MARK PLAN AND EXAMINER'S COMMENTARY – Advanced Level: CR July 2015

Question 1

The candidate is an audit senior working on the audit planning for a group audit. He / she receives details of a number of transactions and is required to determine the appropriate financial reporting treatment of these transactions and also their implications for the group audit.

To answer this question, a good understanding of accounting for acquisitions and disposals (including step acquisitions and part disposals) was essential. The scenario required the candidate to link information concerning the group transactions from different sources and to assimilate the information to determine the correct financial reporting treatment. The candidate was then required to summarise adjustments against the consolidated profit before taxation.

The audit element required the candidate to set out the additional audit procedures not only procedures for the individual transactions but also at group level to assess the impact on the group audit scoping.

Available Marks

Requirement	Marks	Skills
(1) Draft a response to Jazz's email (Exhibit 2) and its attachment (Exhibit 3). In your response you should: a) Set out and explain, for each of the transactions she identifies, the correct financial reporting treatment in Congloma's consolidated financial statements for the year ending 31 August 2015. Recommend and include appropriate adjustments and calculations; and.	20	• Identify that the implications of control threshold not being crossed in respect of the acquisition of Oldone shares. • Apply technical knowledge to determine the split of equity and liability in respect of the bond. • Apply IFRS 10 to determine whether control exists in respect of the Neida investment. • Explain the implication of unidentified intangibles in Neida on consolidation. • Describe the impact on the control threshold arising from the sale of Tabtop and the implications for the consolidation. • Determine the allocation of goodwill between parent and NCI in respect of the Shinwork disposal. • Identify potential omissions regarding fair values and other costs and provisions in respect of the Shinwork disposal
b) Calculate the consolidated profit before taxation for the year ending 31 August 2015, taking into account the adjustments you have identified.	5	• Assimilate information on adjustments and prepare a revised profit before taxation.
(2) Set out in a working paper the additional audit procedures that we will need to perform as a result of the transactions Jazz has identified. Include an explanation of the impact that the transactions will have on the scope of our audit procedures and the components that we consider to be significant.	15	• Determine relevant audit procedures to the transactions identified. • Identify the potential to manipulate profits in arising from the sale of the Oldone CEO's shares – link relevant procedures to this risk. • Apply concept of materiality to determine that Neida is potentially not material to the group and therefore that subsidiary level procedures may not be required. • Link the changes in group structure to the assessment of work required

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		on the identification of significant components and hence the level of audit procedures required at associates and subsidiaries.
Maximum Marks	**40**	

(i) Financial reporting treatment of the matters raised in the finance director's email

Oldone

As Oldone has been recognised as a subsidiary for some time, the acquisition of a further 20% does not "cross an accounting boundary" nor result in any change in control. As a result, no gain or loss will be recorded. The proposed fair valuation exercise is therefore not required.

The accounting entries required in the consolidated financial statements will be as follows:

DR: Non-controlling interest	£2.8 million
DR: Shareholders equity (balancing figure)	£1.2 million
CR: Cash (or elimination of investment in holding company)	£4.0million

Convertible bond issue

The bond issue should be accounted for as a compound financial instrument with a liability element and an equity element.

The liability element of the gross proceeds is calculated as the net present value of the maximum cash flows at the rate of interest for a similar bond without conversions rights, 8%:

Year	Cash flow £'000	Discount factor 8%	PV £'000
1	500	0.926	463
2	500	0.857	429
3	10,500	0.794	8,337
			9,229

Hence of the £10 million gross proceeds, £9.229 million should be shown as a liability payable (on issue). The split between the short and long term elements will need to be redetermined at the year end of 31 August. The remaining balance of £771,000 should be shown as equity. The effect on profit before taxation will be charge of 3 months interest on the bond. This will be £9,229 @ 8% x 3/12 = £185,000.

Neida

IFRS 10 paragraph 12 states that 'An investor with the current ability to direct the relevant activities has power, even if its rights have yet to be exercised'. IFRS 10 paragraph B47 also requires an investor to consider potential voting rights in considering whether it has control and (paragraph B22) whether they are substantive, i.e. whether the holder has the practical ability to exercise the right.

Although Congloma does not have the majority of the voting rights in Neida and there are other powerful investors, two factors in accordance with IFRS10 suggest that Congloma may still have control and should therefore account for Neida as a subsidiary rather than as an associate.

(i) It has the power to affect its returns from Neida through its control of Board decisions over research and development, arguably the most important decisions in a research driven entity such as Neida.

(ii) It has the right to acquire further shares through its call option. The exercise of this option will give it a majority holding of 65%. In this case the rights to acquire further shares appear to be substantive as Congloma's additional 20% holding will cost it £1.5 million compared to the £3.0 million it paid for its initial 45% shareholding. While this is a higher amount per share it is not substantially higher and can reasonably be expected to be a competitive price for a stake which takes it to a majority holding in the company.

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The FD's proposal to account for Neida as an associate is therefore incorrect.

Accounting for Neida as a subsidiary means that 100% of its results, assets and liabilities will be consolidated within the group financial statement and the 55% share not owned by the group will be accounted for as a non-controlling interest.

The acquisition will have a significant impact on the group statement of cash flows with the investment shown within investing activities.

Using the share of net assets method to determine goodwill on acquisition and the net asset information provided will give a goodwill figure of £3 million + (55% of £200,000) - £200,000 = £2.91 million which will be included as an intangible asset in the group financial statements and will need to be subjected to a review for impairment.

However further consideration needs to be given to whether some / most of this value should be attributed to intangible assets which are not shown at present on Neida's statement of financial position. In particular, there may well be value in the research and development project for Lastlo which appears to have reached the commercial exploitation stage.

The Lastlo project should be valued as a separable intangible on acquisition (and subsequently within the consolidated financial statements) if it could be sold separately from Neida and has a stand-alone value. Treatment as a separable intangible will also affect group accounts in future years as intangibles other than goodwill are amortised through the statement of consolidated profit or loss.

In addition to the Lastlo project there may be other separable intangibles in the form of intellectual property rights or contractual rights such as patents.

As Neida is accounted for as a subsidiary, its loss for the 3 months ending 31 August 2015 will be included in group profit before taxation (although 55% of it will then be attributed to the non-controlling shareholders) – therefore adjustment required of £300,000 x 3/12 = £75,000.

Consideration also needs to be given to whether the option to acquire a further 20% of Neida has a value which should be recorded within the financial statements.

Given Neida's loss for the year, an impairment review should also be considered.

<u>Sale of Tabtop</u>

As a significant interest in Tabtop is expected to be retained, Tabtop will be an associate following the part disposal. The loss of control triggers the need to re-measure goodwill and the retained interest will therefore be valued not at net asset value but at fair value.

Therefore the FD is correct in his recommendation of the accounting treatment in this instance however the calculation of the gain on disposal is incorrect. There is in fact a small loss, calculated as shown below:

	£ million
Proceeds received	6.0
Fair value of 25% interest retained	1.0
	7.0
Less:	
Net assets of Tabtop	5.6
Goodwill	1.5
	(7.1)
Loss on disposal in group accounts	(0.1)

This loss includes the downward revaluation to fair value of the remaining non-controlling interest, thus explaining why it is different to the calculation performed by Jazz.

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Jazz is correct in her proposal that the remaining interest in Tabtop will be equity accounted for going forward. The full results of Tabtop will be included in the consolidated statement of profit or loss account up to 30 June 2015. From that date onwards just the group's share of Tabtop's loss after tax will be included and this will also be deducted from the carrying value of the investment in Tabtop in the consolidated statement of financial position.

Tabtop will be included as an associate rather than a subsidiary for the last two months of the year. This will mean that rather than a loss of £3m x 2/12 = £500,000, only a loss of 25% of that amount (£125,000) will be included in profit before taxation. Therefore an adjustment of £375,000.

As Tabtop has been making losses it is possible that it will not succeed under its new owners and the remaining investment in the company will need to be reviewed for impairment.

Shinwork

An impairment adjustment will be required if the carrying amount is lower than the higher of the value in use and the fair value less selling costs. The value in use is £9.2 million which is below the carrying amount and therefore an impairment charge should be recorded. The following calculation assumes that it is correct to use the value in use. If the fair value less costs to sell the remaining business were higher than that figure should be substituted in the calculations above giving a lower impairment charge.

The impairment in the overall value of Shinwork needs to be allocated between Congloma and the non-controlling interest. As the non-controlling interest is determined using the proportion of net assets method, there needs to be a notional grossing up of goodwill in order to compare the carrying and recoverable amounts.

The parent company's goodwill of £4 million needs to be notionally adjusted to include the NCI notional goodwill of £1 million (20%/80% x £4 million) giving a total goodwill figure of £5 million.

Hence the impairment can be calculated as:

	£m
Net separable assets	8.0
Goodwill	5.0
	13.0
Value in use	(9.2)
Impairment	3.8

Of the total impairment, 80% is allocated to Congloma giving a goodwill impairment of £3.04 million to be recorded in the financial statements which is allocated first to goodwill.

Other financial reporting issues

- Whether there are other costs which should be provided for? There are likely to be redundancy costs and other costs of closure / disposal which should be provided for at the point at which a detailed plan and announcement have been made (IAS 37). It is not clear from the information given whether this is the case or will be by year end. However both the amount of the required provision and the timing of its recognition need further consideration.

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(ii) Effect on consolidated profit before tax for the year ending 31 August 2015.

	£'000
Projected profit before adjustments	7,000
Oldone – no effect on profit before taxation but will affect the amount of profit attributable to the non-controlling interest as this will be 20% to 31 May and nil thereafter.	0
Bond issue – effect on profit before taxation will be charge of 3 months interest on the bond. This will be £9,229 @ 8% x 3/12	-185
Acquisition of Neida – as Neida is accounted for as a subsidiary, its loss for the 3 months ending 31 August will be included in group profit before taxation (although 55% of it will then be attributed to the non-controlling shareholders) £300,000 x 3/12 = £75,000.	-75
Goodwill is not amortised but there will be a further reduction in profit if there are other intangible assets for which amortisation is charged.	
Tabtop – loss on disposal	-100
In addition, Tabtop will be included as an associate rather than a subsidiary for the last two months of the year. This will mean that rather than a loss of £3m x 2/12 = £500,000, only a loss of 25% of that amount (£125k) will be included in profit before taxation. Therefore an adjustment of £375,000.	375
Shinwork	
Impairment charge	-3,040
Adjusted projected profit before taxation	3,975

(iii) Group audit procedures required on transactions identified

General points on scope of group audit work

The group auditor's ability to obtain sufficient evidence will be affected by significant changes in the group such as those for Congloma. Identification of significant components may change as entities are added to the group or sold off or as the relative materiality of their operations change. The group auditor should be involved in the assessment of risk for all significant components which will require a full audit using component materiality; and audit of specified balances related to significant risks.

If work done at significant components does not provide sufficient audit evidence then some non-significant components will be selected and additional procedures performed at those rather than the analytical reviews performed in the past. Changes in the group may mean that such an approach becomes necessary.

In this case, work at the components is performed by other teams from A&M LLP but the group audit partner will still need to be involved in planning and directing the work of those teams to ensure that sufficient assurance is given at group level.

Oldone

- As Oldone has been a subsidiary for some time, few additional audit procedures are likely to be required.
- However, the sale by the Chief Executive of his shares does increase his incentive to overstate the results of the company in the period to 31 May 2015. There is therefore an enhanced risk of management override of controls and fraud. The subsidiary audit team should be made aware of this and asked to report to the group team on the results of focussed audit procedures on journal entries and judgemental provisions.
- The results as at 31 May 2015 will determine the entry made to reserves and therefore some additional work may be required to look at whether an accurate cut off in revenue and costs was achieved at that date. Any unusual trends in the last 3 months compared to the earlier part of the year should also be thoroughly investigated.

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- The sale and purchase agreement for the shares should be reviewed to identify key terms and ascertain any performance conditions or additional liabilities.

- The entries made to record the new investment and the elimination of the non-controlling interest balance should be reviewed to ensure that they are accurate.

Convertible bonds

- The terms of the convertible loan agreement should be reviewed and agreed to the loan agreement document and ensure that the financial reporting treatment agrees to the terms.
- In particular the sources for the comparable interest rate should be checked as it is this which drives the split of the compound instrument for accounting purposes. A higher or lower rate could make a significant difference.
- The bond is above planning materiality and is a complex transaction and requires scrutiny given the lack of experience of the client's staff.

Neida

- Review purchase agreement and loan agreement to identify key terms and form an independent assessment as to whether Congloma has control over Neida and whether there are other key terms which should be considered in forming that assessment or determining the amounts to be included in the financial statements.

- Assess the date at which control passed and ensure that Neida's results and cash flows have been consolidated from that date. Given the immateriality of Neida's results to the group, detailed audit work at the subsidiary level is unlikely to be required, although consideration should be given to the total level of costs incurred and whether any material amounts should have been capitalised as R&D – this is unlikely in current year as total loss only expected to be £300,000 and this is likely to equate to the costs as no significant revenue expected in start-up phase.

- Ensure that the investment balance held in the holding company has been eliminated on consolidation and that the goodwill shown has been correctly calculated and disclosed. Check that the investment is correctly included in the group cash flow statement as an investing cash flow.

- Obtain details of the fair values attributed to assets and liabilities at the date of acquisition. For each significant item (tangible assets and net current assets are unlikely to be significant based on information provided), consider the basis for the fair value and assess the reliability of any valuations provided by external experts. This is most likely to be relevant for separable intangibles such as R&D.

- Ensure that we have sufficient understanding of Neida's operations and commitments to be able to assess whether the assets and liabilities at the acquisition date are reasonable and complete as it is possible that liabilities may have been missed or that the identification of separable intangible assets is incomplete. Consider the monitoring controls which Congloma exercises over Neida and discuss plans for the company with the Congloma nominated Neida directors.

- Review Neida's business plans and consider whether there is any indication that the goodwill and / or intangibles are impaired. There will inevitably be significant judgement involved in the valuation of a research company and the assessment performed at the time of the acquisition and basis for the offer of £3 million should be relevant in making this assessment. While significant change would not normally be expected in just a few months it is possible that a research breakthrough or developments made by a competitor could have a significant effect on the prospects of Lastlo and Neida and we need to make enquiries as to whether this is the case. A change in key personnel, particularly those developing the project, would also be significant.

Tabtop

- Review sale agreement and ensure in particular that all costs have been recognised and that consideration has been given to any liabilities or contingent liabilities arising from guarantees or warranties given to the purchaser.

- Consider the terms of the agreement with the new majority shareholder and assess whether Jazz is correct in saying that Congloma retains significant interest and should therefore account for Tabtop as an associate.

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- Review the accuracy of the accounting entries made to reflect the disposal.

- Consider the extent of procedures required at Tabtop to provide assurance on the results consolidated for 10 months (which may still mean it is a significant component) and also whether additional audit procedures are required at the disposal date at Tabtop to verify the accuracy of the net asset balance used in the disposal calculation and the split of results between the period when Tabtop was a wholly owned subsidiary and that when it is an associate. In considering the level of work required we should take into account any due diligence procedures undertaken by the acquirer (although we are unlikely to be given access to these) and whether a closing date audit is planned on which we may be able to rely.

- Consider whether the inclusion of Tabtop as an associate changes our overall assessment of the work required on the associate balances – Tabtop was considered significant when a subsidiary. It may be that in the future it is audited by a different component auditor and that will give rise to the need to assess that auditor and determine the level of assurance gained from their work.

Shinwork

- The key judgement in the impairment calculation is the amount of the value in use. Obtain detailed projections supporting the value of £9.2 million and subject both cash flows and discount rate to scrutiny comparing cash flows to past results, sales order levels etc. and reviewing / performing sensitivity analysis for the key assumptions made.

- There may also be going concern indications and a going concern review should be considered.

- The amounts to be included in the consolidated statement of financial position for Shinwork will be lower than in the prior year (as will its contribution to profit and revenue as business is declining). Need to consider therefore whether Shinwork is still a significant subsidiary entity (although it seems likely that this is the case given the size of its remaining value in use).

- Also need to consider whether, given Shinwork's diminishing contribution and also the disposal of Tabtop, work will be required at some of the subsidiaries previously considered insignificant in order to obtain sufficient coverage of key balances across the group.

Examiners' comments

Financial Reporting treatment

Oldone

Candidates correctly recognised that the acquisition of a further 20% of the shares did not cross the control threshold or result in any change of control. However, the accounting entries required in the consolidated financial statements were less well done.

Convertible bond issue

Candidates demonstrated a very good knowledge of the financial reporting treatment of convertible bonds. They were able to explain how a compound instrument is split between debt and equity and calculate the net present value of the cash flows, correctly allocating the residual value to equity. The most common error was to discount the bond repayment for 4 years instead of 3.

Neida

A significant number of candidates failed to consider the impact of IFRS 10 and therefore question the issue of control. Although Congloma does not have the majority of voting rights there is strong evidence of control via board decisions on R&D and the call option. Several candidates ignored these factors and concluded that Neida was an associate or even a joint venture. Most candidates were able to calculate the goodwill arising on acquisition but only a minority considered the need for an impairment review. Only the very best candidates commented that there may well be other separable intangibles that require recognition.

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Sale of Tabtop

Candidates generally displayed a good knowledge of the financial reporting treatment of a reduction in interest from a subsidiary to an associate and were able to correctly calculate the loss on disposal. Time apportioning profits correctly proved more challenging.

Shinwork

The impairment rules were explained well and most candidates were able to make a reasonable attempt at the impairment calculation. The most common error was to not gross up the goodwill for the NCI component. Other financial reporting issues were rarely identified.

Adjustments to profit before tax

This was generally well done, with candidates demonstrating the ability to assimilate information on adjustments and prepare a revised profit before taxation. Most schedules were clear and cross referenced and it was marked on an own figure principle. Weaker candidates ignored the statement given in the question that the profit figure given was before accounting for any of the transactions.

Audit procedures

Those candidates who did well approached this section methodically addressing each transaction in turn and suggesting procedures specifically relevant to that transaction and stating why the procedure was required. Weaker candidates just produced an unstructured list of tests including many “general” procedures relating to intra company transactions and reliance on other auditors. Many candidates just discussed ‘reviewing’ and ‘looking at’ without stating what they were looking for or why they were reviewing.

Relatively few candidates focused on identifying significant components and instead often produced lengthy answers discussing materiality.

For Oldone little consideration was given to the potential to manipulate profits arising from the sale of Oldone’s shares held by the CEO. Few candidates thought that there may be an issue with buying from the CEO and that there may be fraud. Time was wasted discussing fair values but these would not have been relevant as control was not transferred as a result of the acquisition.

For Neida most procedures appropriately concentrated on the control aspect. Very little was discussed about the fair value of the net assets and identifying the intangibles. The losses may have prompted the need for a goodwill impairment review but the most commonly mentioned procedure was checking that the future losses were forecast correctly without saying why.

By the time Tabtop was discussed many were running out of fresh ideas and concentrated on auditing the disposal – checking the calculations and the proceeds to the bank. It was disappointing that few thought to check that the new holding gave significant influence and could have been control or just an investment.

For Shinwork there were audit procedures of the VIU and little else. Some mentioned the need for a going concern review but not many.

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Question 2

Heston is a listed company which manufactures engines. It has four autonomous divisions operating from separate factories. The candidate has recently joined Heston as deputy to the finance director.

Heston has had some difficult years recently but a new chief executive is beginning to turn the company around. It has been decided to close the lawnmower division but at the accounting year end under consideration it has not yet been sold. In order to boost sales volumes in the other three divisions, selling prices were reduced by 10% at the beginning of the current financial year. Steel is a significant raw material used in production. Fluctuations in steel prices are a major risk so the company has entered into a cash flow hedge for a highly probable purchase of steel. Candidates are required to:

- Set out the financial reporting adjustments for the decision to dispose of the lawnmower division and for the cash flow hedge.
- Redraft the draft financial statements including comparatives
- Analyse Heston's performance and position for the current year using the redrafted financial statements.

Requirement	**Marks**	**Skills**
I would like you to: Set out and explain the financial reporting adjustments required in respect of the issues in Exhibit 3;	14	• Apply technical knowledge to determine the adjustments required for the discontinued operation, including assets held for sale. • Set out the adjustment for cash flow hedge determining the correct amount and the presentation of the FV movement in OCI and OCE • Apply relevant adjustments required to comparatives for SPL but identify that no HFS adjustments required for comparative SoFP. • Explain relevant adjustments clearly identifying the source of authority for treatment from the relevant standard.
Prepare an adjusted statement of profit or loss for the year ended 30 June 2015 and an adjusted statement of financial position at that date in a form suitable for publication, including comparatives.	8	• Assimilate adjustments and prepare in appropriate format. • Identify separate disclosure of continuing and discontinuing activities.
Analyse Heston's performance and position for the year ended 30 June 2015. Include calculations and use the adjusted financial statements. Outline any further information needed, so I can ask somebody to investigate.	8	• Identify causal factors for changes. • Communicate in an appropriate style relevant to the context of the FD's section on the annual report and analysts' questions. • Identify separately the performance of continuing and discontinued activities, explaining the significance of each for shareholders and other stakeholders. • Link price decrease to revenue increase and provide reasoned explanation highlighting changes in sales volumes. • Extrapolate results of analysis to infer reasons for GP and profit changes. • Identify liquidity as an issue and explain main factors affecting liquidity.
Total	30	

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Set out and explain the financial reporting adjustments required in respect of the issues in Exhibit 3

Loss from discontinued operations

The Lawn Mower Division is a substantial and separate part of the Heston business as it is one of only four divisions and it is a profit centre where revenues and costs are therefore separately identified. In accordance with IFRS 5 para 31 it is therefore a component of the entity and should be treated as a discontinued operation in accordance with IFRS 5 para 32. It is therefore required that Heston makes appropriate presentation and disclosure of the effect of the division in the year ended 30 June 2015 in accordance with IFRS 5 para 33 including comparatives for 2014.

The costs identified are those that will no longer be incurred when the division is disposed of.

The post-tax loss for the lawn mower division amounts to £12.274m and is shown in working 1 below.

Asset disposals - Held for sale

Plant and equipment appears to qualify as a held for sale asset in accordance with IFRS 5 from the date they are marketed (i.e. advertised for sale) and should be held at its fair value and in its current condition (IFRS 5 paras 7 & 8). This is 1 April 2015. Heston should charge depreciation up to the time of classification and then no depreciation for the last three months. In Exhibit 3 a full year has been charged which must be reversed and replaced by depreciation for 9 months (see working 1 and 2 below)

It is not a disposal group as assets are to be sold to “a range of different buyers.”

At this date, according to IFRS 5, para 15, each asset of the Lawn Mower Division should be stated at the lower of:

(1) Their carrying amount, less depreciation up to the time it is classified as held for sale; and
(2) Their fair value less costs to sell

If fair value is lower than carrying amount (as is the case above for plant and equipment but not for the land and buildings) then an impairment charge should be made.

Thus the non current assets held for sale should be recognised as a current asset and measured at £17.27m. An impairment charge of £1.235m would be recognised. The details are shown in working 2 below.

The provision for redundancy appears to meet the conditions under IAS 37 but further information should be obtained to confirm this.

The brand is not recognised (IAS 38) as it was not recognised previously in Heston's financial statements as it was internally generated.

Cash flow hedge

Cash flow hedge accounting by Heston attempts to reflect the use of the forward contract to purchase steel to hedge against future cash flow movements from inventory purchases arising from steel commodity price movements. To do this, the movement in the fair value of the contract of £42,000 (which is a loss), in the year ended 30 June 2015, which would normally be recognised in profit or loss, is recognised in other comprehensive income and in other components of equity and as a financial liability.

This balance of £42,000 is recycled to profit or loss in the same period in which the hedged highly probable forecast purchase of steel affects profit or loss. In this case, this is in the year ending 30 June 2016 as the contract will be settled in September 2015.

Note that under cash flow hedge accounting, the change in the fair value of the future cash flows (the hedged item) is not recognised in the financial statements.

It is assumed that the contract is a fully effective hedge as it is based on the price of steel which Heston acquires regularly.

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An adjusted statement of profit or loss for the year ended 30 June 2015 and an adjusted statement of financial position at that date in a form suitable for publication, including comparatives.

Statement of financial position as at 30 June 2015	**2015**	**2014**
	£'000	**£'000**
ASSETS		
Non-current assets		
Property, plant and equipment (113,660 - 18,260)	95,400	120,400
Development costs	10,380	10,380
	105,780	130,780
Current assets		
Inventories	32,300	23,200
Trade and other receivables	36,100	30,400
Cash and cash equivalents	-	5,600
	68,400	59,200
Non-current assets held for sale (W2)	17,270	-
Total Assets	**191,450**	**189,980**
EQUITY AND LIABILITIES		
Equity		
Share capital	37,000	37,000
Retained earnings (68,520 + 15,710)	84,230	68,520
Other components of equity (W3)	(42)	-
	121,188	105,520
Non-current liabilities		
Long-term borrowings	22,000	39,000
Current liabilities		
Trade and other payables	31,600	39,400
Current tax payable	4,420	6,060
Financial liability	42	-
Overdraft	8,400	-
Provision for redundancy costs	3,800	-
	48,262	45,460
	191,450	**189,980**

Statement of profit or loss and other comprehensive income for the year ended 30 June 2015	**2015**	**2014**
	£'000	**£'000**
Revenue (436,000 – 92,000) / (451,700 - 119,300)	344,000	332,400
Cost of sales (306,180 – 72084)/(318,500-77,400)	(234,096)	(241,100)
Gross profit	109,904	91,300
Distribution costs and administrative expenses (107,200-33,800)/101,400-34,700)	(73,400)	(66,700)
Finance costs	(1,500)	(1,500)
Profit before tax	35,004	23,100
Income tax expense (4,420 + 2,600) / (6,060 – 1,400)	(7,020)	(4,660)
PROFIT FOR THE YEAR FROM CONTINUING OPERATIONS	27,984	18,440
(Loss)/Profit from discontinued operations (W1)	(12,274)	5,800
PROFIT FOR THE YEAR	15,710	24,240
Other comprehensive income:		
Cash flow hedge (W4)	(42)	-
TOTAL COMPREHENSIVE INCOME FOR THE YEAR	15,668	24,240

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Workings

1. **Loss from discontinued operations**

	£'000
Per draft accounts (Exhibit 3)	(11,284)
Add back depreciation for 3 months (980 – 90 – 645)	245
Impairment (W2)	(1,235)
	(12,274)

2. **Non-current assets held for sale**

	Land	Buildings	Plant and equipment	Total
	£'000	**£'000**	**£'000**	**£'000**
Carrying amount at 1 July 2014	5,600	5,040	8,600	19,240
Depreciation charge for 9 months:				
Buildings (6,000/50 × 9/12)		(90)		(90)
Plant (8,600 × 10% × 9/12)			(645)	(645)
Carrying amount at 30 April 2015	5,600	4,950	7,955	18,505
Fair value less costs to sell (13,000 & 7,000 x 96%)	12,480		6,720	
Impairment loss (discontinued)	Nil		(1,235)	(1,235)
Carrying amount				17,270

3 **Cash flow hedge**

Value of contract:	**£'000**
Price at 30 June 2015 (6,000 × £158)	948
Price at 1 May 2015 (6,000 × £165)	(990)
Loss	(42)
DR Other comprehensive income	42
CR Financial liability	42

Analysis of financial statements – for inclusion in finance director's section of the commentary in the annual report.

Revenue

The headline figure in the draft financial statement showed a decrease in revenue of 3.5% overall for the company.

The adjusted financial statements strip out the Lawn Mower Division as a discontinued activity. The revenue from Lawn Mowers fell significantly by 22.9% in the year but this, in part, was due to a major new entrant in the industry over which Heston had no control. The response has been to decide to sell off the Lawn Mower division to prevent further losses.

The adjusted statement of profit or loss shows revenue of £344 million from continuing activities (i.e. from the three remaining divisions). This shows that revenue from these three divisions actually increased compared to the previous year by 3.5%.

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One of the underlying possible causes of this change could have been the reduction in all selling prices of the three divisions of 10%, which may, as intended, have increased sales volumes. If we adjust for this price change to show changes in sales at constant prices then this shows:

2014	£332.4m	
2015	£382.2m	(£344m/0.9)

This shows that sales volumes (crudely measured) have increased by about 15%. More information is need to explore the extent to which the price decrease was the primary causal factor for the volume increase (for example, sales mix between products will also affect the year on year analysis) but it is indicative that the policy has proved successful in expanding sales volumes.

Profit

The headline figures in the original draft financial statements show a significant fall of 31.1% in profit for the year from £24.24m to £16.7m.

A key factor for analysts is the extrapolation of profits into the future by exploring trends. The adjusted statement of profit or loss strips out the losses from the Lawn Mower Division and shows profit from continuing activities which will form the basis of profit in future.

The adjusted figures reveal that the three divisions collectively showed an increase in profit for the year on continuing activities of 52% from £18.44m to £27.98m.

This is a positive trend which can be emphasised to analysts, particularly if there is evidence that it will continue in future.

Gross margin

The unadjusted gross profit margin has not changed significantly from 29.4% to 29.7%. However the gross margin from the discontinued operation has fallen from 35.1% to 21.6%.

The adjusted financial statements show that gross margin on continuing operations has increased from 27.5% to 31.9%. At first sight this may seem surprising as selling prices have been reduced which would normally indicate a reduction in gross margin. However, the increased sales volume has taken advantage of the high level of fixed costs, and therefore operating gearing, in order to enhance the gross margin and compensate for the selling price reduction.

Financial position and liquidity

The liquidity position of Heston has worsened significantly as measured by the decrease in cash of £14m from a positive balance of £5.6m to an overdraft of £8.4m.

On the other hand, £17m of the long term loan has been repaid in the year.

A concerning aspect of liquidity which may raise questions from analysts is the apparent worsening of the working capital position. Both receivables and inventories have risen significantly, whilst payables have decreased. All these have had a detrimental effect on cash and have been financed from cash generated from operations. The reasons for the changes in working capital need to be ascertained by further investigation.

There has been no cash spent on PPE in the year. It is not clear whether this is because there were no viable opportunities to acquire new assets or because the cash was not available given it is being consumed by increases in working capital.

A summary of the liquidity changes can be seen by drawing up a statement of cash flows for the year ended 30 June 2015 from the draft financial statements provided.

Tutorial note: Candidates are not expected to prepare a statement of cash flows, but may refer to individual figures or groups of figure (investing, financing, or operating cash flows) within their narrative. The statement of cash flows therefore provides a framework for such an approach.

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	£'000	£'000
Profit before taxation	21,120	
Adjustments for:		
Depreciation (120,400 – 113,660)	6,740	
Provision	3,800	
Increase in inventories	(9,100)	
Increase in receivables	(5,700)	
Decrease in payable	(7,800)	
Cash generated from operations	9,060	
Income taxes paid	(6,060)	
Net cash from operating activities		3,000
Cash flows from financing activities		
Repayment of long term borrowings		(17,000)
Net decrease in cash and cash equivalents		(14,000)
Cash and cash equivalents at 1 July 2014		5,600
Cash and cash equivalents at 30 June 2015		(8,400)

Other matters for further investigation

- An analysis of the fair value of assets. This would include the credentials of those who have completed the valuation. This should evaluate the potential for borrowing using the assets as security in order to enhance liquidity.
- Comparison of the ratios with those for other companies in the sector, to assess relative performance.
- Additional segmental analysis for each of the three continuing divisions, to assess performance and development opportunities for each segment independently. IFRS 8 segment disclosure may be appropriate.

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Examiners' comments

Financial Reporting adjustments

Candidates demonstrated a good knowledge of IFRS 5 and most answers focused on the accounting treatment of assets held for sale. Some candidates wasted time by simply copying out every criteria from the standard rather than focusing on the specific scenario given. The calculations of the impairment of PP&E were generally well done although a minority incorrectly combined the land and buildings and PP&E when carrying out their review. Although most candidates did recognise that depreciation should stop when an asset is held for sale not all selected the right date and/or calculated the adjustment correctly.

The consideration of discontinued operations was less well done with few candidates showing the calculation of the collated loss from discontinued operations. A minority of candidates appeared confused as to the difference between assets held for sale and discontinued operations.

Most questioned the need for the provision for redundancy and whether the brand could be identified.

The cash flow hedge was not explained well. Many candidates copied the principles from the learning materials but could not apply them to the scenario. The value of £42,000 was often calculated correctly but then mistaken for a gain. Sometimes the calculations and the descriptions were made and then concluded that the cash flow hedge did not apply because there was not hedged item – demonstrating that some candidates did not understand the difference between the fair value and cash flow hedges.

Adjusted financial statements

Answers to this part of the question were extremely disappointing with many not taking note of the requirement which stated – 'in a form suitable for publication'. Candidates often failed to demonstrate even basic skills relating to the construction and presentation of financial statements e.g. allocating all assets categories into current or non-current assets, failing to adjust retained earnings for profit adjustments.

In addition, candidates were unable to apply practically the disclosure rules from IFRS 5. Even though most candidates identified that there was a discontinued operation in their earlier discussion many just ignored this when re-stating the profit or loss statement. Even those who adjusted the current year often failed to adjust the comparatives even though sufficient information was given to do this. Assets held for sale were not shown as a separate line item of current assets. Some very weak candidates incredibly wasted time copying out the question without adjustment.

Analysis of performance and position

Answers to this part of the question were extremely variable. Many candidates failed to consider the context of the question and their content and communication style was either not appropriate or irrelevant. Even if a candidate had not presented the financial statements appropriately showing discontinued operations, the quality of the financial statement analysis would be significantly improved had candidates considered that the division should be removed to identify the performance on the continuing business. Weak candidates failed to interpret the scenario and to identify separately the performance of the continuing and discontinued activities. Another common weakness was to consider only performance and not position. At the other extreme there were some exceptionally good answers which clearly and concisely communicated the key issues including identifying high operating gearing and the relationship between price increase and sales volume.

Some candidates spent quite a lot time calculating pages of ratios which were not then used in their narrative. At Advanced Level ratios in isolation receive little or no credit.

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Question 3

Scenario

The candidate is the senior on an audit of a listed company. The audit is in its closing phase. The candidate is required to review working papers provided by an assistant, to identify the financial reporting issues arising and to propose audit adjustments as appropriate to add to the schedule of uncorrected mis-statements and to set out and explain the adjustments the client should be requested to make. The candidate is also required to assess ethical issues in respect of non-disclosure and auditor independence.

The question required a good understanding of financial reporting requirements for leases and deferred tax and the skills in assessing the adequacy (or otherwise) of audit procedures. Analytical skills and application of general principles to a particular situation are required throughout the question.

Requirement	Marks	Skills
1. Explain the financial reporting issues you have identified and recommend appropriate adjustments.	10	• Identify and explain incorrect financial reporting treatment of lease. • Apply technical knowledge of IAS 17 to recommend treatment. • Explain the missing entry in the current tax computation for share option and the incorrect adjustment for the warranty costs. • Link information concerning tax liability and underpayment to propose adjustment to profit or loss in respect of prior year. • Calculate the adjustment for deferred tax required for the share option charge.
2. Prepare a revised schedule of all uncorrected misstatements (Exhibit 1), including your adjustments from 1) above. Identify and explain the misstatements, if any, that we require Homehand to correct.	4	• Assimilate adjustments and prepare schedule of uncorrected misstatements. • Apply materiality to the adjustments to determine which should be adjusted. • Identify and explain need for further work arising from the nature of the errors identified.
3. Set out the audit procedures we need to perform to complete our audit of the current tax and deferred tax balances.	10	• Link errors noted in financial reporting to weaknesses in the procedures prepared by Min. • Explain the need to consider the work performed on opening balances. • Determine the appropriateness of the tax rate used in determining deferred tax liability. • Evaluate the need for auditor expert in tax. • Identify appropriate procedures for the deferred tax adjustments for share options.
4. Identify and explain the ethical issues for our firm and any actions you believe we should take.	6	• Evaluate the lack of professional care in the quality of work performed to date by Karen and her motives. • Explain that BW cannot be associated with an undisclosed error to the tax authorities. • Explain the need to apply professional scepticism. • Explain responsibilities under money laundering legislation. • Explain the duty to report to ICAEW if in the public interest. • Identify an appropriate course of action; identify the facts, inform Karen to disclose. • Consider need to resign as auditor and to report to those charged with governance.
Maximum marks	30	

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(a) Explanation of financial reporting issues and recommendation of appropriate adjustments

Lease of production machinery

The adjustment Min has proposed is incorrect. Homehand has treated this transaction as an operating lease. However it would appear that it is a finance lease for the following reasons:

There are 5 indicators which could indicate a finance lease:

1. The lease transfers ownership of the asset to the lessee at the end of the lease term – this does not appear to be the case in this instance.
2. The lessee has the option to purchase the asset at a price sufficiently below fair value at the option exercise date, that it is reasonably certain the option will be exercised – again not the case here.
3. The lease term is the asset's three year economic life even if title is not transferred –.
4. Present value of minimum lease payments amounts to substantially all of the asset's fair value at inception – this is the case (see calculations below) as PV = £122,452 / £123,000 = almost 100% of normal selling price
5. The leased asset is so specialised that it could only be used by the lessee without major modifications being made – this is not entirely clear but as it is designed for the customer would probably be the case.

Based on indicators 3, 4 and 5 the lease does appear to be a finance lease and the risks and rewards of ownership are with the lessee.

Homehand will recognise a receivable equal to its 'net investment in the lease'.

As Homehand normally sells the equipment itself, dealer / manufacturer considerations are relevant. Homehand will need to recognise separately its normal selling profit and its finance income from the lease. Its initial sales revenue will be calculated as the lower of the fair value of the asset and the present value of the minimum lease payments computed at market interest rate of 8%.

Present value of minimum lease payments:

Payment	Amount £	Discount factor @ 8%	PVMLP £
1	44,000	1.000	44,000
2	44,000	0.926	40,744
3	44,000	0.857	37,708
Total minimum lease payments			122,452

As this is approximately the same as the normal selling price / fair value, revenue recognised will be £122,452

In the this case of a manufacturer, the cost of sales will be its production costs. Hence cost of sales will be £102,000.

Finance income and net investment in the lease:

Net investment in the lease can be calculated as follows:

	£
Present value of minimum lease payments	122,452
Less: Payment made on 1 April 2014	(44,000)
	78,452
Finance income at 8%	6,276
	84728

Finance income of £6,276 will be recognized in the statement of profit or loss for the year ended 31 March 2015.

Net investment will be split between receivables falling due within one year (£44,000) and receivables falling due after more than one year (£40,728).

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Adjustment required:

	£
Dr Revenue	44,000
Cr Net investment in lease	44,000
Dr Cost of sales	102,000
Cr Inventory	102,000
Dr Net investment in lease	122,452
Cr Revenue	122,452
Cr Finance income	6,276
Dr Net investment in lease	6,276

Tax effect is trivial

Dr Current tax liability	3,454
Cr Current tax expense	3,454

Net effect on profit for the year is debit £17,272 – 3,454 = £13,818

Note 1: Current tax liability for the year ended 31 March 2015

The calculation of the current tax liability for the year ended 31 March 2015 is incorrect – it does not include an 'add back' for the share option expense or a deduction for warranty costs actually incurred.

The current tax expense calculation should have included a disallowance for £450,000 for the share option expense as the tax rules state that a deduction for these costs will not be given by the tax authorities until the options are exercised.

The warranty cost disallowed by Karen is the total charge for the year and includes the warranty costs paid which are allowable according to tax rules – only the movement in the provision should be disallowed.

Therefore the calculation of the current tax liability should be:

	£'000
Taxable profit per Karen	2,180
Add share option expense	450
Less warranty costs incurred	(150)
	2,480
Tax at 20%	496

Karen has accrued a current tax liability of £436,000 and the liability should have been £496,000

An adjustment is therefore required:	**£**
Dr tax expense	60,000
Cr Current tax liability	60,000

Note 2: Adjustment in respect of prior year tax – year ended 31 March 2014

The current taxation paid for the prior year was higher than that recorded in the prior year financial statements. As this has simply been recorded as a reduction in the liability, the tax liability is understated by £47,000 at 31 March 2015. The amount of the error even when added to the prior year uncorrected warranty provision is not material so no prior year adjustment will be made and the effect will be to record the amount in the current year tax charge.

In addition Karen has identified a further under declaration of tax relating to non-deductible legal expenses. As we will be informing the client to notify the tax authorities of the error (see ethics points below), we can expect additional tax to become payable. There may also need to be a provision made for penalties or interest.

This would give rise to a further tax liability for the year ended 31 March 2014 of £105,000 x 20% = £21,000

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An adjustment is required in respect of prior year tax as follows:

	£
Dr tax expense	21,000
Dr tax expense	47,000
Cr Current tax liability	68,000

Prior year element of tax charge (which will also include the error above) will need separate disclosure.

Deferred tax balance

The calculation of the deferred tax balance is incomplete as it does not take into account all temporary timing differences.

Share option scheme

The share option scheme gives rise to a temporary difference and a deferred tax asset.

A deferred tax asset arises on the temporary difference which is measured as the intrinsic value of the options which are expected to be exercised at 31 March 2015. This temporary difference can be calculated as:

450 remaining employees x 1,000 options x (market price £8.50 less exercise price £4.00 = £4.50) = £2,025,000 divided by 3 as first year of 3 = £675,000.

As this is higher than the cumulative remuneration expense of £450,000 recorded under the scheme, the total tax benefit of £675,000 @ 20% = £135,000 will be recorded as follows:

Profit or loss (450,000 x 20%)	£90,000
Equity	£45,000

Hence adjustment would be:

	£
Cr Tax expense	90,000
Cr Equity	45,000
Dr Deferred tax asset	135,000

Deferred tax balance now becomes:

	£'000
Taxable temporary difference	
Carrying amount of plant and equipment at 31 March 2015	6,400
Tax base of plant and equipment at 31 March 2015	(5,300)
	1,100
Deductible temporary difference	
Warranty provision at 31 March 2015	(600)
Share option at 31 March 2015	(675)
	(175)

Closing deferred tax asset = £175,000 x 20% = £35,000

Journal – assuming set off of deferred tax asset and liability

	£
Closing deferred tax asset	35,000
Brought forward deferred tax liability =	(87,000)
Therefore:	
Dr Deferred tax liability	122,000
Cr Equity – re share options	45,000
Cr Profit or loss – other timing differences	77,000

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Tutorial note: Reconciliation of accounting profit to taxable profit

				Deferred tax movement	
	£000	**Tax rate 20%**	**£000**	**P&L £'000**	**Reserves £'000**
Accounting profit	2050		410		
Add: permanent disallowables	45		9		
Temporary timing differences					
(TTD) Depreciation – capital allowances (1185 – 1450)	(265)		(53)	53Dr	
(DTD) Warranty (as amended)	200		40	(40) Cr	
(DTD) Share option (as added back in revised computation)	450		90	(90)Cr	
Taxable profit	2480		496	77 Cr	
DTD Share option (Equity)	225				45 Cr
Deferred tax liability brought forward				(87)	
Less movements to p&l and reserves				122	
Deferred tax asset carried forward				35	

2. Revised schedule of uncorrected misstatements

Including prior year items and the items identified from the audit work on tax; the revised statement of uncorrected adjustments is as follows:

	Statement of profit or loss		**Statement of financial position**	
Original proposed adjustments	**Dr £'000**	**Cr £'000**	**Dr £'000**	**Cr £'000**
1. Over-provision of warranty costs due to error in formula used to derive general provision for warranty	-	75	75	-
Tax effect	15	-	-	15
2. Over-valuation of inventory projected due to sample testing of inventory costs	115	-	-	115
Tax effect	-	23	23	-
Further adjustments				
3. Effect of prior year under provision of warranty provision	-	60	60	-
4. Net effect of lease	14	-	-	14
5. Current year tax liability – correction for share option and warranty	60	-	-	60
6. Prior year tax liability – disallowable expenses	68	-	-	68
7. Deferred tax journal	-	77	122	45

In assessing adjustments, consideration needs to be given to the effect on individual line items as well as the overall position:

Taking into account the prior year item as well as the current year warranty items shows that the actual charge for warranty is £60,000 + £75,000 higher than it should be. This is material and the warranty charge is shown

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separately within the financial statements as part of the disclosure of the movement on provision. The prior year item is not material and cannot be corrected without a prior year adjustment which would not be appropriate for an immaterial item. However the client should be asked to book the current year adjustment of £75,000 so that the remaining uncorrected item for warranty is not material. Tax effect of this item would be an increase in the deferred tax liability of £75,000 @ 20% = £15,000.

The error in respect of the previous computation - disallowable expenses in respect of the previous year (£68,000) and the correction for the share option expense and warranty costs in the current year computation (£60,000) all impact on the current tax liability and must be adjusted (see ethics section).

The share option creates a deferred tax asset of £135,000 which taken together with the other timing differences the adjustment for deferred tax is above materiality and should be adjusted.

The remaining uncorrected items for current year are as follows:

	Statement of profit or loss		**Statement of financial position**	
	Dr £'000	**Cr £'000**	**Dr £'000**	**Cr £'000**
Under-valuation of inventory	115	-	-	115
Tax effect		23	23	
Net effect of lease	14	-	-	14
Additional deferred tax on warranty adjustment – see above	15	-	-	15

The net impact of these adjustments is £121,000 which is close to the materiality level of £120,000 and we should ask the client to adjust for the remaining items.

We therefore need to consider whether we should do more work to assess whether the uncorrected items taken together with any undetected items could be material. This is particularly the case as one is an error in the application of an accounting standard (lease) and the other is based on a projected error calculated from sample results (inventory). Such work could include extending further the inventory sample and looking in more detail at other judgmental decisions.

If management do conclude that there are adjustments that they do not wish to correct in the financial statements then these should also be disclosed to the audit committee / those charged with governance as they may have a different view.

3. Audit procedures to complete work on tax balances

General

- Need to ensure that we have audited all elements of the movement in the tax liability balance. Not clear from Min's working papers that the brought forward balances have been agreed to prior year financial statements - this needs to be done for current and deferred taxation.
- In addition the tax payments should be agreed to the cash book and tax authorities' record of receipts.
- Consider whether 20% tax rate is appropriate for current as well as deferred tax balance – will depend on whether any new rate has been enacted or substantively enacted at the balance sheet date.
- Need to ensure that there has been appropriate input to the audit of the tax balances from a tax expert within BW.

Prior year tax balances

- All correspondence with the tax authorities should be reviewed either by the audit team or by an expert from within the tax department. Any issues arising should be assessed fully using expert input as appropriate.
- Need to assess the potential for penalties and interest in respect of the erroneous tax return filed for the previous year – consultation with an expert may again be required to assess the range of outcomes and the probability of each. If client makes immediate disclosure to tax authorities then settlement on this could be reached before the audit is finalised and judgment will not be needed.

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- Need to review differences between tax computations used for prior year financial statements and those submitted to tax authorities to ensure that explanations provided by the client are accurate as these have been relied on to propose adjustments.

Current tax computation

- Errors have been noted in the computation prepared by the client – see above financial reporting issues. Need to consider whether all of the adjustments made by the client to arrive at taxable profit are correct.
- Prior year experience shows that non-deductible expenses were higher than the amount shown in the current year tax computation. Should review the nature of expenses to ensure that the amount added back is complete and a realistic estimate of the actual non-deductible expenses. Particular attention should be paid to any one off expense items, legal expenses etc.
- Should consider whether the adjustments to arrive at taxable profit are complete by reference to any other adjustments made in previous years and consideration of whether there are other general provisions etc.
- Share option scheme
  Charge to profit or loss account has already been audited and detail should be agreed to the relevant working papers. Additional information required to arrive at tax treatment is the share price at the year end and this should be agreed to an external data source showing the quoted price of Homehand's shares at the year end.

Deferred tax

- Review the current tax computation for any temporary differences not accounted for as a deferred tax adjustment
- Obtain a reconciliation of profit per the financial statements to taxable profit and ensure that deferred taxation has been appropriately provided for temporary differences only.
- Verify that the tax rate at which the liabilities and asset unwind is in line with tax legislation enacted.
- Agree the opening position of the deferred tax liability to the prior year financial statements.
- Consider whether it is appropriate for the company to recognise deferred tax assets and liabilities i.e. will profits be made in the future
- Agree that the intrinsic value of the shares at 31 March 2015 is reasonable. Vouch exercise price to supporting documentation

(b) **Implications of ethical considerations**

Karen knows that the prior year tax return is incorrect but is not proposing to notify the tax authorities of the error. Karen is an ICAEW Chartered Accountant and therefore expected to follow the fundamental principles of the ICAEW code. She should not be associated with a tax return which she knows to contain an error and it is unclear why she does not wish to report the error to HMRC. It may be that she is worried about the effect on her reputation / employment if she admits to the error.

As ICAEW Chartered Accountants, the BW tax and audit team have a duty, where it is in the public interest, to report to the ICAEW any facts of matters indicating that a member may have become liable to disciplinary action. Deliberate underpayment of tax cannot be in the public interest so there may well be duty to report Karen.

BW is not the tax advisor submitting the return, however it should not be associated with the false return and risks disciplinary action if it does not act within the spirit of the Ethical Code.

The first action we should take is to ask Karen to disclose the error to the tax authority. If she refuses to do so then the matter should be raised with those charged with governance at Homehand. BW will need to consider whether it can continue to act as auditor to a company which has knowingly filed a false tax return. The Ethics partner at BW should be consulted throughout the deliberations. There may also be reporting implications under the Money Laundering regulations and the MLRO should be consulted.

There is also a quality issue over using a junior member of staff to audit complex tax balances – although the firm in completing this review has addressed the issue in part. However BW should consider its own quality procedures to ensure professionally competence of staff assigned to complex audit work.

With regards to the comment from the Homehand finance director regarding unwillingness to adjust, this potentially raises an intimidation threat. Appropriate action would be to discuss with the assignment partner and

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the firm's ethics partner – ultimately the matter should be raised with those charges with governance and the relevant adjustments made to the financial statements.

Examiners' Comments

This was the least well answered question on the paper. In particular, candidates seemed unable to deal correctly with the current and deferred tax adjustments.

Financial Reporting adjustments

The accounting for the lease of the production machinery was generally well done with candidates correctly applying their technical knowledge of IAS 17.

The treatment of errors in the current tax computation was poor with few candidates recognising the need to add back the share option expense and adjust the warranty cost. The errors on last year's tax computation were also not well addressed. Those candidates that did comment on the issue often incorrectly proposed a prior year adjustment.

The deferred tax calculation for the share option was reasonably well attempted.

Schedule of uncorrected misstatements

The schedule was prepared well by a significant number of candidates. Few, however, answered the second part of the requirement which was to identify and explain the misstatements which Homeland should correct.

Audit procedures

Relevant audit procedures were generally good although weaker candidates tended to produce generic procedures which were not always tailored to meet the scenarios given. The question specifically asks for audit procedures on tax and deferred tax balances and weak candidates wasted time by setting out procedures relating to the warranty provision and share option.

Ethical issues

Most candidates identified the key points relating to the undisclosed error on the tax return, the potential intimidation threat and the issues around professional competence, and stronger candidates were able to link these to the ICAEW's ethical code and the need to comply with it. Weaker and more marginal candidates veered off into discussion on possible modifications to the audit report. Many candidates seemed to believe that the auditors were responsible for the trainee accountant who actually worked for the client. An alarming number of candidates believed they should report Karen to HMRC.

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