 2016) (Using the work of an auditor's expert) to assess whether it is appropriate to rely on the actuary's work.
- Need to consider the source data used by the actuary and its accuracy (eg data relating to scheme members).

- The assumptions and methods used to establish the liabilities need to be assessed.
- The auditor needs to consider the actuary's work in the light of their own knowledge of the business and the results of other audit procedures.

Actuarial assumptions

- Due to lack of expertise, the auditor is unlikely to challenge the reasonableness and appropriateness of the actuarial assumptions – assumptions could include mortality rates, termination rates, retirement ages, changes in salary and benefit levels.
- However, the auditors need to be confident with the qualifications and experience of the actuaries.
- The auditors should obtain a general understanding of the assumptions and review the process used to develop them.
- They should compare the assumptions used for consistency from one year to the next or justifications for changes.
- Based on their knowledge of the business and the scheme and the results of other work, the auditors should consider whether assumptions are reasonable.
- The directors should provide written representations that the assumptions are consistent with their knowledge of the business.

Items charged to profit or loss

- The auditor needs to obtain documentation to support the costs – these costs could include current service cost, past service cost, interest, gains and losses on settlements.
- Confirm that net interest cost has been based on the discount rate determined by reference to market yields on high quality fixed rate corporate bonds.
- Discuss with directors and actuaries the factors affecting current service costs and ensure consistency with other data.

Items recognised in other comprehensive income

- Check basis of the remeasurement of the net defined benefit liability/asset, including verifying the updated assumptions used to calculate actuarial (measurement) gains/losses.
- Check basis of calculation of return on plan assets (excluding amounts in net interest) ie using current fair values. Fair values must be measured in accordance with IFRS 13.

Contributions paid in to plan

- Agree cash payments to cashbook/bank statements.

4.2 This speculative forward contract has the characteristics of a derivative. The business risks in relation to this forward contract include:

- **Market risk**: This is the risk that the fair value of the forward contract will fall.
- **Foreign exchange risk**: As the contract is quoted in $US, an adverse movement in the £/$ will affect Nucleus Ltd's earnings from this contract.
- **Credit risk**: The risk that the counterparty will not settle the obligation at full value.
- **Settlement risk**: When settlement takes place in two years' time it is possible that Nucleus Ltd will not receive value from the counterparty.
- **Liquidity risk:** The risk that Nucleus Ltd will not have the funds available to settle the contract when payment for the titanium becomes due.
- **Operational risk:** The risk related to the specific processing required for the financial instrument.
- **Interest rate risk**: The risk that Nucleus Ltd will suffer loss as a result of fluctuations in the value of the forward contract due to changes in interest rates. If a movement in interest rates causes the price of titanium to fall, then Nucleus Ltd would be adversely affected.

- **Legal risk**: Over the period before settlement becomes due there could be legal or regulatory changes that result in losses being made on the contract.

4.3 Value for money audits usually concentrate on the economy (the inputs), efficiency (outputs) and effectiveness (whether it is achieving its intended impact) of activities and processes.

Inputs and economy

The inputs to the training department are likely to be many and varied. Nucleus currently identify the training department as a cost centre and the internal auditor may well firstly consider whether the costs are appropriate and relevant.

Costs could include:

- salaries (costs of trainers, authors and administrators)
- tangible items (rent and other costs of office space, costs of external resources (eg consultants, training DVDs etc), costs of office facilities used (eg computers), costs of consumables (paper, discs etc), costs of space and equipment used for training (which could otherwise be used for production purposes))
- costs of running training events if any take place away from the main site (venue hire, travel, overnight accommodation etc)
- costs of distance learner materials (duplication and distribution costs etc).
- college fees (course fees, exam entrance fees etc).

Other costs may be included such as the cost of trainees' time when they are involved in training activities. The auditor would need to establish that such costs are fairly apportioned and valued.

In terms of economy, the auditor would be considering whether the inputs have been obtained at the lowest costs for the required standards. The auditor might look both at the absolute costs and make some comparisons with alternative suppliers, but could also look at, and assess, the systems the department uses to ensure it gets value for money (eg tendering processes, how many venues the administrators contact before reaching a conclusion on where courses are to be run etc).

Outputs and efficiency

Outputs mean the results of an activity. In the case of the training department, this could be a mixture of:

- number of hours training delivered
- number of internal courses run
- number of attendees
- numbers of self study packs distributed
- numbers of staff completing on-line training activities
- numbers of staff attending college courses (days attended)
- numbers of staff passing training milestones.

All these should be easily measurable.

Efficiency means relating the outputs to the inputs. For example:

- maximising the number of staff attending a particular training event for a given input (resulting in a minimum cost per employee), or
- for a given output (for example, the number of staff actually receiving a qualification) incurring the minimum input (cost).

Impacts and effectiveness

For a training department, these would be the hardest to measure.

The starting point could be what the organisation expects from its training programme and how that could be measured. The training programme could strive for a measurable objective, ie the numbers of staff achieving an appropriate external qualification having followed a particular training programme.

However, how such narrow objectives relate to the overall business objectives of Nucleus (such as maximising profits) may be less easily measured. The link between cause (training) and effect (eg successfully obtaining a new contract due to complying with industry standards by having appropriately trained staff) may not be direct due to all the other possible influences on outcomes (such as contract price, ability to deliver on time etc).

In order to complete this VFM audit assignment, the internal audit team should ensure that the terms of reference are clarified with management before undertaking the work. When reporting, they need to be very specific about the limitations of the measurement methods that can be used.

5 Sleeper Ltd

Marking guide

			Marks
5.1	Confidentiality	1½	
	Conflict of interest	1½	
	Safeguards	3	
	Intimidation	1½	
	Safeguards	2	
	Total available	9½	
	Maximum		6
5.2	Rights	2	
	Responsibilities	1½	
	Total available	3½	
	Maximum		3
5.3	Management's responsibilities	3	
	Auditors' responsibilities	3	
			6
5.4	Assertions (each)	½	
	Procedure per assertion (each)	1	
	Maximum		6
Total			21

5.1 **Professional ethical issues**

Confidentiality and conflict of interest

Sleeper appears to be in direct competition with Zelig. If our firm accepts the audit engagement, there may be a perceived threat of unauthorised disclosure/use of business-sensitive information.

At the same time, as the two audit clients are competing with each other, circumstances may arise where their interests are in conflict (for example, in the event of disposals and acquisitions, or legal disputes between the two companies). There is a risk that in such circumstances, the audit team's professional judgement may be impaired by the conflict of interest.

Safeguards

- Ensure staff are aware of confidentiality issues.
- Staff confirm awareness in writing.
- Obtain informed consent of both companies.
- Use different partners and teams.
- Chinese walls/staff assigned from different offices.
- Independent review of arrangements for ensuring confidentiality maintained.

Intimidation by management/fear of losing a client

Given our understanding of the reason why the current auditor has not been re-appointed, an independence threat arises. The audit firm may be forced into giving inappropriate opinion through the fear that management may remove them.

Safeguards

- Apply the firm's own procedures for accepting new clients/do not accept if threat too high.
- Apply the firm's annual review procedures/review of threat to independence on a regular basis.
- Consider the overall control environment within the audit firm.
- Notify the firm's audit compliance principal of the potential threat.
- Involve an additional professional accountant on the audit team to review the work done.

5.2 **Rights**

The outgoing auditor has the right to:

- Make written representations of a reasonable length circulated to all members. Such a representation might explain why they should not be removed as auditors.
- Request that management circulate these to members.
- Receive notice, attend and speak at the meeting where they would have been appointed, or the proposed new auditor is appointed.

Responsibilities

The outgoing auditor is responsible for:

- Making a statement of circumstances specifying whether or not any circumstances should be brought to the attention of the members or creditors (unless their term of office has ended or the reason for ceasing to hold office is an exempt reason and there are no matters to report).
- Obtaining written permission from client to discuss its affairs with new auditor.

Having obtained written permission from the client, the outgoing auditor should reply promptly to incoming auditor's communication. Should the outgoing auditor have information which could influence the new auditor's decision as to whether or not to accept the appointment, this information should be provided to the new auditor.

5.3 **Duties in relation to fraud**

Management

- Directors are responsible for the prevention and detection of fraud.
- Directors should implement a system of internal control suitable for the size of the entity/safeguard assets.
- Directors should monitor the system of internal control.

Auditors

- Auditor has no responsibility for the prevention of fraud.
- Auditor is responsible for detecting material misstatements in the financial statements resulting from fraud.
- Auditors should plan, perform and evaluate their work so that there is a reasonable expectation of detecting material misstatements, which includes identifying and assessing risks of material misstatement due to fraud and then responding to those assessed risks, and obtaining sufficient, appropriate audit evidence concerning them.
- As part of their response to the possibility of material misstatements arising from fraud, ISA (UK) 240 (Revised June 2016) requires auditors to:
  - Maintain an attitude of professional scepticism.
  - Have discussions within the audit team concerning the susceptibility of the entity to material frauds or errors.
  - Inquire of management concerning their assessment of the risk of fraud and about any known frauds that have occurred.

5.4 Assertions and procedures

Existence

- Attend the inventory count.
- Scrutinise controls over inventory counting.
- Perform test counts of existing inventory based on a sample from inventory records.
- Trace entries from final inventory sheets to counting sheets.
- Perform cut off testing (trace a sample of purchases and sales before and after the year end to the inventory records to ensure included in correct period).
- Inquire whether inventory is held by third parties and if so, confirm existence directly with third parties.

Accuracy, valuation and allocation

- Identify any instances of damaged or dated inventory (particularly old models of mobile phones may be obsolete) during the count.
- Trace a sample of mobile phone inventory to supplier invoice (which will also give assurance of rights and obligations).
- Examine after date sales to ensure that the inventory is stated at lower of cost and net realisable value.
- Discuss with management/review sales after date for slow-moving or obsolete inventory.

Rights and obligations

Consider whether there is any inventory held for third parties, or inventory on consignment/on a sale or return basis; if required, carry out audit procedures to confirm the ownership of such inventory by direct confirmation with the third party.

Completeness

- Carry out cut off testing.
- Consider other location/inventory held by third parties.
- Attend the year-end inventory count.
- Carry out test counts agreed to inventory records.

Classification and presentation

Inspect the draft financial statements to ensure that inventory has been correctly disclosed.

6 Progear Inc

Marking guide

			Marks
6.1	Increase in revenue	3	
	Fall in gross profit margin	4	
	Increase in operating expenses	4	
	Reduction in inventory days	4	
	Reduction in receivables days	5	
	Total available	20	
	Maximum		13
6.2	Title and addressee	1	
	Restriction on use	3	
	Subject matter	1	
	Respective responsibilities	2½	
	Scope of work	4	
	Level of assurance	1	
	Conclusion	1	
	Details of reporting accountant	½	
	Total available	14	
	Maximum		7
Total			20

6.1 Matters to discuss with the financial controller include the following:

Reason for 9% increase in revenue ((£5,353k – £4,907k)/£4,907k) and why this is out of line with previous years.

This may be due to:

- Any new customers/marketing campaign/wider product range;
- Change in income recognition policy or cut off errors.

Reason for fall in gross profit margin to 16.5%(£881k/£5,353k) from 19% (£933k/£4,907k) and why this is less than the standard margin of 20% (based on the 25% mark-up).

This may be due to:

- Increase in number of customers entitled to discount;
- Understatement of inventory as inventory days have fallen (see below).

Reason for increase in operating expenses as a percentage of sales to 13.9% from 13.2% (£646k/£4,907k) and the fall in operating margin to 2.5% (£134k/£5,353k) from 5.8% (£287k/£4,907k).

This may be due to:

- More customers taking advantage of early payment discounts (as receivable days have reduced);
- Higher selling costs to achieve revenue growth;
- Any new or one-off expenses.

Reason for the reduction in inventory days to 40 days (£994k/£4,472k × 180 days) from 43 days (£951k/£3,974k × 180 days).

This may be due to:

- More efficient management of inventory;
- Understated inventory/cut off errors.

Reason for reduction in receivables days to 27 days (£812k/£5,353k × 180 days) from 30 days (£806k/£4,907k × 180 days).

This may be due to:

- more customers taking advantage of early payment discount
- improved credit control procedures
- possible understatement of receivables/cut off errors (eg after date cash treated as received in year).

6.2 **Main components of the report**

- Title and addressee: ie Independent Review Report to Progear Inc.
- Restriction on use: a statement to the effect that the report is made solely to the company, and to the fullest extent permitted by law the firm does not accept or assume responsibility to anyone other than the company.
- Subject matter: ie the financial information for the six months ended 30 September 20X9.
- Respective responsibilities of management for preparing and the reporting accountant for reviewing the financial information.
- Scope of the work: limited to making enquiries of company personnel and applying analytical and other review procedures. There should be a statement that an audit has not been performed and that an audit opinion is not expressed.

  There may be a reference to any standards under which the review has been conducted for example, ISRE 2400 (Revised) *Engagements to Review Historical Financial Statements* or ISRE (UK and Ireland) 2410 *Review of Interim Financial Information Performed by the Independent Auditor of the Entity*.
- Level of assurance: moderate/limited assurance that financial statements are free from material misstatement.
- Conclusion: expressed using a negative form of words, such as 'nothing has come to our attention….'
- Details of reporting accountant including name, signature and address and the date of the report.

7 WHAT

Marking guide

			Marks
7.1	How it differs	1	
	Agreement and confirmation of terms	2	
	Planning issues	3	
	Evidence	½	
	Review and reporting	1	
	Total available	7½	
	Maximum		5
7.2	Deeds of covenant	2	
	Postal donations	4	
	Collections	5	
	Capital donations	3	
	Grants	2	
	Sales of refreshments	4	
	Fund raising events	4	
	Total available	24	
	Maximum		15
Total			20

7.1 **Differences between this engagement and the statutory audit engagement**

The statutory audit is carried out under the Companies Act 2006 (CA2006) or equivalent legislation. Under the CA2006 the statutory auditor has a duty to carry out whatever work the auditor deems appropriate in order to reach an opinion on whether the financial statements of a company give a 'true and fair view'. The auditor's opinion is then reported to the shareholders in a predetermined form of report (as set out in ISA (UK) 700 (Revised June 2016) and FRC Bulletins.

Here, the auditor has been asked to carry out similar work to an audit, but as it is not statutorily required, the nature of the assurance given and the scope of the engagement will not necessarily be the same as is required for a statutory audit. The scope of this work will be agreed with management and a particular format of report (addressed to management) will also be agreed. The assurance engagement may contain reference to whether the charity operates in accordance with its charitable objects as well as whether the financial statements present fairly.

Approach for assurance engagements

- Agree the scope of work to be performed and the basis of the report to be given.
- Issue written engagement terms detailing the responsibilities of the parties to the engagement, the scope of the work and the basis of the report to be presented.
- Plan the work to be performed, including
  - Assessment of the risks of error and misstatement
  - Determination of the quantity of evidence needed to give the report required.
- Determine the testing plan to be performed.
- Collect and test the detailed evidence.
- Review the results of the testing of the evidence and form an overall conclusion on the engagement.
- Prepare and present the assurance report.

The approach to the engagement and all the testing and results must be properly documented in a set of working papers.

7.2 **Controls over income**

(a) **Deeds of covenant**

- Regular review by a responsible official to ensure that all amounts are duly received (most deeds of covenant will probably be paid by bankers' order and this method of payment should be encouraged).
- Regular monitoring to ensure that all the payments covenanted are obtained, including income tax refunds.

(b) **Postal donations**

- At least two persons to be present at opening of mail.
- Immediate recording of receipts on a post list.
- Prompt banking of the money to ensure maximum interest earned.
- Independent reconciliation of cash book receipts with post list.

(c) **Door-to-door and work-place collections**

- Pre-numbering and sealing of collecting boxes and tins.
- Provision of identification to collectors.
- Prompt collection and removal of proceeds from boxes.
- At least two persons to be involved in counting and recording.
- Prompt banking of cash intact (ie without using the money collected to pay expenses).

(d) **Capital item donations**

- Safe-keeping of documents of title or registration (eg vehicle registration form).
- Safe custody of donated assets (eg vehicles should be fitted with alarms and locked).
- Use restricted to company business by
  - Having authorised drivers
  - Installing tachographs.

(e) **Local authority grants**

- Regular discussion with local authority officials to ensure all available grants are obtained and that specific payments are received.
- Authorisation, by directors, of disbursement of grants to ensure expenditure complies with the terms of the grant.

(f) **Sales of refreshments at the social centre**

- If level of sales justifies it, a till should be used for all takings which should be banked daily and intact.
- Inventories of confectionery, sweets, etc should be securely held.
- Overall tests on gross profit percentage should be made at (say) monthly intervals by the finance director.
- Some degree of supervision may need to be present to prevent losses of inventory through staff pilferage. 'Spot checking' may suffice.

(g) **Fund-raising events**

- Approval by the board of directors.
- Adequate records of income for each event.
- Clear responsibility for cash handling allocated to two persons.
- Takings to be banked promptly and intact, with separate authorisation and payment of expenses.

8 Spirit Consulting Ltd

Marking guide

			Marks
8.1	Process	5	
	Purposes	7	
	Total available	12	
	Maximum		6
8.2	General	3	
	Project costing system	6	
	Fixed-price contracts	3	
	Revenue	6	
	Expenses billed to clients	1½	
	Trade receivables	1½	
	Allowance for receivables	3	
	Accrued income	1½	
	Total available	25½	
	Maximum		11
8.3	Revenue	4	
	Time contracts	6	
	Fixed-price contracts	8	
	Income per consultant	1	
	Foreign currency invoices	1	
	Trade receivables and allowance for receivables	7	
	Accrued income	2½	
	General	3½	
	Total available	33	
	Maximum		15
8.4	Business relationships	5	
	Personal relationships	4	
	Address the ethical issues	8	
	Total available	17	
	Maximum		8
Total			40

8.1 **Process**

The firm should have explained to Spirit its professional duty to communicate with the existing auditor and obtained written authority from Spirit to discuss its affairs with the existing auditor. If permission had been refused, the firm should have considered declining the engagement.

Once written authority was obtained, the firm should have written to the existing auditor seeking any information relevant to its decision to accept the appointment as auditor. Once received, the response from the existing auditor should have been reviewed for any reasons that would have impacted on the firm's decision to accept appointment. The firm might have needed to address any issues arising from the information before accepting. If no reply had been received from the existing auditor, the firm should have chased it up by sending a further request via recorded delivery and stating the firm's intention to accept appointment in the absence of a reply. The firm should have informed Spirit of the outcome of this process.

Purposes

There may be a threat to professional competence and due care if an engagement is accepted before the firm knows all pertinent facts. There may be implications for the firm's reputation if it becomes associated with an inappropriate client.

Clients may wish to change auditors due to disagreements with management or issues around management integrity that may not be easily overcome. Professional clearance procedures will help to mitigate the risk that similar issues arise once the audit engagement has been accepted.

The response may highlight issues such as unpaid fees or unlawful acts by the client and also provides some evidence as to the identity of the client – this is important in ensuring the audit firm complies with UK money laundering regulations.

The process, as set out by the ICAEW Code of Ethics, is designed to maintain client confidentiality.

8.2 **General**

Revenue and receivables are highly material balances and the loan application is contingent on a review by the bank of the audited financial statements which is likely to lead to management bias in areas such as revenue recognition and the allowance for receivables.

Project costing system

Errors may occur around the accuracy and completeness of items recorded in the project costing system such as expenses and time being recorded incorrectly, against the wrong project code or in the incorrect accounting period which may lead to receivables not being recoverable.

The project system was replaced during the accounting period which increases the risk of error resulting from data being transferred to the new system incorrectly or the new system not functioning correctly.

Fixed-price contracts

The accounting for revenue is complex and the stage of completion of fixed-price contracts is a matter of estimation and judgement which increases the risk of management bias or error.

Revenue

Compared to prior year, total revenue has fallen by 12.8% and alternative fee income (excluding expenses billed) by 14% (£125,903 – £108,277)/£125,903) and fee income per consultant has fallen by 11.4%. This may suggest an understatement of revenue, perhaps resulting from cut-off errors or other recording errors for time and expenses or inappropriate estimates for fixed-price contracts.

However, revenue is outperforming the industry average, which has declined at a rate of 16%. This may suggest that the decline in revenue has not been recognised to its full extent in the financial statements indicating an overstatement of revenue.

Operating profit has risen from 9.4% to 11.5% which is inconsistent with the falling revenues identified.

Some customers are invoiced in foreign currencies, which may not be translated correctly or translated using inappropriate exchange rates.

Expenses billed to clients

Expenses billed to clients have risen to 9.4% of fee income compared with 7.9% in the prior year; this could be due to operational reasons, for example, more accommodation costs as more projects were carried out in Europe this year, but it could also suggest misstatement of fee income: either expenses are not matched correctly to fee income, or expenses have been misclassified or inflated.

Trade receivables

Trade receivable days has fallen from 43 days to 37 days (alternative 37 days to 33 days) suggesting a possible overstatement of revenue or understatement of receivables.

Allowance for receivables

The allowance for receivables has fallen from 13.5% of receivables to 10.8% which may suggest a less prudent policy for calculating the allowance. This is inconsistent with the fall in revenue and may result from management bias or an error in the calculation.

Accrued income

Accrued income has increased by 40.4%. This is a significant increase, and the auditors should confirm whether there are justifiable reasons for this increase, or whether it suggests a possible overstatement.

8.3 **Revenue**

Ascertain and test the control procedures around the completeness and accuracy of recording time and expenses in the project costing system.

Compare the revenue recognition policy to similar companies to ascertain its appropriateness.

Ascertain the procedures for ensuring only legitimate expenses are recorded against project codes and are appropriately authorised.

Compare revenue to budget and ascertain the reasons for any material discrepancy.

For a sample of time contracts:

- ascertain the time and expenses recorded in the project costing system and trace to amounts invoiced in the year
- agree time recorded to timesheets or payroll records
- agree expenses to receipts or invoices
- trace any time recorded in the project costing system which has not yet been billed at the year end to the accrued revenue balance
- inspect the signed contract with Spirit's client.

For a sample of fixed-price contracts:

- ascertain from management the basis for estimating the stage of completion of the contract and consider its appropriateness
- inspect the signed contract with Spirit's client for the total contract value and the timing of amounts to be invoiced
- recalculate revenue for the contract with respect to the stage of completion and the total contract value
- agree the amounts actually invoiced at the year end to the contract terms
- compare the revenue earned with the amounts invoiced by the year end and trace any difference to the accrued income balance.

Ascertain from management the basis of the income per consultant calculations and recalculate.

Ask management, and corroborate reasons, why the income per consultant has fallen compared to prior year.

Select a sample of invoices prepared in a foreign currency and check the exchange rate applied to a reliable external source and reperform the calculation and trace to the accounting records.

Trade receivables and allowance for receivables

Ascertain from management the basis of estimating the allowance for receivables and assess its reasonableness, specifically enquiring as to the reasons for the relative decline in the allowance.

Reperform the calculation of the allowance for receivables and trace the movement in the allowance to the statement of profit or loss.

Inspect post year-end bank statements for cash receipts and trace to balances in receivables for evidence of recoverability.

For a sample of receivables at the year end perform direct confirmation of balances.

Obtain a copy of Spirit's aged receivables analysis and ascertain reasons for any balances significantly overdue.

Review correspondence with Spirit's customers and board minutes for indications of any disputes and irrecoverable receivables.

Accrued income

Ascertain from management reasons for the increase in accrued revenue and apparent slower billing.

Review sales invoices issued post year end to ascertain if this revenue is billed soon after year end.

General

Ascertain from management the results of the parallel run of the old and new project costing systems and discuss any problems with the new system or changeover with management.

Obtain client documentation prepared during the parallel run of the systems to ascertain the appropriateness of the conclusion that the new system is operating correctly.

Select a sample of transactions and balances recorded in both systems during the parallel run and compare them to ascertain whether the new system is performing as expected.

Agree opening balances to prior year financial statements/previous auditor's working papers.

8.4 **Business relationship**

The business relationship between the audit firm's tax department and Spirit gives rise to a perceived loss of independence. A self-interest threat may exist, as the tax department may be less willing to criticise the figures it is involved in auditing whilst Spirit is still providing services to it.

The FRC's Revised Ethical Standard 2016 Part B section 2 *Financial, Business, Employment and Personal Relationships* prohibits such relationships except where they involve the purchase of services in the ordinary course of business, are on an arm's length basis and are not material to either party (para 2.29). In the case of Spirit, the nature of the services provided by Spirit are in the ordinary course of business and there is nothing to suggest they are not on an arm's length basis, however, the services could potentially be material to one or both parties.

Personal relationship

An immediate personal relationship exists between the planned tax team manager, Charles Tomm and a director at Spirit, as they are husband and wife. This could give rise to self-interest threat and a familiarity threat. Charles Tomm's objectivity is likely to be impaired and he is less likely to be critical of the tax figures or may not scrutinise the tax figures sufficiently.

Charles may be in a position to exercise influence over the outcome of the audit and Charles Tomm's wife would, as a director, be in a position to influence the financial statements. In these circumstances, Revised Ethical Standard 2016 Part B section 2 requires that Charles Tomm should not act as tax manager on the audit (para 2.59).

Addressing the ethical issues

The engagement partner should report the issues to the ethics partner, in particular, to determine if the provision of services is material to either party. He should also report the issue to those charged with governance at Spirit.

If the services are determined to be material, the firm should either terminate the agreement with Spirit for the provision of services or withdraw from the audit engagement.

The engagement partner should use a different tax manager to manage this part of the audit work and Charles Tomm should not be involved in any audit work for Spirit.

The tax team should not include anyone already involved with Spirit as part of its provision of services around the marketing strategy for the tax department.

An independent partner not involved in the audit engagement should review whether the tax audit work has been properly and effectively conducted. Where the threat is considered too great, the firm should use external experts for the tax audit work.

9 Hoop plc

Scenario

The company in this scenario, Hoop, operates in the food packaging industry. The candidate works for RN, the auditors of Hoop. In this role the candidate has replaced the previous audit senior who had left several unresolved financial reporting and audit issues.

These issues relate to: recognition of pension costs in profit or loss; a change in accounting policy for inventory from FIFO to weighted average cost; and cut off issues relating to revenue and cost of sales for a partially completed contract with a payment in advance.

There is an additional issue that the previous audit senior believes that Hoop might be trying to understate profit in a good year.

Candidates are required to:

- set out and explain the appropriate financial reporting treatment
- outline the key audit risks and the detailed audit procedures
- determine whether there is any evidence of profit manipulation.

Marking guide

Requirements	Marks	Skills assessed
Set out and explain the appropriate financial reporting treatment.	13	**Pension obligation** • Apply technical knowledge of IAS 19 to the data provided to determine the appropriate accounting treatment • Explain the accounting treatment selected • Compare correct treatment to original treatment and reverse previous entries **Change of accounting policy – inventories** • Apply technical knowledge of IAS 2 and IAS 8 to the data provided to determine the appropriate accounting treatment. • Explain the accounting treatment selected • Compare correct treatment to original treatment and reverse previous entries **Revenue recognition** • Apply technical knowledge of IAS 18 and cut-off procedures to the data provided to determine the appropriate accounting treatment • Explain the accounting treatment selected • Compare correct treatment to original treatment and reverse previous entries
Outline the key audit risks and the detailed audit procedures.	6	• Assimilate information to identify key audit risks • Use judgement to select audit procedures which most appropriately respond to each of the key risks identified • Clearly explain the nature and purpose of each audit procedure selected
Determine whether there is any evidence of profit manipulation	4	• Clearly identify the individual and cumulative impact of each of the adjustments to the draft profit • Draw clear conclusions whether the adjustments provide evidence of manipulation by the Hoop board to understate profit.
Available marks	23	
Maximum marks	23	

Hoop

Issue (1) – Pension obligation

Financial reporting

Present value of defined benefit obligation:

	£'000
1 July 20X3	20,500
Past service cost	800
Current service cost	2,100
Benefits	(1,500)
Interest cost ((20,500 + 800 + (2,100 × 6/12) – (1,500 × 6/12)) × 4%)	864
	22,764
Remeasurement **gain** (balancing figure)	(64)
30 June 20X4	22,700

The remeasurement gain (net of any remeasurement gain/loss on assets) is recognised through other comprehensive income.

Audit risks and procedures

Present value of defined benefit obligation

It is necessary to assess whether we can rely on the work of the actuaries. In this case as the actuary is an auditor's expert, rather than a management expert, a high degree of reliance can be placed on the independence and competence of the actuarial assumptions based on RN's quality control procedures in appointing the actuary.

Nevertheless, in respect of the actuary's work in assessing the present value of the defined benefit obligation, the auditor should have a clear understanding of:

- the source data used
- the assumptions and methods used
- the results of actuaries' work in the light of RN's knowledge of the business and results of other audit procedures.

Current service costs

- Discuss with directors and actuaries the factors affecting current service cost and review service costs against salaries (for example, as the scheme is closed to new employees, for employees in the scheme the current service costs may see an increase year on year as a percentage of pay with the average age of the workforce increasing)
- Agree terms of service costs to the pension agreement between employees and the pension fund
- Verify an appropriate method has been used (eg projected unit credit method)
- Review discount rate used by comparison to market yield on high quality fixed-rate corporate bonds

Past service costs

A plan amendment arises when an entity either introduces a defined benefits plan or changes the benefits payable under an existing plan. As a result, Hoop has taken on additional obligations that it has not hitherto provided for. This will create a new defined benefit obligation.

- Discuss with directors the reasons for the change
- Agree the amendments to the terms of the scheme to the revised pension plan agreement documentation
- Ensure that all costs to Hoop arising from past service costs are recognised immediately in profit or loss
- Discuss with directors and actuaries the factors affecting past service costs (future benefits, timing of benefits, discount rate used)

Interest cost

- Confirm that net interest cost has been based on the discount rate determined by reference to market yields on high quality fixed-rate corporate bonds.

Benefits paid

Gary said he has 'verified the cash contributions and the benefits paid to supporting documentation'. As a minimum this should have included:

- agree cash payments to cashbook and bank statements
- agree appropriate amounts have been paid using a sample of employees
- carry out analytical procedures to evidence the total benefits paid (number of retired employees, increase in pensions per scheme agreement, number of deaths in year)
- ensure payments were paid promptly.

Note:

Pension contributions paid to the scheme are not the same as the increase in obligations in the year and the entries made by Hoop should be reversed.

Issue (2) – Change in accounting policy – inventories

Financial reporting

	Profit
	£000
Inventory valuation (change in policy) Adjustment to opening inventories (782 – 785)	3
Adjustment to closing inventories (786 – 795)	(9)

Therefore the net effect is to reduce profit by £6,000.

Audit risks and procedures

The difference in measurement is small and well below the materiality level. Nevertheless, enquiries should be made of Hoop management as to why they have changed the inventory identification basis for such a small financial difference. In particular because the implementation of weighted average cost is more difficult to administer than FIFO.

IAS 8 only permits a change in accounting policy (other than due to an IFRS change) if it results in the financial statements providing reliable and more relevant information. In the case of packaged foods that are perishable this seems unlikely, with physical movement more properly reflecting a FIFO basis.

Audit procedures:

- review recent purchases and changes in invoice prices (Attest to original invoices)
- examine procedures for maintaining a moving average of costs as inventory levels change (continuous inventory records may be in place)
- review inventory count records and attest the means of identifying the age and movement of inventories.

Issue (3) – Revenue recognition

Financial reporting

The Illustrative Guidance to IAS 18 states that revenue from sales is normally recognised when the goods are delivered, even where cash is paid in advance.

An exception to this general rule is buy and hold where the goods accepted by the buyer are on hand, identified and ready for delivery to the buyer. This does not appear to be the case for Hoop as only a deposit has been received in respect of the goods retained in inventory.

Consequently revenue and profit can only be recognised on goods that have been delivered. Therefore:

- Total value of order (£90,000/0.2) = £450,000
- Revenue to be recognised: (£450,000 × 70%) = £315,000
- The £90,000 should initially have been recognised as a payment on account liability rather than revenue.
- The remaining payment on account at the year-end is: £90,000 × 30% = £27,000

- Inventories are: (£200,000 × 30%) = £60,000

The correcting journal is:

DEBIT Sales	£90,000	
CREDIT Cash		£90,000

Reversing original entry

The remaining journals are therefore:

DEBIT Inventories	£60,000	
CREDIT Cost of sales		£60,000

Cost of production included in inventory

DEBIT Cash	£90,000	
CREDIT Payment on account		£90,000

Receipt of deposit from DistribFoods

DEBIT Receivables	£315,000	
CREDIT Sales		£315,000

Goods delivered pre year end

DEBIT Payment on account	£63,000	
CREDIT Receivables		£63,000

Transfer from payment on account to receivables for goods delivered.

Audit risks and procedures

Hoop has taken credit for only £90,000 of revenue which is on a cash received basis and is incorrect.

Audit procedures

- From the year-end inventory count, trace the goods in respect of this order to ascertain whether the correct figure of £60,000 has been included at the year end
- Trace the delivery on 14 June 20X4 to supporting documentation (delivery note, invoice and subsequent cash received) checking dates and physical movements
- Attest receipt of cash on 19 May 20X4 to cash book and bank statement
- Verify details against initial contract
- Circularise receivable for balance outstanding
- Post year end check to see if remaining element of contract delivered and balance settled before audit clearance.

Assessment of profit understatement risk

Pension obligation

Hoop has recognised the contributions it has paid of £1 million as its pension expense.

The correct expense would include:

	£'000
Past service cost	800
Current service cost	2,100
Interest cost	864
Expected return on plan assets*	(776)
	2,988

* £19.4m × 4% (this uses opening/closing assets as an approximation for average assets)

Overall therefore there is no evidence of Hoop seeking to understate profits based on the pension obligation as the charge to profit or loss made of £1m was significantly lower than the correct charge of £2.988m.

Inventory – change of accounting policy

As noted above, the change in policy decreases profit by £6,000 but this figure is immaterial (eg by comparison to the pensions adjustment or the materiality level) and therefore reducing profit seems a poor motivation for the change in policy.

Revenue recognition

Revenue of £90,000 has been recognised rather than the correct revenue of £315,000. There is some evidence of Hoop seeking to understate profits based on the revenue recognition as revenue is understated by £225,000 (£315,000 – £90,000).

In addition, inventories have been incorrectly accounted for as all contract costs have been recognised in the year ended 30 June 20X4, rather than apportioned between cost of sales and inventories. There should be recognised in inventories an additional £60,000 (30% × £200,000) and cost of sales reduced by the same amount. This has the effect of increasing profit for the year ended 30 June 20X4 by a further £60,000.

The total adjustment for profit should therefore be an increase of:

	£
Additional revenue	225,000
Reduced cost of sales	60,000
Increased profit	285,000

Conclusion

There is mixed support for the notion that Hoop is seeking to understate profit based on the three transactions highlighted by Gary. One adjustment required increases the reported profit. Two of the three adjustments decrease profit and the dominant effect is the pension adjustment so, in value terms, there is a net decrease in profit from the adjustments. There is therefore little conclusive evidence based on these three adjustments, to support the notion that the client is trying to understate profit.

Overall effect on profit:

	£'000
Profit before tax	8,000
Adjustments:	
Pension	(1,988)
Inventory	(6)
DistribFoods	285
	6,291

Note:

As a consequence of the adjustments the level of planning materiality should be reviewed.

10 Plumbdown Properties Ltd

Scenario

The scenario in this question is an investment property company (PP) where the owners are trying to sell the business and are conscious that reported asset values are likely to be a key determinant of future selling price. PP has elected to measure the properties at fair value in accordance with IAS 40, so the audit of fair values is an underlying issue throughout the question. The candidate is an audit senior working on the audit of PP with specific responsibility for dealing with a number of outstanding auditing and financial reporting issues which have been highlighted by the audit junior; reviewing the management accounts for additional audit issues; and preparing a schedule of investment properties, including determining carrying amounts.

The issues highlighted by the audit junior comprise: the impact of the failure and replacement of an air conditioning unit on the fair value of the Manchester property; the acquisition under an operating lease of a Birmingham property; and the transfer to the bank of an Inverness property and assumption of a new loan, in return for the bank extinguishing the existing loan on the property.

In the first requirement, candidates are required, for each of the above three issues raised by the audit junior, firstly, to set out and explain the appropriate treatment in the financial statements; and secondly, to explain the related audit procedures.

In the second requirement they are asked to prepare a schedule of investment properties.

Marking guide

Requirements	Marks	Skills assessed
For each of the issues identified in Exhibit 2: – Set out and explain the correct treatment in the financial statements for the year ended 30 September 20X3; and – Highlight the audit procedures we should carry out. I do not require a general list of audit procedures for investment properties, so please just focus on the issues raised by the audit junior.	19	• Explain the alternative accounting treatments for investment properties held under operating leases • Recommend the use of PVMLP for the Birmingham retail park to maximise asset values taking into consideration shareholders' wishes to maximise asset values • Identify and explain the impact on net assets of the choice of accounting policy • Determine appropriate audit tests relevant to the recommended financial reporting treatment
Produce a schedule showing all PP's investment properties and the total amount which should be recognised as investment properties in PP's statement of financial position at 30 September 20X3	6	• Assimilate and present information in a suitable format for the engagement manager
Available marks	25	
Maximum marks	23	

Explanation of the correct financial reporting treatment of the issues and audit procedures in Exhibit 2.

Manchester Office Block

1 **Financial reporting issues**

The gain or loss on de-recognition of an item of investment property is the difference between the net disposal proceeds (which are zero in this case), and the carrying amount of the item. The gain or loss is included in profit or loss.

Air conditioning carrying amount at disposal	=	(6.25/10) × £500,000
	=	£312,500
Loss on disposal with zero proceeds	=	£312,500

Disclosure note investment properties:

	£
Fair value at 1 October 20X2	28,500,000
Addition	800,000
Disposal	(312,500)
Fair value movement (residual)	(1,700,000)
Fair value at 30 September 20X3 (W1)	£27,287,500

(W1) Fair value at 30 September 20X3

26,800,000 – 312,500 + 800,000 = £27,287,500

2 **Audit procedures**

Regarding the valuations that have taken place in the year:

- Obtain the valuation report and ascertain whether it is external or internal. Verify the date of valuation; basis used (eg open market), assumptions made (eg full occupancy).
- The qualifications, experience and objectivity of the valuer(s) (internal or external). Perhaps consider using an auditor's expert to review assumptions and the basis of valuation.
- Examine the data provided to the valuers to assess the extent they have relied on information from the company (eg floor space). Make sure, as a minimum, that these are consistent with prior year information.
- Review previous information for consistency (eg financial statements from previous years).
- Ascertain how the air conditioning unit has been valued within the overall property valuation in order to ensure that an appropriate amount is being recognised on a fair value basis.

IAS 40 now uses the IFRS 13 definition of fair value, so far value is the price that would be received to sell an investment property in an orderly transaction between market participants at the measurement date. Ensure valued on this basis.

Regarding the disposal of the old air conditioning unit:

- Enquire the reason for the failure from engineers who installed and/or removed it in order to gather evidence regarding the useful life of the new unit and make any assessment for impairment of the new unit in future.
- Review original purchase agreement to ascertain whether there is any warranty or insurance cover in respect of the failure. Enquire of directors and examine any other insurance documentation.
- Ascertain what has happen to the old unit. Enquire of engineers whether it had any value in order to ascertain whether disposal proceeds at zero have been understated. Check whether scrapped. Check with new contract whether engineers installing new equipment had rights over ownership/disposal of old equipment.
- Inspect minutes of meetings (board meeting; facilities department meetings).

Regarding the acquisition of the new air conditioning unit:

- Verify the cost of £800,000 to contract agreement and ensure it represents fair value for inclusion in overall valuation of investment property (potentially use valuers as auditor's expert if there is significant doubt).

- Ensure contract and installation completed by year end (inspect contract date; enquire of PP staff).
- Ensure unit is functional (physically inspect; enquire if post year end warranty claims repairs).
- Consider useful life in light of failure of old unit.
- Check cut off as installation was so close to year end (eg when was the work signed off as complete?) and it was not recognised in the management accounts.

Birmingham Retail Park

1 **Financial reporting issues**

IAS 40 para 25 permits (but does not require) investment properties held under operating leases to be classified as investment properties and measured as for finance leases (ie at the lower of the fair value of the interest in the property and the present value of the minimum lease payments (PVMLP)) if they meet all other conditions of being classified as investment properties.

As a consequence, PP is not permitted simply to use the fair value of the property as it has in its management accounts as the present value of the minimum lease payments is lower than the fair value. Instead, it may either not recognise the property at all in the statement of financial position; or recognise it at the PVMLP. The schedule that I have prepared (see below) has shown the property at PVMLP as the shareholders wish to maximise the amount at which assets are recognised. It should be noted however that the obligation under the lease would also need to be recognised as a liability (initially at the PVMLP). Thus although total assets would increase, net assets would not necessarily be enhanced.

The Birmingham Retail Park investment property should therefore be recognised initially, on 30 June 20X3, at its PVMLP of £13.4 million. In the statement of financial position at 30 September 20X3 the carrying amount should be revised downwards by £0.6 million to £12.8 million, which is the PVMLP at that date.

2 **Audit procedures**

Given there is choice of accounting policy available under IAS 40, enquire of management whether they wish to recognise the operating lease at PVMLP or at zero. Assuming that they wish to recognise at PVMLP then the following audit procedures are applicable:

- Obtain a copy of the lease contract with SpaceLand and review the terms of the lease to:
  - Establish rights and obligations of PP under the lease including the contractual cash flows incorporated in the PVMLP calculation and the rights/obligations over the property on termination of the lease.
  - Review for a break clause in lease.
  - Verify that it is an operating lease to ensure PP management has a choice of treatment. (As if it is a finance lease then it must be capitalised at the lower of fair value and the PVMLP)
  - The PVMLP calculation is more uncertain for an operating lease than for a finance lease as a greater proportion of the PV is dependent on the uncertain terminal value of the property, rather than fixed contractual rental payments.
  - Review the discount rate used in the PVMLP calculation to ensure it is an appropriate interest rate ie the rate implicit in the lease or otherwise the cost of borrowing (note the interest rate implicit in the lease is heavily dependent on the terminal value of the property which as noted already is uncertain).
- Review terms of PP's leases to ensure that none of the leases is a finance lease which would exclude classification as an investment property.
- Use valuer to evidence the fair values of the properties to ensure that they are higher than the PVMLP. Capitalisation is at the lower of fair value and PVMLP.

Disposal of Shopping Arcade in Inverness

1 **Financial reporting issues**

The principle with this transaction is the de-recognition of a financial liability in accordance with IAS 39.

IAS 39, para 39, requires that a financial liability shall be extinguished from the statement of financial position when the obligation in the contract is discharged or cancelled or expires. In this case, the bank has agreed to extinguish the liability in return for PP transferring the Inverness shopping arcade to the bank and assuming a new liability.

As the new loan has substantially different terms from the old loan, the old loan should be extinguished and the new loan recognised as a separate liability (per IAS 39, para 40).

The difference between the carrying amount of the financial liability extinguished and the consideration paid is recognised in profit or loss (IAS 39, para 41).

The new loan should be recognised at fair value to determine the net consideration for extinguishing the old loan. This is:

£1m/$(1.05)^2$ = £907,029

The profit on extinguishment of the loan; the assumption of the new loan; and the de-recognition of the property is therefore:

	£	£
Loan extinguished		15,900,000
Property transferred at fair value	14,800,000	
Liability assumed	907,029	
Net consideration		(15,707,029)
Profit recognised		192,971

In the statement of financial position at 30 September 20X3 the original loan is derecognised; the investment property is derecognised and the new loan is recognised at its fair value.

The original loan would have been recognised at amortised cost. Accrued interest and any impairment would need to be recognised on the loan prior to the consideration of the de-recognition transaction.

2 **Audit procedures**

The contract with the bank should be obtained and inspected. The terms of the agreement as stated should be verified to the contract.

The carrying amount of the existing loan should be agreed to the accounting records in accordance with the existing accounting policy.

The market interest rate of 5% needs to be agreed to similar loans in financial markets in order to substantiate the fair value of the new loan.

Verify that the new loan has been recognised in the financial statements at fair value.

Verify that the old loan and the investment property have been derecognised.

Schedule of PP's investment properties at 30 September 20X3

Property	**Fair value at 30/9/20X3** £'000
Manchester office building	27,287.5
Birmingham retail park	12,800
Inverness shopping arcade	–
Land in Wales – undeveloped (note 1)	3,300
Industrial development – Yorkshire (note 2)	–
Total	43,387.5

Thus the statement of financial position at 30 September 20X3 should show £43,387,500 as the total for investment properties.

Note 1: **Land in Wales**

If a use has not been determined, then IAS 40 permits the land to be treated as an investment property (IAS 40 para 8(b)).

However, more evidence is needed that there has not been a change in use.

Note 2: **Industrial development – Yorkshire**

There has been a change in intended use of this property hence, in accordance with IAS 40 para 9(a), it is no longer an investment property but should be transferred to inventories under IAS 2. In this case it should be measured at the lower of cost and net realisable value rather than at fair value.

11 Stoghopper plc

Scenario

The scenario in this question is a UK-based machine tools manufacturer with the £ as its functional currency. The company expanded at the beginning of the current accounting period by opening a manufacturing division in Thailand in order to serve customers based in East Asia. The candidate is working on the audit of Stoghopper and a colleague has raised a number of audit issues with respect to the Thai operation as follows:

- Translation of multi-currency bank account balances where normal control procedures have not operated to convert a yuan receipt from a Chinese customer into the Thai currency (the baht) prior to the year end.
- An interest free loan to a supplier has been made in the year.
- There has been an impairment indicator with respect to the new production facility in Thailand following a patent by a competitor of a more efficient production process.

Candidates are required for each of the above three issues: first to set out and explain the appropriate financial reporting treatment; second to describe audit risks and related audit procedures.

Marking guide

Requirements	Marks	Skills assessed
• Set out and explain the appropriate financial reporting treatment in the financial statements of Stoghopper for the year ended 30 June 20X3.	12	• Apply technical knowledge to translate multi-currency cash balances using the correct functional currency. • Determine fair value of loan by applying discounting then translate as a monetary liability. • Use judgment to apply a sceptical approach to the validity of the calculations of the FD and then reassess the impairment using the closing exchange rate to determine recoverable amount.
• Prepare notes describing the audit risks and related audit procedures.	11	• Assimilate information to attribute appropriate audit procedures to each audit risk. • Identify both issues of control and substantive audit procedures. • Identify a range of risks relating to loan eg control risk, market risk and credit risk. • Assess the risks relating to a range of estimates needed to determine recoverable amount.
Available marks	23	
Maximum marks	23	

Issue 1 – bank accounts

1.1 **Financial reporting treatment**

Sale transaction to Chinese customer

The sale should be recorded at the exchange rate at date of transaction. A receivable would be recorded at the same time. As the transaction has not been entered in the cash book the receivable will still be outstanding at the year end and will therefore be overstated at the year end.

Cash balances

The balance on the Number 1 account of 440m baht is a monetary asset and needs to be translated into Stoghopper's functional currency of sterling at the year-end exchange rate on 30 June 20X3 of £1 = 55 baht. (With most sales and costs in the UK it is clear that the Stoghopper functional currency is sterling.)

Similarly the other bank account with a balance of 2 million yuan needs to be translated to sterling at the year end. Ideally, this should be translated directly to sterling from yuan at the £1/yuan year end exchange rate. However assuming currency markets are efficient then this can be translated first into baht and then sterling using the information provided. Thus

2 million yuan × 5.1	= 10,200,000 baht
Total baht bank balances (10.2m + 440m)	= 450.2m baht

Sterling equivalent

Number 1 account (450.2m baht/55)	= £8,185,455

This figure will be shown in the statement of financial position of Stoghopper at 30 June 20X3.

Exchange gain

On receipt, the value of the yuan in sterling is 2 million yuan × 5/54.5	= £183,486
At 30 June 20X3 value of yuan in sterling is 2 million yuan × 5.1/55	= £185,455
Exchange gain	£1,969

Tutorial note

Any movement on the £/baht exchange rate from that previously reported would give rise to an exchange difference on the cash balance as a monetary asset. However insufficient information is provided to calculate this.

1.2 **Audit risks and procedures**

Audit risk	Audit procedures
Bank account balances are not being properly controlled giving rise to unauthorised exchange rate differences	Review instructions to banks to transfer funds and treasury policies to find out why the yuan balance was not transferred immediately on receipt.
If cash is not controlled then there is a risk of misappropriation	Investigate who has control to authorise receipts and payments from each bank account (central control from UK?).
Unidentified bank balances	Obtain full disclosure of all bank accounts from managers (trace transactions between accounts as corroborative evidence). Obtain bank confirmations from all bank accounts including nil balances as a test for under and over statement.
Timing differences between bank and cash book	Perform bank reconciliation (or review client's reconciliation). Review all differences between bank and cash and trace to source documentation to verify validity and timing.
Window dressing between bank accounts	Examine significant transactions post year end.

Issue 2 – Loan to supplier

2.1 **Financial reporting treatment**

IAS 39 para 43 requires a financial asset to be measured initially at fair value. A zero interest rate is not a fair value, but the fair value can be determined by using a market yield to discount to a present value.

The initial fair value of the loan when issued on 1 July 20X2 is therefore:

400m baht/$(1.06)^2$ = 356m baht

In terms of £ sterling this would be translated at this date as:

356m baht/50 = £7.12m

Treating the loan as held to maturity then, using the amortised cost method, the loan at the financial year end of 30 June 20X3 is:

356m baht × 1.06 = 377.36m baht

This is a monetary asset and would be translated at the year-end rate of 55 baht = £1. In the financial statements of Stoghopper it would therefore be translated as:

377.36m baht/55 = £6.86m

There are two elements to these transactions for financial reporting purposes: interest income on the loan; and exchange loss.

The interest income is recognised at the effective rate even though there is no cash received. As it accrues over the year, it is translated at the average exchange rate. The interest income in baht is therefore:

356m baht × 6% = 21.36m baht

Translated into £ this is:

21.36m baht /52.5 = £406,857

The exchange loss has two elements:

- on the interest
- on the loan

The exchange loss on the interest is:

21.36m/52.5 – 21.36m/55 = £18,494

The exchange loss on the loan is:

356m/50 – 356m/55 = £647,273

Reconciliation:

	£
Interest income	406,857
Exchange loss	
On interest	(18,494)
On loan	(647,273)
	(258,910)

This reconciles with the opening balance divided by the opening exchange rate less the closing balance divided by the closing exchange rate as above. (£7.12m – £6.86m) = £0.26 million.

2.2 **Audit risks and procedures**

Audit risk	Audit procedures
The supplier may not be able to repay the loan and the loan should then be written down as impaired. This is a particular risk as there are no cash interest payments to observe that these can at least be serviced.	Check procedures used to verify the creditworthiness of the supplier when the loan was originally extended. Verify the terms of the loan and the security available from Rangoon if the loan is not repaid. Enquire whether there is a charge over assets as security for the loan. Examine correspondence (legal correspondence, board minutes, as well as letters/emails/memos with Rangoon) for any possibility of early repayment. Consider audit visit to Thailand or instructing local auditors.
The market rate of interest of 6% may not be a risk equivalent in which case the validity 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 held to maturity may be inappropriate.	Confirm terms of the loan agreement. Examine correspondence for any possibility of early repayment.
Control risk in authorising a large loan on favourable terms in a country where there has been no previous experience from physical presence.	Review level of authorisation of loan (main board). Review treasury procedures to attest information on creditworthiness, legal advice and means of drawing up loan agreement. Consider link between loan terms and contractual supply agreement with Rangoon. Eg, deep discounting of purchase cost of goods as part of loan agreement.
Check appropriateness of exchange rates.	Verify exchange rates and estimate average exchange rates. Check date on which loan was extended.

Issue 3 – impairment of production facility

3.1 Financial reporting treatment

	Baht
Cost	600m
Depreciation	100m
Carrying amount at 30 June 20X3	500m

Expressed in baht the asset is not impaired as the recoverable amount is the value in use of 520m baht (which is greater than the fair value less costs to sell).

However for the purpose of testing for impairment the carrying amount should be measured at the normal historic exchange rate, but the recoverable amount should be determined at the closing exchange rate.

Thus the carrying amount in £s is 500m baht/50 = £10m
The recoverable amount in £s is 520m baht/55 = £9,454,545
There is therefore an impairment charge of £545,455 on this basis.

3.2 Audit risks and procedures

Audit risk	Audit procedures
Inappropriate asset life and therefore inappropriate depreciation	Review the basis on which the useful life was determined. It may seem that 6 years is a short useful life for a new production facility. If output is to be reduced (ie reduced sales due to the competitor's development) the useful life may be extended.
Impairment indicator is valid	Investigate nature of competitor's development to ensure this is a valid impairment indicator
Impairment review has been properly carried out re value in use - some subjectivity required	Has a reliable estimate been made? How have future cash flows been determined? (Eg, past sales, exchange rates used, budgeted costs). Has an appropriate interest rate been used to discount net cash inflows? Has an appropriate cash generating unit been identified? Re-perform calculation, testing sensitivity to assumptions.
Residual value may be non-zero	Enquire why zero residual. Has any residual been built into value in use calculation?
Impairment review has been properly carried out re fair value less costs to sell	If the FV less costs to sell is less than the value in use then it is irrelevant in determining the recoverable amount. In this respect the risk is low unless the value in use has been substantially overstated; or the FV less costs to sell has been substantially understated by management.
Impact of the rival company's development has been significantly underestimated	Examine available evidence about rival company (eg, patent office records; industry intelligence; Stoghopper's own records and calculations). Estimate whether new production will be brought into use by rival within the next 6 years of the Stoghopper asset life.