ADVANCED LEVEL EXAMINATION

MONDAY 3 NOVEMBER 2014

(3½ HOURS)

# CORPORATE REPORTING

This paper consists of **THREE** questions (100 marks).

1. Ensure your candidate details are on the front of your answer booklet.
2. Answer each question in black ballpoint pen only.
3. Answers to each question must begin on a new page and must be clearly numbered. Use both sides of the paper in your answer booklet.
4. The examiner will take account of the way in which material is presented.

**The questions in this paper have been prepared on the assumption that candidates do not have a detailed knowledge of the types of organisations to which they relate. No additional credit will be given to candidates displaying such knowledge.**

| | |
|---|---|
| **IMPORTANT**<br><br>Question papers contain confidential information and must NOT be removed from the examination hall.<br><br>**DO NOT TURN OVER UNTIL YOU ARE INSTRUCTED TO BEGIN WORK** | You MUST enter your candidate number in this box |

## QUESTION 1

You are Anton Lee, a recently-qualified ICAEW Chartered Accountant working for Pryce Gibbs LLP (PG), a firm of ICAEW Chartered Accountants. You are currently assigned as audit senior to the audit of Couvert plc for the year ended 31 August 2014. Couvert is a listed company.

Couvert sells high-quality carpets. It has struggled during the recession as demand for its products has fallen. However, the company's directors are now confident that it will benefit from the expected recovery in the carpet industry.

Couvert has several subsidiaries, most of them carpet retailers. In 2013, Couvert's directors decided to implement a strategy of vertical integration in order to protect the company's sources of supply. On 1 September 2013, as part of this strategy, Couvert acquired 55% of the ordinary share capital of Ectal, a carpet manufacturer based in Celonia. Background information on the investment in Ectal is provided (**Exhibit 1**). On 1 March 2014, Couvert also acquired 100% of the shares of Bexway Ltd, a UK carpet manufacturer.

Mary, the audit manager assigned to the Couvert audit for the year ended 31 August 2014, left PG last week to start a new job in Australia. The audit partner, Lucille Jones, has sent you the following email:

> **To:** Anton Lee, audit senior
> **From:** Lucille Jones, audit partner
> **Date:** 3 November 2014
> **Subject:** Couvert audit
>
> I have assigned a new audit manager to the Couvert audit, but he is currently concluding another engagement, and will not be able to join you until next week. In the meantime, there are several urgent tasks outstanding on the Couvert audit. Our deadline for completion of the audit work is 12 November 2014. Couvert is due to release its preliminary results to the stock market one week later.
>
> I am concerned that Couvert has only today received year-end financial information from its subsidiary Ectal (**Exhibit 2**) for consolidation into the Couvert group financial statements. I am also perturbed by the apparent lack of involvement by Couvert's management in Ectal's affairs. Ectal has not prepared regular management accounting reports during the year.
>
> Another concern is the conduct of the audit of Ectal by the local Celonian auditor, Stepalia LLP; they have not communicated the results of their audit to us. We originally assessed audit risk for Ectal as moderate, but given the lack of information received we may need to look at this assessment again. Ectal is material to Couvert's consolidated financial statements.
>
> Also, I've just received a request for advice regarding two financial reporting issues from Couvert's finance director. His email is attached **(Exhibit 3)**.

I would like you to prepare a working paper in which you:

(1) 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.

(2) 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.

(3) Explain, in respect of the audit of Ectal by Stepalia:

   i. the actions to be taken by PG; and
   ii. the potential implications for the group audit report

(4) Explain the appropriate financial reporting treatment for the two issues identified by Couvert's finance director (Exhibit 3).

**Requirement**

Respond to the audit partner's email.

**Total: 40 marks**

## Exhibit 1: Background information on Couvert's investment in Ectal

Ectal was incorporated twenty years ago in Celonia, a country well known in the carpet industry for the high quality of its wool products and its skilled labour force. The currency of Celonia is the Celonian dollar (C$).

Ectal was founded by Ygor Vitanie, who held a majority shareholding until, on 1 September 2013, Couvert purchased 55% of Ectal's ordinary share capital from him, at a substantial premium. The remaining 45% of the shares are now held as follows:

| | |
|---|---|
| Ygor Vitanie | 35% |
| Other members of the Vitanie family | 10% |

<u>Corporate governance arrangements</u>

Ygor is Ectal's managing director, and his daughter, Ruth, is the manufacturing director. There are three other directors nominated by Couvert. These are Couvert's managing director, finance director and operations director. Ygor has the casting vote in cases where voting is tied. Since 1 September 2013, Couvert's operations director has attended four of Ectal's monthly board meetings, Couvert's finance director has attended one board meeting in November 2013 and Couvert's managing director has been unable to attend any of the meetings because of other commitments.

<u>External audit arrangements</u>

PG does not have a correspondent or branch office in Celonia. The audit of Ectal continues to be conducted by a local Celonian audit firm, Stepalia, which was first appointed to the Ectal audit in 1997. PG issued group audit instructions to Stepalia several months ago, but has received very little information from Stepalia. Component materiality for the Ectal audit was set at the planning stage at C$20 million.

<u>Due diligence</u>

Due diligence in respect of Couvert's acquisition of Ectal was carried out jointly by PG and Stepalia. The principal member of PG's staff involved in the due diligence exercise was Mary, the PG audit manager who has just left the firm.

### Exhibit 2: Year-end financial information received from Ectal

The Ectal financial statements have been prepared in compliance with IFRS.

### Ectal: Statement of profit or loss for the year ended 31 August 2014

| | 2014 Actual C$ million | 2014 Budget C$ million | 2013 Actual C$ million |
|---|---|---|---|
| Revenue | 305.4 | 358.6 | 350.4 |
| Other income | 4.8 | – | – |
| | 310.2 | 358.6 | 350.4 |
| Change in finished goods and WIP | 5.9 | (8.3) | (18.6) |
| Raw materials and consumables used | (192.8) | (205.7) | (194.1) |
| Employee expenses | (26.3) | (25.8) | (21.0) |
| Depreciation expense | (52.4) | (60.8) | (59.4) |
| Impairment of property, plant and equipment | (60.0) | – | – |
| Other expenses | (29.7) | (21.0) | (21.2) |
| Finance costs | (5.1) | (5.0) | (5.0) |
| (Loss)/profit before tax | (50.2) | 32.0 | 31.1 |
| Tax | – | (10.0) | (9.3) |
| (Loss)/profit after tax | (50.2) | 22.0 | 21.8 |

### Ectal: Statement of financial position at 31 August 2014

| | 2014 Actual C$ million | 2014 Budget C$ million | 2013 Actual C$ million |
|---|---|---|---|
| Property, plant and equipment | 551.3 | 622.5 | 603.7 |
| Inventories | 98.0 | 90.0 | 92.1 |
| Trade receivables | 50.7 | 55.0 | 57.0 |
| Cash | 1.5 | 15.0 | 10.1 |
| Current assets | 150.2 | 160.0 | 159.2 |
| Total assets | 701.5 | 782.5 | 762.9 |
| Ordinary share capital | 5.0 | 5.0 | 5.0 |
| Retained earnings | 529.0 | 621.5 | 599.2 |
| Loan from director | 50.0 | 50.0 | 50.0 |
| Provisions | 16.0 | – | – |
| Non-current liabilities | 66.0 | 50.0 | 50.0 |
| Trade and other payables | 98.7 | 96.0 | 99.4 |
| Short-term borrowings | 2.8 | – | – |
| Current tax payable | – | 10.0 | 9.3 |
| Current liabilities | 101.5 | 106.0 | 108.7 |
| Total equity and liabilities | 701.5 | 782.5 | 762.9 |

**Exhibit 3: Email to Lucille Jones from Couvert's finance director**

Lucille

I would appreciate your advice on the following two financial reporting issues that affect Couvert's consolidated financial statements for the year ended 31 August 2014.

<u>Issue 1 – Accounting for retirement benefits</u>

As you know, the Group's pension plan is a defined contribution plan, which is open to employees in most, but not all, of our subsidiaries. However, as part of our vertical expansion strategy we purchased 100% of the shares of Bexway Ltd halfway through the financial year, on 1 March 2014. Bexway has a defined benefit scheme for senior staff. Bexway's accountant retired shortly after the takeover and there is now no-one at the company who understands the accounting for a defined benefit scheme. The only accounting entry that has been made since recognising the net pension liability on acquisition is in respect of employer contributions paid. This amount has been debited to staff costs.

I have the following information about the pension plan between 1 March 2014 and 31 August 2014:

| | **£'000** |
|---|---:|
| Current service cost for six months (estimated by actuary) | 604 |
| Fair value of plan assets at 1 March 2014 | 8,062 |
| Present value of plan liabilities at 1 March 2014 | 8,667 |
| Contributions paid into plan by Bexway on 31 August 2014 | 842 |
| Retirement benefits paid out by plan | 662 |
| Fair value of plan assets at 31 August 2014 (estimated by actuary) | 8,630 |
| Present value of plan liabilities at 31 August 2014 (estimated by actuary), not including amendment to plan (see below) | 8,557 |

On 14 April 2014, Bexway's directors decided to amend the pension plan by increasing the benefits payable to members with effect from 1 September 2014. From this date benefits will increase, as will the contributions payable by Bexway. I am informed by the actuary that the present value of plan liabilities should be increased by £500,000 at 31 August 2014 in this respect.

The applicable six-month discount rate is 3%.

I am unfamiliar with current practice in respect of accounting for defined benefit plans.

Please advise me of the correct accounting treatment for the plan for the six months ended 31 August 2014 and provide me with the appropriate journal entries for Bexway.

Issue 2 − Financial asset

On 1 April 2014 Couvert's board bought a put option contract over 500,000 shares in an Australian wool-producing company, The Brattle Company. The exercise price of the option is £6.00 per share and it will expire on 31 March 2015. The bank has supplied me with the following information about the put option:

| | **1 April 2014** | **31 August 2014** |
|---|---|---|
| Market price of one share in Brattle | £6.00 | £5.90 |
| Value of put option contract | £63,000 | £95,000 |

I recorded the initial investment of £63,000 as an available-for-sale financial asset, but I have made no other accounting entries in respect of this asset and I am not sure whether any adjustment is necessary. Please explain the appropriate financial reporting treatment for this item, and set out the appropriate journal entries.

I look forward to your response to my queries.

## QUESTION 2

You are an ICAEW Chartered Accountant employed as an analyst at the private equity firm, ADV Investments (ADV), which owns 20% of the equity shares in BathKitz plc. BathKitz is an AIM-listed company, which sells a range of flat-pack kitchens and bathrooms to building trade customers. Your manager, who has recently been appointed a non-executive director of BathKitz, gives you the following briefing:

"I have become increasingly concerned about ADV's investment in BathKitz. In particular, BathKitz's revenue has increased, but there has been a net cash outflow from operating activities. The financial controller of BathKitz provided me with some extracts from the draft financial statements for the year ended 30 September 2014 (**Exhibit 1**). I have performed some initial analysis on these and asked the financial controller for explanations of some of the numbers. The explanations were emailed to me today (**Exhibit 2**).

"I have to go to a meeting now, so I would like you to review the draft financial statements extracts, together with the explanations and prepare a briefing note for me. Specifically, in the briefing note I would like you to:

(1) 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.

(2) Prepare a revised statement of cash flows, after recording your correcting journal entries. Include a note reconciling the adjusted profit before tax with cash generated from operations.

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

### Requirement

Prepare the briefing note requested by your manager.

**Total: 26 marks**

## Exhibit 1: BathKitz draft financial statements extracts

### Draft summary statement of profit or loss for the year ended 30 September 2014

| | 2014<br>£'000 | 2013<br>£'000 |
|---|---|---|
| Revenue | 617,000 | 553,000 |
| Operating profit | 41,039 | 52,500 |
| Investment income | 5,200 | 1,200 |
| Finance costs | (3,500) | (1,000) |
| Profit before tax | 42,739 | 52,700 |
| Income tax expense | (10,000) | (11,000) |
| Profit for the year | 32,739 | 41,700 |

### Draft statement of financial position as at 30 September 2014

| | 2014<br>£'000 |
|---|---|
| **ASSETS** | |
| **Non-current assets** | |
| Property, plant and equipment | 42,535 |
| Investment property | 12,000 |
| | |
| **Current assets** | |
| Inventories | 93,062 |
| Trade receivables | 134,500 |
| Cash and cash equivalents | 18,622 |
| | 246,184 |
| | |
| **Total assets** | 300,719 |
| | |
| **EQUITY AND LIABILITIES** | |
| Share capital and share premium | 70,000 |
| Retained earnings | 45,339 |
| | 115,339 |
| | |
| Long-term borrowings | 31,260 |
| Trade and other payables | 103,120 |
| Current and deferred tax | 23,000 |
| Provisions | 28,000 |
| | 185,380 |
| | |
| **Total equity and liabilities** | 300,719 |

**Draft statement of cash flows for the year ended 30 September 2014**

| | £'000 | £'000 |
|---|---|---|
| **Cash flows from operating activities** | | |
| Profit before taxation | 42,739 | |
| Adjustments for: | | |
| Depreciation | 10,631 | |
| Increase in provisions | 3,250 | |
| Gain on investment property | (4,000) | |
| Interest expense | 3,500 | |
| | 56,120 | |
| Increase in trade receivables | (53,978) | |
| Increase in inventories | (23,090) | |
| Increase in trade payables | 27,400 | |
| Cash generated from operations | 6,452 | |
| | | |
| Interest paid | (3,500) | |
| Income taxes paid | (12,000) | |
| Net cash used in operating activities | | (9,048) |
| | | |
| **Cash flows from financing activities** | | |
| | | |
| Dividends paid | (5,000) | |
| Proceeds from issuing bonds | 20,000 | |
| Net cash from financing activities | | 15,000 |
| | | |
| **Net increase in cash and cash equivalents** | | 5,952 |
| | | |
| Cash and cash equivalents at beginning of period | | 12,670 |
| Cash and cash equivalents at end of period | | 18,622 |

 

**Exhibit 2: Email from financial controller**

Email to: Manager ADV
From: Financial controller, BathKitz
Date: 3 November 2014
Subject: Explanations - BathKitz financial statements

Please find below the explanations as requested:

**(1) Gain on investment property**

The gain recognised of £4 million in respect of the investment property reflects a fair value increase at 30 September 2014 on BathKitz's property located in the TarkHill Shopping Centre. This property is one of three similar properties at the same location. The other two properties were owned by a company unconnected to BathKitz. This company sold one of the properties for £9 million in April 2014 to an investment company based in London and the other property to an overseas investor for £12 million in May 2014. The overseas investor was interested in making an initial purchase in the property market in the UK and was therefore willing to pay a higher price than local institutions would have been prepared to pay.

In accordance with BathKitz's accounting policy, I have revalued BathKitz's investment property to a fair value of £12 million. The change in the property's fair value has been recognised in investment income together with the rental income of £1.2 million.

**(2) Increase in revenue**

BathKitz supplies flat-pack kitchens and bathrooms to building trade customers. The BathKitz sales managers are authorised to negotiate a discount with customers on the standard price list.

There are two explanations for the increase in revenue:

<u>(i) Share option incentive scheme</u>

Revenue increased because 100 managers have been motivated by the implementation of a share option scheme on 1 January 2014. At that date each manager was granted options over 10,000 shares at an exercise price of £5.80 per share, which was the market price at 1 January 2014. Each option gives the right to buy one share in BathKitz. The options vest on 1 January 2017 subject to the following conditions:

(a) The manager remains in the employment of BathKitz until 1 January 2017; and

(b) Revenue for their depot increases by an average of 10% per year over the three years of the vesting period.

The fair value of an option was estimated to be £4.60 at 1 January 2014 and £4.80 at 30 September 2014. The price of one BathKitz share at 30 September 2014 was £5.90.

At 30 September 2014, all 100 managers were still employed, but the directors estimate that six managers will leave the scheme before 1 January 2017 when the options will vest.

As there is no cash cost to the company, no adjustment has been made to the financial statements for the share options, but the motivational impact has already been seen in the increase in revenue, particularly in the last three months of the year.

(ii) New ‘Pick and Collect’ sales

Since incorporation, BathKitz has operated only by means of trade counter sales. Trade counter customers visit a depot to order and collect their goods. The number of depots has been constant for many years. Customers receive 60 days’ credit and BathKitz recognises revenue on collection of goods by the customer from its depots.

Following an internal review, a new online sales system was developed called ‘Pick and Collect’. The system allows trade customers to order goods online and collect directly from the depot. To service this system, 10 new depots were opened on 1 July 2014 in various locations in the UK. Revenue from these sales is recognised when the order is placed online by the customer and sales are made at a standard discount of 10% off list price and 60-day credit terms. An analysis of revenue is as follows:

| **Year ended 30 September** | **2014**<br>**£’000** | **2013**<br>**£’000** |
|---|---|---|
| Trade counter sales | 804,550 | 737,334 |
| ‘Pick and Collect’ sales | 54,560 | - |
| Total trade discounts | (242,110) | (184,334) |
| Revenue after trade discounts | 617,000 | 553,000 |

The ‘Pick and Collect’ sales have created problems with credit control as existing customers continue to take 60 days’ credit from when they collect their goods, which can be up to two weeks after placing the order online. Receivables from ‘Pick and Collect’ customers were £39 million at the year end, which included £10 million for goods sold and not collected.

**(3) Decrease in operating profit margin from 9.5% (2013) to 6.7% (2014)**

BathKitz installed automated storage and retrieval equipment in its depots. The equipment, which is highly specific to BathKitz’s business, was acquired by means of a lease with EG Capital. The lease, which commenced on 1 July 2014, has an implicit annual interest rate of 7%, and BathKitz is required to make four annual payments of £4.7 million payable in arrears. The equipment could have been purchased for a cash price of £16 million. A rental expense of £1.2 million, for the three months to 30 September 2014, has been included in operating expenses and in provisions. The equipment has a useful life of six years with a zero residual value.

**(4) New depot leases**

BathKitz rents its 10 new depots from a property company called HYH on four-year operating leases which commenced on 1 July 2014. The total annual rentals have been agreed at £10 million. However, as an incentive to sign the lease, HYH gave BathKitz an initial rent-free period of six months, which means that BathKitz will pay £35 million in total. As the rent payment had not been paid at the year end, no charge has been made in the statement of profit or loss.

 

### (5) Increase in long-term borrowings

To finance expansion, on 1 October 2013 BathKitz raised £20 million by issuing, at par, 5% three-year convertible bonds. The issue proceeds of £20 million have been credited to long-term borrowings. The coupon interest has been paid to the bond holders on 30 September 2014 and has been recognised in finance costs for the year. The annual market rate of interest for a similar bond with a three-year term, but no conversion rights, is 7%.

At the choice of the holders, the bonds can be either redeemed at par on 30 September 2016 or converted into ordinary shares in BathKitz at the rate of one ordinary share for every £10 bond held.

**QUESTION 3**

ERE Ltd designs, manufactures and installs medical equipment for healthcare providers. ERE is currently unlisted but its shareholders are considering an AIM listing within the next three years. The chief executive, Frank Mann, owns 30% of the shares in ERE and the remaining 70% are owned by private equity investors. ERE has a 31July accounting year end.

You are Tom Tolly, an audit senior with Ham and Heven LLP (HH), a firm of ICAEW Chartered Accountants. HH has audited ERE for a number of years. You have just returned to work after study leave and you have received the following email from your audit manager setting out your assignment for today.

**To:** Tom Tolly
**From:** Audit manager
**Date:** 3 November 2014
**Subject:** ERE – audit of payables and deferred tax for the year ended 31 July 2014

ERE's financial controller, Josi Young, is a former employee of HH. She left HH in August 2014 before completing her training contract and shortly afterwards secured a job with ERE. Josi had been a member of the ERE audit team for a number of years before leaving HH.

I assigned Chris King, a junior audit assistant, to the payables and deferred tax sections of the ERE audit as I felt confident that Josi would be able to provide him with some assistance. However, I now have some concerns with the work that he has produced. I have attached a working paper that I asked Chris to prepare summarising the audit procedures he has performed on payables and deferred tax (**Exhibit**). I would like you to review this working paper and prepare a report for me in which you:

(1) 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 and the audit procedures that should to be completed in order to address each risk.

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

(3) 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.

(4) Identify and explain any ethical issues for HH, and recommend any actions for HH arising from these issues.

**Requirement**

Prepare the report requested by your audit manager.

**Total: 34 marks**

**Exhibit: Working paper - prepared by Chris King**

**ERE: Audit procedures for payables and deferred tax for the year ended 31 July 2014**

The planning materiality is £120,000.

Payables and deferred tax per the statement of financial position are as follows:

| | Reference to audit procedures | 2014 £'000 | 2013 £'000 |
|---|---|---|---|
| Trade payables | **(i)** | 13,709 | 14,628 |
| Other payables | **(ii)** | 2,620 | 550 |
| Deferred tax | **(iii)** | 440 | 950 |

**(i) Audit procedures for trade payables**

Trade payables comprise:

| | 2014 £'000 | 2013 £'000 |
|---|---|---|
| Trade payables ledger balances | 11,820 | 12,036 |
| Add: Debit balances | 345 | 52 |
| Add: Goods received not invoiced | 1,544 | 2,540 |
| Total trade payables | 13,709 | 14,628 |

Trade payables ledger balances

I reviewed a sample of 10 supplier statement reconciliations selected for me by Josi, who has performed reconciliations for all the major suppliers.

I re-performed the reconciliations for the three largest suppliers, which represented 89.8% of the total trade payables balances at 31 July 2014, as follows:

| | Mesmet plc £'000 | KH GmbH £'000 | Medex £'000 |
|---|---|---|---|
| Balance per ledger | 2,563 | 1,739 | 1,962 |
| Payments in transit | 950 | - | 250 |
| Invoices in transit | 525 | - | 540 |
| Mesmet invoices 'on hold' | 1,230 | - | - |
| Disputed Medex invoices | - | - | 850 |
| Balance per supplier statement | 5,268 | see below | 3,602 |
| % of trade payable ledger balances | 44.6 | 14.7 | 30.5 |

I agreed payments in transit to the cash book and to the bank reconciliation. All payments were presented within 30 days of the year end.

All invoices in transit were agreed to invoices posted in August 2014.

Mesmet invoices 'on hold'

I queried the invoices 'on hold' on Mesmet's supplier statement. Josi was unsure about these invoices, but said that they have now 'disappeared' from Mesmet's most recent supplier statement. ERE's finance director has told her not to contact Mesmet to query these invoices as he deals personally with the Mesmet finance department.

KH

KH is a new supplier and invoices ERE in euro. The supplier statement shows a balance of €2,000,000 at 31 July 2014. On 1 October 2013, ERE purchased a large consignment of monitors from KH for €4,000,000 and recorded this transaction at the exchange rate on that date. ERE paid €2,000,000 to KH on 1 April 2014 and made a final payment of €2,000,000 on 1 November 2014 at the exchange rate on that date of €1.28:£1. The year-end ledger balance has been adjusted for an exchange gain. I have checked the calculation of the exchange gain using the following exchange rates:

| | **€/£** | **€'000** | **£'000** |
|---|---|---|---|
| 1 October 2013 | 1.15 | 4,000 | 3,478 |
| 1 April 2014 | 1.20 | (2,000) | (1,667) |
| Exchange gain | | | (72) |
| Year-end balance | | | 1,739 |

The €/£ exchange rate at 31 July 2014 was €1.27:£1.

Disputed Medex invoices

I queried the £850,000 of disputed Medex invoices with Josi and have noted below her explanation:

Medex supplies components to ERE. ERE used these components to manufacture its oxygen units, which are installed for hospital customers in operating theatres. On 10 August 2014, legal proceedings were commenced against ERE by a hospital which claims that failure of the oxygen units installed by ERE during the year ended 31 July 2014 caused delays to the performance of operations. The hospital is claiming £1.2 million compensation for loss of income.

On 14 September 2014, ERE appointed legal advisers who suggested that it is possible, but not likely, that the claim will succeed. However, the legal advisers estimate that, if the case is settled, it would be in July 2016. Also, they have advised that legal costs will be £100,000, which will also be settled at that date. Josi has included an accrual for the legal fees as part of 'other payables' (see below). The ERE board does not want to disclose any information regarding the legal case as the directors believe that it will cause reputational damage for ERE.

ERE believes that the Medex components were faulty. Therefore Josi has requested credit notes from Medex in respect of invoices for these components and has credited purchases with £850,000 and debited the Medex payable ledger account.

Debit balances

This is an adjustment to reclassify debit balances as receivables. I have checked that the debit entry of this adjustment is included in receivables.

Goods received not invoiced

I reviewed the list of goods received not invoiced and noted several items dating from January 2014. Josi informed me that she is still chasing invoices from the suppliers for these goods but as the amount involved is only £115,000, and therefore less than materiality, I have not carried out any further audit procedures.

**(ii) Audit procedures for other payables**

Other payables comprises:

| | **2014** | **2013** |
|---|---|---|
| | **£'000** | **£'000** |
| Legal fees (see above) | 100 | - |
| Provision for restructuring: | | |
| Redundancy payments | 270 | |
| One-off payments to employees for relocation costs | 50 | |
| Costs of removing plant and machinery | 400 | |
| | 720 | - |
| Lease cost of factory | 1,100 | - |
| Payroll and other current taxes | 200 | 200 |
| Other accruals | 500 | 350 |
| Total | 2,620 | 550 |

Provision for restructuring

On 1 October 2014, ERE closed down a manufacturing division which operated from a factory in the North of England. I have agreed the provision for restructuring to the budget and also to the board minutes which stated that negotiations with employee representatives and the factory landlord were completed on 30 July 2014 and a formal announcement was made to all employees on 31 July 2014.

Lease cost of factory

ERE signed a 10-year lease for the factory on 1 August 2010 at an annual rental of £240,000, payable annually in arrears. It was noted in the board minutes that, following the closure of the division on 1 October 2014, ERE has the choice of subleasing the factory to another company for the remaining six years at an annual rental of £60,000 payable annually in arrears; or paying £1.1 million as compensation to the factory landlord to terminate the lease. The directors asked Josi to obtain more information and to prepare calculations using an annual discount rate which reflects the time value of money of 5%. Until this information is made available, a provision of £1.1 million has been made in the draft financial statements.

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**(iii) Audit procedures for deferred tax**

Josi has provided the following deferred tax computation and notes:

Deferred tax computation

| | **£'000** |
|---|---|
| Taxable temporary difference: | |
| Carrying amount of plant and equipment at 31 July 2014 | 12,800 |
| Tax base of plant and equipment at 31 July 2014 | (8,600) |
| Taxable temporary difference on plant and equipment | 4,200 |
| | |
| Deferred tax liability on taxable temporary difference at 20% | 840 |
| Deferred tax asset in respect of carried forward trading losses | (400) |
| Deferred tax balance | 440 |

Notes:

Accounting profits equal taxable profits except in respect of depreciation.

ERE made a tax loss of £2 million in the year ended 31 July 2014. Under current tax legislation this loss can be carried forward indefinitely. ERE has prepared a budget for 2015 and 2016 which shows taxable profits of £500,000 and £750,000. No projections are available after this date due to the uncertainty of tax law.

ERE revalued its head office building on 31 July 2014. The revalued carrying amount at 31 July 2014 was £5 million and its tax base was £4 million. Gains on property are charged to tax at 20% on disposal. However ERE has no intention of selling its head office therefore no deferred tax liability has been recognised.

I have agreed the carrying amount of plant and machinery to the financial statements and the tax base to the company tax return.