CORPORATE REPORTING - MARKS PLAN AND EXAMINERS COMMENTARY
NOVEMBER 2014

Solution 1

Scenario
In this scenario the candidate is in the role of a recently-qualified ICAEW Chartered Accountant assigned to the audit of Couvert plc. Couvert has made two acquisitions during the year: a 55% shareholding in Ectal, an overseas subsidiary; and a 100% shareholding in a UK subsidiary, Bexway, acquired partway through the year. The skills required to answer this question successfully are: financial statement analysis in conducting relevant analytical review procedures; application of technical knowledge to identify appropriate actions; assimilation and structuring skills e.g. in linking poor corporate governance with the financial reporting question over control of Ectal; and communication skills to different audiences.

The candidate is first asked to perform analytical procedures on Ectal's financial information which has been provided to Couvert only very recently and close to the reporting date. The candidate should identify that the information is incomplete; (SOCIE and cash flow is missing, no tax charge) and perform financial statement analysis in preparing, e.g. profitability ratios. The candidate should identify that Ectal has performed significantly worse than in 2013 and against budget expectations, which raises the possibility of earnings management prior to the acquisition to enhance the acquisition price. Linking the finance costs in the statement of profit or loss with the SOFP suggests a return of 10% on a loan from a director. The candidate should express scepticism over the amount of interest and question whether it is reasonable in the context of the overseas jurisdiction. The candidate should select relevant financial ratios and determine that the financial position has declined in 2014 and in particular inventory ratios indicate a slow-down in the inventory turnover.

The candidate is then asked to discuss the governance structure at Ectal and identify that control is effectively retained by the vendor of the 55% shareholding. Linking this to the financial reporting treatment of the investment is an embedded point requiring higher level skills.

The candidate is asked to explain the financial reporting treatment and again there is an embedded point to be identified concerning the impairment of assets in the statement of profit or loss which has implications for the value of goodwill at acquisition.

The candidate is then asked to recommend appropriate audit actions arising from the investment and is required to apply technical knowledge therefore of
ISA 600.

Finally the candidate is required to explain the appropriate financial statement adjustments in respect of a pension issue and a put option which arise the in the financial statements of Bexway, the 100% newly-acquired subsidiary.

Available Marks

Requirement	**Marks**	**Skills**
• Analyse and explain, using analytical procedures, the financial performance and position of Ectal for the year ended 31 August 2014 (Exhibit 2). Include enquiries that will need to be made of Ectal's management and its auditor Stepalia arising from these analytical procedures.	15	• Identify that the financial information is incomplete • Identify and calculate appropriate ratios • Perform financial statement analysis to enable comparable profitability ratios to be prepared. • Appreciate the possibility of earnings management prior to the acquisition to enhance the acquisition price • Link the finance costs in the statement of profit or loss with the SOFP to identify a return of 10% on a loan from a director. • Apply scepticism over the amount of interest and question whether it is reasonable in the context of the overseas jurisdiction.
• Identify and explain your concerns about the corporate governance arrangements at Ectal and the impact of these on the financial reporting of the investment in Ectal in Couvert's consolidated financial statements for the year ended 31 August 2014.	9	• Identify the implications for group audit through lack of commitment by Couvert directors • Appreciate that governance arrangements can form part of the determination of the appropriate accounting treatment for Ectal in the Couvert consolidated financial statements • Identify the need for information concerning the rights of the shareholders to appoint board members.
• Explain in respect of the audit of Ectal by Stepalia: i. The actions to be taken by PG ii. The potential implications for the group audit report	8	• Apply technical knowledge of ISA 600 to determine actions for PG
• Explain the appropriate financial reporting treatment for the two issues identified by Couvert's finance director (Exhibit 3).	8	• Identify and explain appropriate financial reporting treatments.
Total Marks	**40**	•

(1) Report on analytical procedures of Ectal's financial information for the year ended 31 August 2014

Prepared by Anton Lee, Audit Senior

Introduction
It is clear that Ectal's performance has declined significantly; the business produced a substantial loss in 2014, compared to budgeted and prior year profit. This loss in 2014 arose primarily because of the highly-significant impairment of property, plant and equipment.

General comments

The financial statements, on which the analytical review is based, are incomplete. There is no statement of cash flows, no explanatory notes, no statement of changes in equity and the performance statement also appears to be incomplete. The movement in retained earnings for the year is a reduction of C$70.2 million, but only C$50.2 million has been accounted for as loss in the year. Therefore there is, presumably, a further C$20 million of loss/expense accounted for in other comprehensive income. If this is accounted for by a dividend paid in the year it would be expected that 55% of it will have been received by Couvert. But it could be something else and we need to find out what this difference relates to.

Ectal's performance

Ectal classifies expenses by nature, rather than by function. The budgetary information for the year ended 31 August 2014 provides a set of expectations against which actual performance can be judged, and a comparison against the prior year results is also possible. Analysis of the principal profit or loss items shows the following:

	Actual 2014 as a % of budget	**Actual 2014 as a % of 2013**
Revenue	85.2%	87.2%
Raw materials (RM) and consumables used, adjusted for changed in inventories and WIP*	87.3%	87.9%
Employee expenses	101.9%	125.2%
Depreciation expense	86.2%	88.2%
Other expenses	141.4%	140.1%

*Consumption of raw materials and consumables adjusted for inventory change

	2014 Actual	**2014 Budget**	**2013 Actual**
Inventory change	5.9	(8.3)	(18.6)
RM & WIP used	(192.8)	(205.7)	(194.1)
	(186.9)	(214.0)	(212.7)

Revenue for 2014 is very much lower than both prior year and budget figures, which may suggest a downturn in trade. However, it is also possible that cut-off at the beginning of the year was incorrect, and that revenue was recognised too early in order to manipulate profits immediately prior to takeover and to improve the price paid for the acquisition. This factor could have affected many of the figures in both the performance and position statements, and if so, the consequences for the audit and for the client would be very significant. It would be helpful to undertake some trend analysis of Ectal's results, going back over three or four years, and also to look at the extent to which their budgeting has deviated from actual results in the past. We should be able to obtain this information from the due diligence files.

Employee expenses are higher than budget, and much higher than in the previous year. The increase appears to have been expected in that the 2014 budget figure is substantially increased compared to 2013 actual figures. It may indicate a significant planned pay increase for staff, but it is difficult to tell without further information. Other expenses have increased even more, both against budget and prior year. Again, more information would be required. It is possible that expenses have been misallocated, and that the totals that we are currently examining are not accurate comparators.

Depreciation, on the other hand, is much lower than planned, and much lower than in the prior year. However, the C$60 million impairment, which is material, has had a significant impact on the PPE balance. More information would be required about the timing of this impairment. If it occurred and was recognised at the year end, as seems likely, then it does not explain the drop in depreciation which should have been recognised in full before the amount of the impairment was calculated. It is impossible to reconcile the movement property, plant and equipment without further information on acquisitions and disposals. The carrying amount of PPE at 31 August 2013 was £603.7 million, which reduced to £551.3 million at 31 August 2014. The difference between the two figures is £52.4 million, exactly the amount of the depreciation charge for the year ended 31 August 2014. It appears, therefore, that net acquisitions amounted to exactly £60 million, balancing the amount of the impairment. The note to the financial statements on PPE and the cash flow statement would help in providing explanations.

Profitability

Because of the classification of expenses by nature, no figure for gross profit is disclosed. However, gross profit can be estimated by deducting change in inventory, RM and WIP used, employee expenses and depreciation expenses from revenue, as follows:

2014 Actual: 305.4 + 5.9 – 192.8 – 26.3 – 52.4 = 39.8 (i.e. excluding impairment)
2014 Budget: 358.6 – 8.3 – 205.7 – 25.8 – 60.8 = 58.0
2013 Actual: 350.4 – 18.6 – 194.1 – 21.0 – 59.4 = 57.3

Margins can then be calculated as follows:

	2014 Actual	2014 Budget	2014 Actual
Gross profit margin	13.0%	16.2%	16.4%
Operating profit margin (operating profit = (loss)/profit before tax + finance costs)	(14.8%)	10.3%	10.3%
Net pre-tax margin	(16.4%)	8.9%	8.9%

Note: all calculations exclude other income, which was not budgeted. There is no indication of what this might be, but audit work will be required on this figure.

Gross margin has suffered a significant decline. This may possibly be the result of a change in sales mix, but the decline requires further explanation.

Finance costs

Linking finance costs to the statement of financial position, the principal liability at the 2014 and 2013 year ends was the loan from director. It appears that the director is earning approximately 10% pa from this loan. Whether or not this is a reasonable return depends to some extent upon interest rates in Celonia, but the interest rate may be excessive.

Other issues

	2014 Actual	2014 Budget	2013 Actual
Return on capital employed	(7.7%)	5.6%	5.6%

Return on capital employed is negative in 2014. Budgeted and 2013 actual ROCE are both relatively modest figures. It could be helpful to compare these and other performance ratios with industry averages, both within Celonia and globally.

There is no tax charge or credit for 2014. We need to know more about tax relief available for losses in Celonia, but on the face of it, a figure appears to have been omitted in this respect. Depending upon loss relief available, the bottom line loss for 2014 may be reduced.

Financial position

A selection of relevant accounting ratios is presented in the table below:

	2014 Actual	2014 Budget	2013 Actual
Non-current asset turnover	0.55	0.58	0.58
Inventory turnover (days)*	134.7 days	109.3 days	114.7 days
Receivable turnover (days)	60.6 days	56.0 days	59.4 days
Current ratio	1.48:1	1.51:1	1.46:1
Quick Ratio	0.51:1	0.66:1	0.62:1
Payables turnover (days)**	148.3 days	134.4 days	142.3 days

* Calculated on the basis of year-end inventory/ (change in inventories and WIP, raw materials and consumables, employee expenses and depreciation expense).
**Calculated on the basis of year-end trade and other payables/ (change in inventories and WIP, raw materials and consumables, employee expenses and other expenses)

The statement of financial position shows a general decline between the two financial year ends. Non-current asset turnover has declined, even though it is calculated on a year-end figure that has been subject to impairment. Inventory turnover is significantly worse than budget and last year, and may indicate inability to sell finished goods. Presumably quite a lot of finished goods are sold to Couvert (we need to know the proportion of Ectal's business that is accounted for in this way) and so it may reflect a decline in demand in the UK for Celonian products. Current ratio looks quite reasonable, but quick ratio confirms the initial impression given by a review of the statement of financial position which is that the business is illiquid. Both payables turnover and inventory turnover are at a very high level and there is only an insignificant quantity of cash in the business at 31 August 2014.

We currently have no explanation of the C$16 million in provisions and we need to obtain further information on this point without delay. There is no indication of where this amount has been recognised in profit or loss. This information may help to explain some of the anomalies in the comparison of the expense totals, mentioned earlier.

Analytical review summary

The analytical review raises a lot of questions, and also some suspicions about the opening position. The significant decline in 2014 could suggest that the financial statements for the year ended 31 August 2013 were manipulated to show a better performance in the year then ended and a stronger closing position. Due diligence should have revealed any accounting manipulation but clearly this effect was not observed.

(2) Concerns about the corporate governance of Ectal

Couvert plc is a listed company. Assuming that it is listed on the London Stock Exchange, the UK Corporate Governance Code applies to it. Because Ectal is a subsidiary, and is incorporated in Celonia, the Code does not formally apply to it. It would, however, be best practice to adopt the Code in Couvert's subsidiaries, including any foreign subsidiaries. Many provisions of the Code are apparently missing in Ectal's corporate governance arrangements. For example, the board of Ectal appears to have no non-executive directors, and there is no separation of the roles of chairman and chief executive. There appear to be no board committees, and the whole board does not, in practice, meet regularly.

The corporate governance arrangements for Ectal effectively grant power over Ectal's operations to Ygor Vitanie. The arrangements are constitutionally unsatisfactory in that, unless all three Couvert directors attend board meetings, Ygor has control of the Board. Even if only one Couvert director is absent, the board is four in number, and Ygor has the casting vote in case of a tied vote. This assumes that Ygor's daughter, Ruth, always votes with her father; we may be able to test this supposition with the co-operation of the Celonian auditors, by examining board minutes. An interview with Couvert's operations director, who has attended all of Ectal's board meetings this year could help to establish the pattern of voting that actually took place during the year.

The additional problem is that the Couvert directors have not, on the whole, taken much interest in Ectal's operations in the first year of ownership. Because Couvert's managing director has not yet attended an Ectal board meeting, all meetings have therefore been dominated by Ygor (again, assuming that his daughter votes with him). This is clearly unsatisfactory, and should be addressed by Couvert, the majority shareholder, without delay.

Financial reporting implications for Couvert's consolidated financial statements for the year ended 31 August 2014

The implications of the analysis above are as follows:

(a) Ectal's financial reports for the year ended 31 August 2014 are incomplete, and appear to require a lot of additional work. This may have the effect of delaying the consolidation and thus placing the group's preliminary reporting deadline at risk.

(b) Goodwill on consolidation in respect of the Ectal investment may be misstated, and any misstatement could be highly material. The material impairment loss in respect of property, plant and equipment could indicate that PPE was overstated at acquisition,

and that goodwill was therefore understated. However, if the financial statements for the year ended 31 August 2013 (the opening position for this year) were manipulated to show an improved performance and position, it is likely that Couvert paid too much for the investment, and goodwill may require impairment. If the loss for the year ended 31 August 2014 is, on the other hand, genuine (and not affected by the misstatement of the opening position) goodwill may still require impairment.

(c) The extent to which Couvert actually controls Ectal requires careful examination from a financial reporting perspective. Couvert has the majority shareholding which would normally indicate control. However, IFRS 10, Consolidated Financial Statements, states that an investor controls an investee if and only if it has all of the following:

- Power over the investee
- Exposure, or rights, to variable returns from its involvement with the investee; and;
- The ability to use its power over the investee to affect the amount of the investor's returns.

Couvert apparently has power over the investee as it owns 55% of the share capital. The fact that the Couvert board members have not exercised control is not a determining factor in deciding whether Couvert has control over Ectal. However further information would be required regarding the rights of the shareholders to appoint board members. If Ygor has further rights to appoint more members of his family it could be that Couvert does not have control over Ectal.

If Couvert does not control Ectal under IFRS 10, then the investment cannot be recognised in the consolidated financial statements as a subsidiary and would be recognised instead as an associate.

(3) Actions to be taken by PG, and potential implications for the group audit report arising from the audit of Ectal by Stepalia

<u>Reassessment of audit risk</u>

We may need to reassess audit risk in respect of the investment in Ectal. Audit risk was originally assessed as moderate. There appear to be some good reasons for reassessing the risk as high:

(a) There are now questions over the effectiveness of Ectal's corporate governance and, especially, over the extent of Couvert's involvement in Ectal's governance.
(b) There is now an apparent risk that Ectal's opening figures were misstated and that due diligence was compromised.
(c) There is a continuing lack of communication from Stepalia LLP (see below).

If the due diligence engagement was not conducted thoroughly, PG's relationship with Couvert may be damaged, and engagement risk may increase.

Poor performance by Ectal's auditors, Stepalia LLP in respect of the audit for the year ended 31 August 2014

As at today's date, no returns or information have been received from Stepalia. ISA 600, Special Considerations – Audits of Group Financial Statements (Including the Work of Component Auditors) requires that group auditors should evaluate the work of the component auditor but currently it is not possible to do this.

We should take the following actions immediately:

- Seek a meeting with the Couvert finance director to explain that our group audit cannot be concluded satisfactorily unless full information is received about the Ectal audit from Stepalia.

- Attempt further direct communication with the Stepalia audit team via phone or email.

- Plan attendance at key audit meetings between Stepalia and Ectal's management. This is likely to involve a visit to Celonia before our audit completion deadline.

If we do not receive full information from the component auditors before our reporting deadline, the implication for our audit report is that modification may be necessary. This is likely to take the form of a limitation of scope opinion, which is material but not pervasive. The appropriate form of audit report would state a true and fair opinion (assuming no other audit modification was necessary in respect of Couvert and other parts of the group) except in respect of the audit of Ectal where insufficient information was received from the component auditors.

(4) Financial Reporting queries received by email from Couvert's finance director

Issue 1 – Accounting for retirement benefits

The following working shows the movement in the six-month period in respect of pension plan assets and obligations:

	Assets	**Obligations**
	£'000	**£'000**
Fair value/present value at 1 March 2014	8,062	8,667
Interest for six months to 31 August 2014 (£8,062,000 x 3%) (£8,667,000 x 3%)	242	260
Current service cost		604
Past service costs		500
Contributions paid into plan	842	
Benefits paid	(662)	(662)
Gain on plan assets (balancing figure – OCI)	146	
Gain on remeasurement (balancing figure – OCI)		(312)
Fair value/present value at 31 August 2014	8,630	9,057

The present value of obligations at 31 August 2014 has been adjusted upwards to take account of the additional £500,000 in plan liabilities in respect of the plan amendment. The increase in benefits has been announced and is therefore properly recognised as a liability.

Journal entries to reflect these transactions are as follows:

	Dr £'000	Cr £'000
Dr Staff costs (in respect of service costs)	1,104	
Cr Plan obligations		1,104
Dr Finance costs	260	
Cr Plan obligations		260
Cr Finance costs		242
Dr Plan assets	242	
Dr Plan assets – contributions to the scheme	842	
Cr Staff costs		842
Dr Pension plan assets – gain on plan assets	146	
Dr Pension plan liabilities – gain on plan liabilities	312	
Cr OCI actuarial gain		458
	2,906	2,906

The total gain on pension assets and liabilities is recognised in other comprehensive income. The six-month discount rate of 3% is applied to opening plan assets and liabilities, and the amounts calculated are added to plan assets and liabilities and credited/debited to finance costs in profit or loss.

Issue 2 – Financial asset

The put option appears to fulfil the definition of a derivative: its value changes in response to the changing price of an underlying security, its initial investment is small relative to the underlying value of the security, and it is settled at a future date. This being the case, the correct IAS 39 classification for the option is as a derivative at fair value through profit or loss. The initial recognition of the financial asset was therefore incorrect, and the following correcting journal is required:

	Dr £	Cr £
Dr Financial assets at fair value through profit or loss	63,000	
Cr Available-for-sale financial assets		63,000

The share price has fallen below the put option price of £6.00 and the option is therefore in-the-money. A gain can be expected on the option, measured at the year-end date of 31 August 2014 as the increase in the fair value of the option of £32,000 (£95,000 - £63,000).

The required journal entry is:

	Dr £	Cr £
Dr Financial assets at fair value through profit or loss	32,000	
Cr Profit or loss		32,000

Examiner's comments

Financial statement analysis

Most candidates made a reasonable attempt at the first part of the question which required analysis and explanation of Ectal's incomplete financial statements, plus queries for Ectal's management and its auditor. There were few really impressive answers, but most candidates managed to achieve at least half marks for this section.

Few candidates identified the risk that the prior year figures may have been manipulated to improve the price paid to acquire the subsidiary. The fact that the statement of profit or loss analysed expenses by nature rather than function was rarely commented on therefore caused problems in the calculation of standard ratios such as gross profit margin. Although some candidates commented on the loan from a director, it was very rare to see the loan related to the level of interest and the possibility that the interest being paid was excessive. Finally, disappointingly few candidates noted that the information given was incomplete thus limiting the amount of analysis that could be done and few identified the unexplained movement in retained earnings.

However nearly all candidates achieved all the available marks for identifying further enquiries to be made. Other points that were picked up and commented on by most candidates included:

- the significant and unexpected downturn in revenue
- the appearance for the first time of other income
- the high levels of employee expenses and the unexpectedly low level of depreciation
- the current year impairment and creation of a provision (most also commenting that these were potentially "one off " expenses)
- the decline in liquidity ratios and the low level of cash held at the year-end

Concerns about corporate governance and financial reporting implications

There were some very good answers to this part of the question which required identification and explanation of concerns about Ectal's corporate governance. However, relatively few candidates considered the potential impact of the corporate governance failings on the group financial statements. Very few candidates grasped the point that goodwill might be overstated and might require impairment.

Actions to be taken by PG and group audit implications

The third part of the question required an explanation of the actions that the group auditors, PG, should take in respect of the apparently inadequate performance by the component auditors, and an explanation of the potential effect on the group audit report. This part of the question was generally well-handled, although it was noticeable that a large minority of candidates failed to apply their knowledge of ISA 600 to the specific circumstances in the question. So, for example, many candidates wasted time on spelling out the actions that the group auditor should have taken at the start of the audit, rather than examining the actions that the group auditor should take now in the final stages. Most candidates managed to say something sensible about the implications for the group audit report.

Financial reporting treatment of defined benefit pension scheme and financial asset.

The fourth and final part of the question required the candidate to provide advice on accounting for retirement benefits (a defined benefit scheme) and for a derivative financial asset. Accounting for retirement benefits was generally well understood by candidates, although some seemed to spend a lot of time and space on their description of the adjustments. The aspect of the question that most got wrong was the past service cost with some candidates ignoring it altogether and others including it in the year-end liability but not the expense or vice versa. Most did identify that debiting current year contributions to staff costs was incorrect although some simply ignored what had been done and simply wrote out the standard journals to account for the movements in the pensions account.

Candidates generally fared less well with the financial asset. It was common to find that they did not understand that the financial instrument was a derivative and must therefore be recognised as fair value through profit or loss. A significant minority of candidates became heavily bogged down in discussions of hedging.

Question 2

Scenario

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

Requirement	**Technical marks**	**Skills**
• Explain the appropriate financial reporting treatment for each of the matters in the email (Exhibit 2) showing journal entry adjustments where possible. I will have the tax looked at separately, so please ignore any current or deferred tax adjustments	16	• Identify and explain appropriate financial reporting treatments • Identify when further information is required to provide recommendations • Explain the impact of the adjustments on statement of cash flows
• Prepare a revised statement of cash flows, after recording your correcting journal entries. Include a note reconciling profit before tax with cash generated from operations.	6	• Assimilate information from different parts of the scenario to prepare statement of cash flows
• Explain briefly why the revised statement of cash flows shows a net cash outflow from operating activities despite an increase in revenue	4	• Prepare relevant financial statement analysis to enable comparison of like-for-like sales • Apply scepticism to the increase in revenue based on the motivations of managers
Total marks	**26**	

Briefing Note to Manager

(1) Identify incorrect financial reporting treatments and recommend and set out appropriate adjustments required to the draft extracts

Investment property

The fair value of the investment property should reflect the market conditions at the reporting date. The valuation of £12 million should not be used as a fair value because the sale transaction appears to have been made with a buyer who was not knowledgeable of local market conditions and therefore not a market participant. The valuation of £9 million would better reflect market conditions. Therefore an adjustment is required to the financial statements to reflect the fair value of £9.0 million which reduces profit by £3 million.

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

Correcting journal:

	£'000	**£'000**
Dr Investment income	3,000	
Cr Investment property		3,000

Share options

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

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

The scheme conditions are non-market based. The fact that the share price has increased since the grant date is ignored when determining the charge to profit or loss. The continuing employment condition should be based on the best estimates at the statement of financial position date, which in this case is for 6 managers to leave and therefore only 94 to be employed at the vesting date.

The charge to profit or loss is therefore £1.08 million (10,000 × 94 × £4.60 × 1/3× 9/12). In addition this sum is also credited in the statement of financial position to equity. IFRS 2 does not state where in equity this entry should arise, and many companies add it to retained earnings.

	£'000	**£'000**
Dr Operating profit	1,081	
Cr Equity		1,081

Revenue recognition

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

Lease of equipment

The lease should have been treated as a finance lease since the equipment is specialised and specific to BathKitz business. Also the PV of MLP is substantially all of the cash price. Therefore the equipment should be recognised as an asset at the lower of PV of MLP and the fair value which is £16m. The implicit interest rate in the lease is 7% and therefore the asset and the obligation should be recognised on the SOFP at £16 million (£4.7 m x 3.387 = £16 million). A finance cost of (£16 m x 7%) x 3/12= £0.28 million and depreciation of £1m / 4 x 3/12 = £1 million will be recognised in profit or loss. The operating lease charge of £1.2 million will be reversed out of the statement of profit or loss and debited to provisions.

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

Dr Assets under finance obligations	16,000	
Cr Finance lease obligations		16,000

Being recognition of equipment as asset acquired under finance lease.

Dr Depreciation	1,000	
Cr Assets		1,000

Being depreciation of equipment over the lower term and useful life (4 years)

Dr Finance interest	280	
Cr Obligations under finance leases		280

Being recording of 3 months interest

Dr Provisions	1,200	
Cr Operating profit		1,200

Being reversal of provision for rental incorrectly made

Lease of warehouses

BathKitz should recognise the aggregate benefit of incentives as a reduction of rental expense over the lease term on a straight line basis. Therefore the amount of rental expense to be included should be:

Total rent expense over 4 years = ((£10 m x 3) + £5 m = 35 million over 4 years = £8.75 million therefore three months = £2.2 million.

Journals

	£'000	**£'000**
Dr Operating profit	2,200	
Cr Payables		2,200

Being an accrual for the warehouse rent taking into account the lease incentive.

Bonds

The convertible bond is a compound financial instrument per IAS 32 Financial Instruments - Presentation. IAS32 para 28 requires separation of the equity and liability components. This has not been done in the financial statement extracts of BathKitz.

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

	Cash flow £'000	**DF @ 7%**		**£'000**
30.09.2013	1,000	1/1.07	0.935	935
30.09.2014	1,000	$1/1.07^2$	0.873	873
30.09.2015	21,000	$1/1.07^3$	0.816	17,136
				18,944

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

£20m - £18,944m = £1.056 m

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

Journals

	£'000	**£'000**
Dr Bond	1.056	
Cr Equity		1.056
Dr Interest costs (18,944 x 7%)	1,326	
Cr Bond		1,326
Dr Bond	1000	
Cr Interest cost		1,000

(2) Draft cash flow statement at 30 September 2014

	£'000
Cash flows from operating activities	
Profit before taxation (see working 1)	36,052
Adjustments for:	
Depreciation (10,631 + 1,000)	11,631
Increase in provisions	2,050
Gain on investment property (4,000-3,000)	(1,000)
Investment income (Rental income - see below)	(1,200)
Share option expense – non cash investment	1,081
Interest expense (3,500 + 280 - 1,000 + 1,326)	4,106
	52,720
Increase in trade receivables	(53,978)
Increase in inventories	(23,090)
Increase in payables	29,600
Cash generated from operations	5,252
Interest paid (see working below)	(3,500)
Income taxes paid	(12,000)
Net cash used in operating activities	(10,248)
Cash flows from investing activities	
Rental income	1,200
Cash flows from financing activities	
Dividends paid	(5,000)
Proceeds from issuing bonds	20,000
Net cash flows from financing activities	15,000
Net increase in cash and cash equivalents	5,952
Cash and cash equivalents at beginning of period	12,670
Cash and cash equivalents at end of period	18,622

Working 1 - Adjusted profit

	£'000
Profit per the question	42,739
1. Investment gain	(3,000)
2. Share option	(1,081)
3. Depreciation on equipment	(1,000)
Reverse rent	1,200
Finance lease interest	(280)
4. Warehouse lease cost	(2,200)
5. Bond – actual coupon interest	(1,326)
Revised finance cost	1,000
Revised profit before tax	36,052

Working 2 - Interest paid

	£'000
Revised charge	4,106
Less finance lease interest	(280)
Less finance charge for bond	(1,326)
Add coupon interest on bond	1,000
Cash flow statement – interest paid	3,500

(3) Explain briefly why the revised statement of cash flows shows a net cash outflow from operating activities despite an increase in revenue.

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

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

Year ended 30 September	**2014**	**2015**
	£'000	**£'000**
Trade counter sales	804,550	737,334
Total trade discounts (242,110 – (54560 x 10%)	(236,654)	(184,334)
Revenue	567,896	553,000

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

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

Year ended 30 September	**2014**	**2013**
	Receivables days	**Receivables days**
Trade counter sales (£134.5m – £39m)/£567.896m x 365	61 days	53 days
'Pick and Collect' sales (£39./(£54.56m x 90%) x 365) x 3/12	72 days	N/A

As discussed above in part 2, the revenue recognition policy on Pick and Collect is inappropriate for this business and revenue may be overstated – customers are also taking longer to pay which has affected cash flow.

Examiner's comments

Financial reporting issues

The first part of this question required candidates to explain the appropriate financial reporting treatment of several matters set out in the question. Well-prepared candidates often scored full marks on this element of the question, producing impressive and comprehensive answers. Weaker candidates, however, revealed significant gaps in their knowledge of financial reporting. While many candidates produced the correct calculation for recognising the effects of the share option incentive scheme, it was common to find straight forward errors in the calculation.

The investment property issue was answered well and it was very common to see the correcting journal. The share options expense was also extremely well dealt with as were both the leases. Some candidates wasted time trying to make complex adjustments to revenue and costs for the new pick and collect sales when there was insufficient information to do more than highlight that revenue and receivables were both overstated.

Where errors were made they often included:

- taking the change in value of the investment property to equity rather than to profit and loss
- for the share options – failing to time apportion the current year expense /not adjusting correctly for the managers expected to leave/using the fair value of the option at the year-end rather than the grant date.
- for the finance lease – failing to capitalise at the lower of fair value and present value of minimum lease payments/ depreciating over useful life rather than lease term/failing to time apportion both interest and depreciation
- for the operating lease – failing to time apportion the current year expense

- for the compound instrument – making errors in the calculation of the discounted cash flows/preparing journals as if no entries had currently been made rather than correcting for the errors made.

Statement of cash flows

The second part of the question required a revised statement of cash flows. Some candidates, and not just the weaker ones, missed out this requirement altogether. Omitting parts of questions is risky and is not advised. Others produced only a very sketchy attempt at an answer and limited themselves to just making adjustments to profit. Candidates at Advanced Level are expected to be able to prepare, amend and interpret cash flow statements.

Explanation

The final part of the question required a brief explanation of why the cash flow statement showed a net cash outflow despite an increase in revenue. This part of the question was sometimes omitted. Those who did attempt it scored few marks because the answers mostly were generic in nature and not tailored to the specific circumstances of Bathkitz.

Answers were very disappointing and often very brief. Most candidates simply wrote generally about why cash outflows might arise often relating this to positive operating profits rather than the increase in revenue. Very few made use of the specific information in the question.

Question 3

Scenario

The candidate in this scenario is asked to review the audit procedures performed by a junior member of staff on payables and deferred tax. To answer this question the candidate needs to identify weakness and missing procedures and to recommend further audit procedures to enable a conclusion to be determined on the audit of ERE. There are also errors in financial reporting which the candidate needs to assimilate in order to recommend adjustments. A summary of uncorrected errors needs to be prepared from which the candidate should determine a reasonable course of action to enable the firm to arrive at an audit opinion on the financial statements of ERE.

Finally the candidate must identify the ethical issues arising from the scenario which relate to the potential weakness in the firms quality procedures and a potential fraud at the client.

Available Marks

Requirement	**Marks**	**Skills**
• Explain the key weaknesses in the audit procedures performed by Chris. Identify the audit risks arising in respect of ERE's payables and deferred tax liability and the audit procedures that should to be completed in order to address each risk	10	• Identify general and specific weaknesses in the work performed by Chris • Determine that the supplier statement sample should be based on throughput • Identify evidence of window dressing • Explain that need to identify date of goods received to determine appropriate cut off • Link large number of invoices in transit with cut off error • Identify the potential fraud relating to invoices 'on hold' • Recommend further explanations from those charged with governance. • Explain that there may be other non-sterling payables requiring adjustments • Determine that there may be unrecognised assets/obligations arising from hedge transactions • Recommend use of auditors' expert in respect of legal claim • Identify no audit work performed on balances in excess of materiality level • Identify audit risks and relevant procedures
• Identify and explain the financial reporting issues. Recommend appropriate adjustments	12	• Assimilate information from the scenario and identify correct and incorrect financial reporting • Recommend appropriate adjustments
• Summarise on a schedule of uncorrected misstatements the adjustments that you have recommended. Explain the further action that we should take in respect of the uncorrected misstatements	6	• Assimilate adjustments and present in appropriate format • Recommend a reasonable course of action to determine a conclusion on the audit of ERE.
• Identify and explain any ethical issues for HH, and recommend any actions for HH arising from these issues	6	• Determine lack of professional care in the quality of work performed to date • Explain the weaknesses in audit quality • Identify potential threat to independence and familiarity in relying on Josi

		• Identify management threat in assistance with financial reporting • Explain that an unaddressed fraud at client is a potential ethical issue for ERE • Determine the need to apply professional scepticism • Explain responsibilities under money laundering legislation.
Maximum marks	**34**	

(1) Explain the key weaknesses in the audit procedures performed by Chris King. Identify the audit risks arising in respect of ERE's payables and deferred tax liability and the audit procedures that should to be completed in order to address each risk.

General weaknesses

1. The working paper prepared by Chris does not adequately document the work he has performed.

2. There are no references to how he has calculated his sample size and how he has used the materiality level.

3. There is no evidence that he has carried out analytical procedures.

4. ISA 500 requires that audit evidence should be 'sufficient' and 'appropriate'. Appropriateness relates to the quality of evidence which should be relevant and reliable:
   - In terms of relevance, there is no reference to relevant audit assertions for each class of balance being tested. Nor has he identified which audit assertions are more relevant dependent upon the nature of each balance.

   - With respect to reliability, he has relied heavily on the client for oral evidence which is not an independent source. In so far as he has examined supplier statements this provides third party evidence but he has allowed the client to select the sample which reduces the quality of such evidence.

Specific weaknesses in work performed by Chris

<u>Trade payables</u>

1. It appears that the client chose the balances for the supplier statement reconciliation test on the basis of the largest balances at the year end. The client should not have selected the sample. Also it should have been selected based on throughput rather than year-end balance as the key risks are both understatement and overstatement.

2. Chris has also underestimated the amount of coverage of the sample selected since he has based the percentage coverage on the supplier balance not on the ledger balance. His sample represents 53% of the unadjusted purchase ledger balance.

3. The work performed on the cash in transit is inadequate and needs to be followed up – there is evidence here of window dressing and this point needs to be raised with the board. There is at least £1.2 million which has reduced the payables and cash balances at the year end and I have recorded £1.2 million on the schedule below. However, there may be more and the amount should be quantified and raised at the audit completion meeting.

4. The work on invoices in transit is not adequate. Chris should have determined when the goods were received rather than just when invoice was posted. If the goods were received pre year end, Chris should have agreed the amount to an accrual within goods received not invoiced and ensured that the goods were either in inventory or sold at the year end. Further audit procedures are required to provide assurance that payables are not understated by sampling goods received notes immediately prior to the year end and ensuring they are recognised in payables, particularly where they have not been invoiced at the year end.

5. The large number of invoices in transit on two suppliers may suggest a cut-off error so further emphasises that there is a need to do careful work here.

6. The explanation of the invoices on 'hold' is inadequate and should be taken forward to be discussed with those charged with governance. Potentially this is indicative of a fraud at a supplier company and has ethical implications and reputational risks for the firm and for ERE as there may be collusion with ERE staff – see below.

7. The calculation of the KH exchange gain is incorrect - see below financial reporting issues. The work performed by Chris is again inadequate. He should have enquired about other currency denominated creditors and how these have been treated at the year end.

8. Chris should also have asked whether there are any hedging arrangements in place for such large forex balances as there may be unrecognised derivatives at the year end.

9. The legal claim and Medex disputed invoices should be raised for discussion with the board and further audit procedures are required in terms of direct confirmation with the legal advisers and potentially an auditors' expert.

10. The adjustment to credit purchases is large - £850,000, and in excess of materiality, and there is no evidence that Medex has accepted liability and intend to issue credit notes for this amount. I have highlighted this on the schedule below.

11. The work on debit balances is inadequate – Chris should have investigated how and why such balances have arisen this year and whether they are recoverable.

<u>Other payables</u>

12. The provision for restructuring and the lease have been calculated incorrectly - see below under financial reporting issues. In terms of the audit procedures performed this is also limited. The division has now closed and Chris should have confirmed the restructuring costs to payments after the year end. There are also potentially further costs for impairments of non-current assets and receivables and no audit procedures appear to have been carried out to identify these.

13. No work has been performed on other accruals which has increased from last year even after taking account of legal costs, and exceeds the materiality level.

14. Deferred tax work is clearly inadequate - I have therefore summarised the risks and audit procedures in the following schedule:

<u>Audit risks and procedures</u>:

Audit risks	Procedures
• Risk of both over and understatement of year end trade payables –	• Re-perform a sample of supplier statement reconciliations based on throughput, obtain explanations for all reconciling items and recommend appropriate adjustments • Perform cut off procedures on supplier invoices, accruals – directional testing in both directions, both pre and post year end • Obtain explanation for debit balances and ensure recoverable • Obtain a list of credit notes after date and consider whether further adjustments are required • Obtain documentation in respect of disputed Medex invoices and assess appropriateness of the credit note accrual. • Quantify the total cash-in-transit and determine whether adjustment is required to eliminate window dressing. • Obtain permission from those charged with governance to contact Mesmet. If permission refused consider whether

	alternative procedures are possible to confirm the balance. Document for audit completion meeting the ethical implications of the invoices on 'hold' see below.
Foreign exchange	
• There is a clear risk that there may be other misstatements of Forex balances. • Inventory may be overstated if the goods purchased in other currencies are still in inventory at year end. • There may also be missing balances in respect of derivatives	• Review the list of trade payables for other currency balances and reform calculations of exchange gains and losses • Confirm with other team members that adequate testing has been performed on NRV for inventory • Enquire whether there have been any forward contracts undertaken in the year. Enquiries should be made of the finance director as this is unlikely to be an area which is the responsibility of the financial controller.
Other payables	
• Other payables may not be fairly stated	• Obtain a list of other payables, compare to previous year and supporting documentation. Verify to third party evidence and re-performing calculations as appropriate.
Provisions	
• There is a risk that there may be other similar balances that required discounting which may cumulatively be material.	• Review accruals schedule for other accruals which may need discounting and quantify the impact of such an adjustment
• There is a risk that impairments of assets in the factory have not been correctly assessed therefore non-current assets will be overstated. • Receivables relating to the division may also not be correctly stated.	• Confirm with other audit team members that adequate testing has been performed on impairments of receivables and non-current assets
• There could be additional liabilities which have arisen which were not originally in the budget.	• Review payments after date and ensure that the provision is fairly stated. Agree to supporting third party documentation.

Legal claim	
• The financial statements may not be fairly stated if the legal claim is not disclosed	• Make appropriate enquires of those charged with governance including obtaining representations • Review board minutes and correspondence with ERE's legal advisers • Ask for permission from those charged with governance to communicate directly with ERE's lawyer by means of a letter of enquiry with the reply sent direct to HH. • Consider all matters pertaining to the legal case up to the date of signing the audit report
Deferred tax There is a risk that the client lacks the appropriate financial reporting knowledge to prepare accurate deferred tax computations resulting in a misstatement of the financial statements.	• 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 given future forecasts of taxable profits.

(2) Identify and explain the financial reporting issues. Recommend appropriate adjustments

<u>Issue 1: Forex gain on KH balance</u>.

The purchase has been recorded correctly at the rate of exchange on 1 October 2013

	£'000	**£'000**
Dr Purchases	3,478	
Cr Trade payables		3,478

On 1 April 2014 ERE paid €2,000,000 to settle half of the trade payable (£1,739,130). This cost €2,000,000 / €1.20:£1 = £1,666,667 and the company therefore made an exchange gain of £72,463, which (assuming the credit has gone to profit or loss) has been correctly recorded as:

	£'000	**£'000**
Dr Trade payables	72	
Cr Exchange gains: profit or loss		72

However on 31 July 2014, the year-end date, the liability should be recalculated using the year-end balance: €2,000,000 / €1.27:£1 = £1,574,803 which gives rise to a further gain of £1,739,130 - £1,574,803 = £164,327

Further adjustment required

	£'000	£'000
Dr Trade payables	164	
Cr Exchange gains: profit or loss		164

Issue 2: Legal claim made by hospital

The issue here is whether the legal claim should give rise to a provision or a contingent liability requiring disclosure and, if possible, quantification; or if remote no disclosure. It appears likely that this issue represents a contingent liability and further audit procedures are required to determine and quantify the level of disclosure. There may also be an offsetting claim against Medex and an assessment must also be made of whether any disclosure can be made in respect of a contingent asset. At the moment there is insufficient information to determine the adjustment for this claim.

The legal fees have been correctly accrued. Given the size of the balance, discounting is unlikely to be material but should be quantified for the schedule of uncorrected misstatements below. I have used an annual discount rate of 5% for two years ($1/1.05^2$) to calculate the following adjustment:

100,000 x .907 = £90,700

However the interest rate should be confirmed as appropriate to this type of liability and level of risk.

Issue 3 Provision for restructuring

The provision for restructuring has been overstated and should not include the one-off payment nor the removal costs of the plant and machinery. An adjustment is required as follows:

	£'000	£'000
Dr Other payables	450	
Cr restructuring costs: profit or loss		450

Further adjustments will be required on completing of audit work in this area.

Issue 4: Lease cost

The signing of the lease is a past event which creates a legal obligation to pay for the property under the terms of the contract and is an obligating event. ERE has correctly created a provision for the onerous contract. This is calculated as the excess of unavoidable costs of the contract over the economic benefit to be received from it. The unavoidable cost is the lower of the cost of fulfilling the contract and the penalty arising from failing to fulfil it. If the effect of the time value of money is material it should be taken into consideration in calculating the provision.

The present value of the sublease arrangement is:

(£240,000 - £60,000) x 5.076 = £913,680

This is lower than the immediate payment of £1.1 million and therefore an adjustment is proposed of:

	£'000	£'000
Dr Other payables	186	
Cr Lease costs: profit or loss		186

This assumes that the 5% discount rate is correct. It should be confirmed that it is appropriate to this type of provision and level of risk.

Issue 5: Deferred tax

The offsetting of deferred tax assets and liabilities is permitted by IAS 12 provided that the entity has a legally enforceable right to offset current tax assets against current tax liabilities – this appears to be the case but further audit procedures should be carried out to confirm this.

A temporary difference arises with the upward revaluation of the head office building. This should be provided for in full and therefore the following adjustment is proposed:

	£'000	**£'000**
Dr Other comprehensive income	200	
Cr Deferred tax liability		200

Unused tax credits carried forward against taxable profits will give rise to a deferred tax asset to the extent that profits will exist against which they can be utilised.

The existence of unused tax losses, however, is strong evidence that future taxable profits may not be available. The deferred tax asset should be limited to the likely future profits - £1,250,000 x 20% = £250,000

	£'000	**£'000**
Dr Deferred tax: profit or loss	150	
Cr Deferred tax liability		150

Therefore the total deferred tax liability at year end is £790,000

(3) Summarise any proposed adjustments you have identified on a schedule of uncorrected misstatements and determine what further action we should take

	Statement of profit or loss		Statement of financial position	
	DR **£'000**	CR **£'000**	DR **£'000**	CR **£'000**
1. Window dressing - cash in transit				
Dr Cash			1,200	
Cr Payables				1,200
2. Medex disputed invoices				
Dr Purchases	850			
Cr Trade payables				850
3. Exchange gain on KH balance				
Dr Trade payables			164	
Cr Exchange gains: profit or loss		164		
4. Discount on legal fees				
Dr Accruals			10	
Cr legal costs		10		
5. Provision for restructuring				
Dr Other payables			450	
Cr Restructuring costs: profit or loss		450		
6. Lease costs				
Dr Other payables		186	186	
Cr Lease costs: profit or loss				
7. Deferred tax on office building				
Dr Other comprehensive income			200	
Cr Deferred tax liability				200
8. Deferred tax asset				
Dr Deferred tax: profit or loss	150			
Cr Deferred tax liability				150

Further action

Clearly some of these adjustments are material and will therefore be required so that the financial statements are fairly stated. However, the audit work to date would appear to be inadequate therefore I propose the following actions:

- Completion of audit work as proposed above.
- Review of the entire audit file and quantification of adjustments by an appropriately qualified member of staff.
- The schedule of uncorrected misstatements should also include any brought forward errors which impact on the current year's results and SOFP.
- Arrange a meeting with those charged with governance to discuss the adjustments
- Refusal to adjust or refusal to permit HH to obtain necessary explanations and confirmations may result in limitation of scope of audit work and an emphasis of matter or a modification of the audit report may be required.
- In accordance with ISA 530, *Audit sampling*, HH is required to project misstatements found in the sample into the population. If the projected misstatement (plus anomalous misstatement if any) exceeds the tolerable misstatement the sample does not provide a reasonable basis for conclusions about the population. HH may then (i) request management to investigate actual and potential misstatements, or (ii) perform further audit procedures.

(4) Identify and explain any ethical issues for HH, and recommend any actions you believe we should take

- For HH there is a professional ethical concern in respect of the quality of the work being performed. HH are not acting in accordance with the ethical code in respect of professional competence and due care.
- A junior member of staff appears to have been inadequately supervised and performed inadequate audit work to date. Although this has been identified on a timely basis on this assignment there may be quality issues with other assignments.
- Although there is no breach of the ethical code in respect of Josi's appointment at ERE, clearly relying on the work she is producing represents a threat to audit independence which needs to be addressed in the planning of audit procedures.
- There is evidence of poor training, lack of professional competence. Maybe also lack of policies in HH for addressing problems when staff members leave for employment with a client.
- There is potentially a fraud being perpetrated at an ERE supplier company, Mesmet. HH needs to determine whether there is collusion with ERE staff and the whether there is a material risk of misstatement of the ERE financial statements. This is an ethical issue for HH if the client has unaddressed ethical issues as this increases engagement risk for HH.
- HH should adopt an attitude of professional scepticism and obtain relevant audit evidence of this impact which should be documented including tests performed, discussions with audit team members and detailed enquiries made at the appropriate level of management and their responses.

- If fraud is suspected, HH should report to those responsible for governance at the appropriate level – as potentially the finance director is involved then this should be given careful consideration.
- There may also be responsibilities under the money laundering legislation and therefore we should consult the firm's MLRO.

Examiner's comments

<u>Comment on candidates' performance</u>

A significant minority of candidates' attempts at this question were perfunctory and partial. Some candidates omitted answering this question which makes being successful at the paper very difficult.

However, there were some excellent answers demonstrating a very high level of analysis skills and knowledge of auditing and financial reporting.

<u>Key weaknesses, risks and procedures</u>

The first requirement was an explanation of key weaknesses in the audit procedures carried out on payables by a junior member of the audit staff. There were many relevant points that could be identified in this respect and well-prepared candidates appeared to find little difficulty in scoring the maximum marks for this part of the question. Even weaker candidates were often able to score relatively highly on this, although their efforts were often marred by repetitious and sometimes irrelevant answers.

Candidates produced comprehensive answers that clearly identified the weaknesses in the work done as well as identifying risks and suggesting procedures. Most answers were in a logical format with candidates working their way methodically through the information given. The most common weakness was with regard to further procedures which were sometimes vague – " discuss with management" or inappropriate – suggesting contacting a supplier directly without first obtaining the client's permission.

<u>Financial reporting treatments and appropriate adjustments</u>

The second requirement was to identify and explain the financial reporting issues. This was generally less well-handled. Despite lengthy calculations and explanations, many candidates were unable to calculate an exchange gain. Weaker candidates were unsure about how, or if, to recognise a contingent liability, and relatively few identified the point about the need to discount the liability for legal fees. A significant number of candidates completely omitted any reference to the provision for restructuring. Of those that did address the provision for restructuring, few candidates realised that relocation and costs of removing plant and machinery should not be included. Well-prepared candidates were able in most cases to produce a correct calculation for the present value of the sublease arrangement, and the consequent correcting journal. Weaker candidates tended to omit any reference to this issue. Most candidates who got this far were able to calculate the deferred tax asset and deferred tax liability correctly, although some omitted to recommend adjustments.

Other common errors included:

- mis-calculating the foreign currency gain at the year- end by ignoring or dealing incorrectly with the impact of the part payment made / occasionally treating it as a loss rather than a gain.
- suggesting a provision should be set up even where the solicitors had advised that it was only possible the claim would succeed.
- failing to reverse out the adjustment for credit notes that had not been agreed with the supplier.
- identifying that there was an onerous lease but making errors in calculating the discounted future cash flows /failing to recognise that the provision should be at the lower of this figure and the termination cost/ adjusting for the entire amount rather than just correcting the provision already made.
- recognising the entire amount for the deferred tax asset re trading losses rather than calculating the adjustment to the asset currently recognised.

Schedule of uncorrected misstatements

The third part of the question required candidates to summarise their adjustments on a schedule of uncorrected misstatements. This requirement was often omitted. Missing out sections of questions is not advisable. Those candidates who did attempt it tended to produce just a list of journals, without any attempt to separate the profit or loss effects from the statement of financial position effects.

Those that did attempt to explain further action often achieved good marks for simple points such as discussing the errors with the client and considering the potential impact on the audit report.

Ethical issues

Finally, candidates were required to identify and explain any ethical issues in the scenario. Most candidates were able to gain a mark or two, at least, on this section and some did very well.

Most candidates made a reasonable attempt at identifying the ethical issues but the most common weakness was to focus almost entirely on the issue of a previous member of the audit team joining an audit client.

Other issues such as the quality of work performed by the junior member of the team, the potential fraud at a supplier and the motive to manipulate caused by the potential AIM listing were then often overlooked limiting the marks that could be awarded.