MARK PLAN AND EXAMINER'S COMMENTARY – Corporate Reporting July 2014

This report includes:

- A summary of the scenario and requirements for each question.
- The technical and skills marks available for each part of the requirement.
- A description of how skills should be demonstrated.
- Detailed points for a full answer.
- Examiner's commentary on candidates' performance.

The information set out below was that used to mark the questions. Markers were encouraged to use discretion and to award partial marks where a point was either not explained fully or made by implication.

Question 1 - UHN

Scenario

In this scenario the candidate is in the role of an audit manager being asked to take over in the final stages of an audit of UHN. UHN is a manufacturing company which has survived the recession but is still reliant on bank support who monitor performance against gearing and interest cover ratios calculated on the year-end audited financial statements. The company is easily meeting these ratios provided that the accounting policy choices of the directors are appropriate and the accounting treatment of certain financial reporting issues is correct.

These financial reporting issues have been identified by the audit senior as areas which he believes the board has exercised significant judgement in the choice of accounting policies. Issue 1 involves a sale and lease back arrangement - the lease back is on the cusp of being treated as either an operating lease back or a finance lease and therefore a matter on which the directors have exercised judgement. Issue 2, an impairment charge involving an overseas asset where the accounting rules have been applied incorrectly. Issue 3, a hedge for delivery of titanium where the directors have chosen (incorrectly) not to apply hedge accounting despite satisfying the conditions; and Issue 4 where a liability has been treated incorrectly as a provision. The impact of the adjustments for these issues is that the interest cover ratio is still met but the gearing covenant would be breached.

The candidate is required to propose appropriate financial reporting treatments, adjust the financial statements in order to recalculate the covenant ratios based upon their recommendations and to identify the key audit risks arising from the review of the seniors notes. The candidate is required to exercise scepticism in their recommendations to distinguish accounting errors from areas where judgement has been applied. In particular the candidate is required to recognise that although there is potentially judgement to be exercised by the board, this is acceptable if the accounting policy choices are within the substance of the relevant IFRS.

In addition the firm has been asked to tender for a one-off audit assignment. The candidate is asked for a report on the ethical implications of this tender for the firm.

Requirement	Marks	Skills assessed
• Set out and explain the implications of the financial reporting issues in Greg's handover notes. Make recommendations on the appropriate financial reporting treatment where relevant.	20	• Determine the appropriate financial treatment for the property. • Identify that the sale of land has been appropriately treated as an operating lease. • Calculate the present value of the minimum lease payments • Calculate the recoverable amount of the service centre based on the year-end rate • Determine that no impairment has arisen • Recommend the impairment is reversed • Identify and explain the incorrect treatment for the hedge and recommend appropriate adjustment. • Identify that provision is now liability and increases long term liabilities

		• Determine the adjustment required to correct over provision and reclassification of provision to liability.
• Using your recommendations above, evaluate and explain the impact of your adjustments on the gearing ratio and the interest cover ratio in accordance with the bank's loan covenants (Exhibit 1).	6	• Assimilate information to adjustment financial statements for the proposed adjustments • Calculate gearing ratio and interest cover • Identify potential breach of covenant.
• Outline the key audit risks we need to address before signing our audit opinion on the financial statements. I do not need the detailed audit procedures, just concentrate on the key risks	9	• Determine and explain the key audit risks arising - including going concern, use of inexperienced staff, and implication of covenants on managements' judgement, implications of the accounting errors identified.
• Prepare a file note explaining the ethical implications for our firm if we decide to tender and, if successful, accept this one-off assurance assignment	5	• Determine that the proposed engagement would be a 'non-audit' assignment. • Identify threats to independence and self-review • Explain the implications of undertaking work beyond the capabilities and expertise of the firm.
Maximum marks	**40**	

Working Paper - Prepared by Audit Manager

For the attention of Petra Chainey

I have examined the issues identified by the audit senior as follows:

Issue 1 Sale and leaseback

The transaction includes two elements

- Sale and leaseback of the property itself; and
- Sale and leaseback of the land on which the property stands.

In the case of the leaseback of the land on which the property stands, IAS 17 requires the lease to be classified as an operating lease. The profit on the land has been correctly recognised as an operating lease and this asset correctly derecognised.

The directors' justification for the treatment of the lease on the property as an operating lease is not correct. IAS 17 identifies 5 factors which would lead to the conclusion that a lease should be classified as a finance lease. There is limited information regarding 2 of these situations and more information would be required; (i.e. whether there is an option to purchase, and whether the asset is so specialised that it could only be used by the lessee without major modification.)

However there is information to assess the application of the two factors; the lease term and the relationship of the PV of the MLP and the fair value of the asset at the inception of the lease.

The asset was purchased in 2004 and had a useful life at that date of 30 years. Therefore at 31 March 2014 at the inception of the lease, the 20 year lease term is for the entirety of the assets' remaining useful life. This is strong evidence that the company has entered a finance lease for the factory building. We would need to consider if the assessment of useful life has changed but if not, this is reasonably strong evidence that the lease term is for the entire useful life of the building.

The present value of discounted future rentals relating to the building is £763,900 x £6m/£7.5m = £611,120 × 20-year annuity discount factor @ 8 %, ie £611,120 × 9.818 = £6 million. The fair value of the building at the inception of the lease is £6 million. Therefore this is strong evidence that the leaseback of the building is a finance lease.

Therefore as regards the building, from the information provided, it would appear that UHN has entered into a sale and finance leaseback and this would significantly change the picture presented in both the statement of profit or loss and the statement of financial position.

If the factory leaseback is a finance lease, the transaction is a means whereby the lessor provides finance to the lessee, with the asset as security. The excess of fair value (where fair value equals proceeds) over the carrying amount (£3.040 million) should be deferred and amortised over the term of the lease. As the lease was taken out at the year end, no profit should be recognised on the lease back of the building.

The finance lease is then recorded in the normal way, with the asset and corresponding liability both initially recognised at £6 million which is the lower of the fair value and the present value of minimum lease payments.
Correcting journals

	£'000	**£'000**
Dr Exceptional item	3,040	
Cr deferred income more than 1 year (£3.04m x 19/20)		2,888
Cr deferred income current year £3.040m /20 years		152
Dr PPE	6,000	
Cr Finance lease creditor – long term liabilities see working below		6,000
Cr Current liabilities		130
Dr Finance lease creditor – long term liabilities	130	

Finance lease creditor

£m b/f	£m Lease payment due on 31.3.2015	£m finance charge 8% in arrears	£m c/f	Due > 1 year	Due< 1 year
			6.00	5.87	0.13
6.0	(0.61)	0.48	5.87		

Issue 2 – impairment of service centre

The restrictions imposed by the government would indicate impairment and the directors have correctly carried out an impairment review.

Financial reporting treatment

	RUB
Cost	266
Depreciation	44
Carrying amount	222

Expressed in RUB, the asset is impaired because the recoverable amount, which is the fair value less costs to sell of RUB 204 is greater than value in use of RUB 180.

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

Thus the carrying amount in £s is 222/53 = £4.189m
The recoverable amount in £s is 204/48 = £4.25m

Therefore no impairment charge is required

Correcting journals

	£'000	**£'000**
Dr PPE	375	
Cr Cost of sales		375

This is an error and must be adjusted.

Issue 3 Hedge

The directors have not applied hedge accounting correctly and therefore an adjustment is required to reflect the profit on the movement of the price of titanium held in inventory at 31 March 2014. The directors have already taken the loss to operating profit. However as hedging is applied a gain must be recognised in the income statement to reflect the movement in the value of the inventory

	£'000	**£'000**
Dr Inventory 680,000 kg x £15 = £10.2 million- Cost £8.2 million	2,000	
Cr income statement - Gain on inventory		2,000

The net gain recognised in profit or loss is £232,000.

Therefore the hedge is effective 1.768m/2.000m = 88.4%

Issue 4 Provision for claim for damages

The provision should now be classified as liability as the timing and amount are no longer uncertain. It would therefore form part of the long-term borrowings of the company and be taken into consideration when applying the bank gearing covenant. The provision stands at 9.26 million at 31.3.2014 (£10 million x 0.926 = £9.26 million).

The liability has been agreed to be £9.1 million. 25% will be payable within the next 12 months £2.275 million. The balance will be due after more than 1 year and should be discounted for 1 year.

	Short term £'000	**Long term £'000**	**Total £'000**
Provision	740	8,520	9,260
Actual liability	2,275	6,825 x 0.926 = 6,320	8,595
	(1535)	2200	(665)

Correcting journals

Provisions should be reclassified to liabilities and then

	£'000	**£'000**
Dr Long term liabilities	2,200	
Cr Profit and loss		665
Cr Short term liabilities		1,535

Recalculation of the gearing ratio and the interest cover ratio in accordance with the covenant with the bank (Exhibit 1).

Year ended 31 March 2014	**Statement of profit or loss**						
	Before						**After**
	£'000	Issue 1	Issue 1	Issue 2	Issue 3	Issue 4	**£'000**
Revenue	(56,900)						(56,900)
Operating costs:	49,893			(375)	(2,000)	(665)	46,853
Exceptional item (*Issue 1*)	(3,540)	3,040					(500)
Operating profit	(10,547)						(10,547)
Finance costs	2,200						2,200
Profit before tax	(8,347)						(8,347)
Statement of financial position							
ASSETS							
Non-current assets	**£'000**						
Property, plant and equipment (*Issue 2*)	20,040		6,000	375			26,415
Current assets	**£'000**						
Inventories (*Issue 3*)	21,960				2,000		23,960
Trade receivables	15,982						15,982
Cash and cash equivalents	128						128
Total assets	58,110						66,485
EQUITY AND LIABILITIES							
Equity	**£'000**						
Share capital – ordinary £1 shares	(1,000)						(1,000)
Share premium	(15,000)						(15,000)
Retained earnings - deficit	500						500
Total equity	(15,500)						(15,500)
Non-current liabilities	**£'000**						
Loans	(20,000)						(20,000)
Long-term liability – (*Issue 4*)	(8,520)					2,200	(6,320)
Finance lease creditor and deferred income		(2,888)	(5,870)				(8,758)
Deferred tax liability	(1,000)						(1,000)
Total non-current liabilities	(29,520)						(36,078)

Current liabilities	**£'000**						
Trade and other payables	(12,350)						(12,350)
Short-term provision – (*Issue 4*)	(740)					(1,535)	(2,275)
Finance lease creditor and deferred income		(152)	(130)				(282)
Total current liabilities	(13,090)						(14,907)
Total equity and liabilities	(58,110)	-	-	-	-	-	(66,485)

Conclusion
Therefore although the covenant in respect of the interest cover ratio is still satisfied, the impact on the gearing ratio changes significantly and it is now breached.

Interest cover ratios

Before and after

10,547/2200 = 4.79 times

Gearing ratio
Net debt defined as long-term borrowings and long-term payables (excluding provisions)

Equity (Share capital and reserves)

After			
Loans	20,000		
Long-term liability	6,320		
Finance lease creditor and deferred income	8,758		
		35,078	
Equity		15,500	226%
Before			
Loans		20,000	
Equity		15,500	129%

The key audit risks to be addressed before signing our audit opinion on the financial statements.

Inappropriate accounting treatments
The directors are under pressure to meet covenant requirements and although clearly the interest cover ratio can be easily met, the gearing ratio covenant is encouraging the directors to be creative in their judgements. This represents a key risk for the audit firm and would require the exercise of scepticism in areas of judgement made by management. For example other areas of judgement in this type of industry would be inventory, bad debt provisions and warranty provisions.

Correction of accounting errors
Whereas there is judgement involve in the treatment of the sale and lease back (issue 1), and further discussion will be required with the directors over this matter, issue 2 the impairment of the service centre and issue 4 the incorrect categorisation of the provision are less subjective and adjustments should be proposed for correction of this accounting treatment. The outcome of these issues would result in the gearing covenant being breached. Clearly with covenants in place, any adjustment exceeds the materiality of £100,000. The materiality level should therefore be revisited and other areas of the audit re-examined in the light of a recalculated materiality level.

Going concern

A key audit risk is therefore going concern. If the covenant is breached UHN will need to show the loan as short term whether or not they are able to reschedule and the company does not have sufficient cash to repay the loan if it is recalled immediately.

Consideration should be given to whether the going concern is affected by the breaching of the gearing covenant. Initially we should discuss with management their relationship with the bank and the probability of funding being withdrawn and their contingency plans to obtain an alternative funding arrangement.

The effect of UHN being unable to meet its covenant does not necessarily mean that the entity is not a going concern if the financial risk of this event can be counterbalanced by management's plans to reschedule its loan capital.

The directors are required to report that the business is a going concern with assumptions or qualifications if necessary as part of their responsibilities under the UK corporate governance code. The listing rules also require auditors to review the annual statement by the directors that the business is a going concern. As part of the audit we will have performed audit procedures to examine the directors' review of going concern to establish whether the use of this assumption is appropriate. ISA 570 requires auditors to consider the same period used by management therefore in the first instance we will need to discuss with management their assessment of going concern. We should ensure that management's assessment considers the financial risk of the withdrawal of the loan funding.

If there is adequate disclosure in the financial statements by the directors regarding the uncertainties about going concern then an unmodified audit opinion with an emphasis of matter paragraph is likely to be sufficient. If the directors do not disclose going concern uncertainties appropriately, however, it may be necessary to modify the audit opinion.

Audit quality

There is also a risk arising from the use of inexperienced audit staff on the assignment – additional review procedures will be required to mitigate this risk.

File Note – the ethical implications for our firm tendering and, if successful, accepting the one-off assurance assignment

Petra suggests that the fee for this work would be lower as we could use some of our findings as part of the audit work. ES 5 specifically prohibits other work undertaken by the engagement team from being categorised as part of the audit. This is because the nature of the work is not to gather evidence to support the audit opinion and the nature and extent of the assignment will not be determined by the auditor but by the terms of the engagement agreed with the client.

This assignment would therefore be called a 'non-audit related service'. The firm should identify any threats to independence and objectivity. If a low fee for the work is agreed as suggested in the email, then this would clearly be a threat to independence. We would need to consider the relative size of the engagement fee in relation to the audit fee and discuss with the ethics partner.

Other considerations here of the nature of the proposed work and whether it breaches rules and principles of ES5 – If this is of an advisory nature there is a risk that firm would be auditing its own work when assessing the arrangement for audit purposes. There is also a hint here that the firm is being pressurised by the client with threat it might lose audit and this in itself would be a threat which should be carefully considered.

The firm should not undertake work for which it does not have expertise. There is a basic requirement that ICAEW Chartered Accountants act in accordance with professional competence and behaviour. Doing work which is beyond their knowledge would be a breach of the ICAEW ethical code.

Examiners' comments

General comment on candidates' performance

The prepared candidates answered this question very well. The technical aspects were identified and candidates were able to distinguish between those issues when the directors had exercised of judgement and those where the directors had applied an accounting treatment inappropriately or incorrectly. The strong candidates also applied scepticism and recognised the potential for deliberate manipulation to meet covenants as motivation for the directors' actions. Good candidates also adjusted the relevant balances, calculated gearing and interest cover and made appropriate comments and identified a range of risks arising from the scenario.

Weaker candidates unfortunately demonstrated technical weakness and understanding of the topics. It was not uncommon to see a failing candidate omit one or more issues. Although follow through marks were available for calculating and commenting on gearing and interest cover, weak candidates found difficulty in calculating the gearing ratio pre-adjustments despite the definition being given in the question paper.

Detailed comments

Requirement 1 – Financial reporting implications of the issues identified

Issue 1 Sale and lease back

The land would normally represent an operating lease and therefore the gain would have been appropriately recognised. Some candidates questioned this and full marks were awarded.

Also as the transaction has happened at the year end, there would be no charge for interest in the current year. Candidates seemed very keen to put through adjustments when these were not required.

Showing the portion of the finance lease as non-current was important to the gearing calculation and many candidates missed this point.

Issue 2 Impairment of service centre

A common mistake made by candidates was to not appreciate that a 1 year depreciation charge needs to be deducted before calculating the impairment charge. Weaker candidates used inappropriate rates or very weak candidates failed to translate altogether.

Issue 3 Hedge

For those candidates who had prepared for this assessment, this was a fairly straight forward issue. However many candidates wasted unnecessary time writing out vast sections of the accounting standards instead of applying to the scenario.

Issue 4 Provision

It was very pleasing to see that candidates appreciated the difference between a provision and a liability which of course would then significantly impact on the gearing ratio as the directors had chosen not to adjust the provision. What was less pleasing was the inability to discount and show adjustments. Many candidates failed to interpret the SOFP, and did not realise that the provision comprises of a current and non-current element. This was not a technically difficult issue. For well- prepared candidates, this issue presented no difficulties.

Requirement 2 – Explain impact on gearing and interest cover ratio.

Most candidates realised that the adjustments they proposed would change the ratios. Well prepared candidates achieved full marks easily on this section. Full follow-through marks were awarded and marks awarded for sensible comments.

However plenty of candidates demonstrated basic inabilities to adjust a set of financial statements and to calculate basic ratios.

Requirement 3 – Key audit risks

The major weakness here was to repeat the same weakness for each of the issues – ie the accounting is wrong - without seeing the issues behind the incorrect accounting treatment and the decisions of the directors regarding those treatments - the third requirement is broader and not just relating to the financial reporting of the issues. Weak candidates would fail therefore to achieve many marks for this section because their answer did not address the breadth of audit risks which arise in this scenario.

Better candidates produced a full range of risks and scored well on this section.

Ethics

This section was attempted well by both weak and strong candidates. Candidates demonstrated good application of the ethical framework and understanding of the treats arising from the scenario.

Question 2 – Snedd

Scenario
This question involves adjusting the financial statements of three companies (a parent and two subsidiaries), and applying the principles of acquisition accounting to produce consolidated financial statements. The most recently acquired subsidiary is based overseas, and its results and position (in the form of a trial balance) require translation. Other issues covered include adjustments within and outside the measurement period, an adjustment to the overseas financial statements in order to comply with IFRS, payment of a supplier in ordinary shares and deferred tax adjustments.

Requirements	**Marks**	**Skills assessed**
(i) For each of the outstanding issues I have identified, set out and explain the correct financial reporting treatment, showing appropriate adjustments		• Analyse information from trial balance. • Apply technical knowledge to determine appropriate adjustments. • Link information to reconcile exchange loss • Identify incorrect entries and recommend appropriate adjustments • Evaluate the most appropriate accounting treatments based on the scenario. • Assimilate information concerning shareholdings to determine accounting treatment • Link information in respect of exchange rates to consolidation of overseas subsidiary and adjustments
• Acquisition of Bellte • Acquisition of Terald • Share-based payment • Deferred tax	8 7 3 4	
(ii) Prepare Snedd's consolidated statement of profit or loss and other comprehensive income for the year ended 31 May 2014 and a consolidated statement of financial position at that date. Take into account any adjustments for the outstanding issues and set out your workings showing how you arrived at your consolidated figures so that I can understand them	8	• Assimilate adjustments and prepare consolidation schedule • Present notes and workings in appropriate format
Maximum marks	**30**	

Explanation of the correct financial reporting treatment, showing appropriate adjustments

1. Acquisition of Bellte

Goodwill on the acquisition date of 1 June 2013 was originally calculated as follows:

	£'000	£'000
Consideration transferred		800.0
Non-controlling interest (25% x £922)		230.5
		1030.5
Net assets acquired		
Net assets at carrying amount	932.0	
Less: contingent liability at fair value	(20.0)	
Add: fair value uplift in specialist plant (£60,000 - £50,000 (W1))	10.0	
		922.0
Goodwill on acquisition		108.5

W1: Carrying amount of specialist plant at 1 June 2013: 5/10 x £100,000 = £50,000
However, the goodwill amount of £108,500 was based upon provisional values. IFRS 3, Business Combinations, requires that during the measurement period following acquisition the acquirer should retrospectively adjust provisional amounts recognised at the acquisition date to reflect new information obtained about the facts and circumstances that existed at the acquisition date.

In this case, the settlement of the contingent liability occurred within the measurement period (which cannot exceed 12 months). The valuation of the specialist plant, however, did not occur until after the 12 months had elapsed, and therefore the provisional fair value cannot be retrospectively altered.

The recalculation of goodwill is as follows:

	£'000	£'000
Consideration transferred		800.0
Non-controlling interest (25% x £902)		225.5
		1,025.5
Net assets acquired		
Net assets at carrying amount	932.0	
Less: contingent liability at fair value	(40.0)	
Add: fair value uplift in specialist plant (£60,000 - £50,000 (W1))	10.0	
		902.0
Goodwill on acquisition		123.5

Goodwill is increased by the group's share of the additional value of the contingent liability (£40,000 - £20,000) x 75% = £15,000. NCI at acquisition is decreased by £5,000.

Tutorial note:
Journal entries are required as follows:

	£'000	£'000
DR Goodwill	15	
DR Non-controlling interests	5	
DR Contingent liability recognised	20	
CR Bellte operating expenses		40
	20	20

Treatment of specialist plant:
In the consolidated financial statements this plant was recognised at the date of acquisition, 1 June 2013, at its provisional fair value of £60,000. At that date it had a remaining useful life of five years. Because the valuation of the plant was made after the end of the maximum measurement period of 12 months, the estimate of its value at the date of acquisition of 1 June 2013 was no longer relevant, and therefore the provisional amount is not adjusted retrospectively.

In Bellte's own financial statements the carrying amount of the specialist plant at 31 May 2014 was: £50,000 - (£50,000/5) = £40,000, i.e. depreciated cost.

The carrying amount of the specialist plant in the consolidated financial statements at 31 May 2014 is calculated as follows:

£60,000 - (£60,000/5) = £48,000.

The consolidation adjustment required in respect of depreciation is:

(£60,000/5) - (£50,000/5) = £2,000.

Tutorial note: A journal entry is required as follows:

	£'000	£'000
DR Cost of sales	2	
CR Non-current assets		2

2. Investment in Terald Inc

First, an adjustment must be made in respect of the measurement of the financial asset. The increase in fair value is D$5,000 which must be recognised as a gain in profit or loss, and as an increase in the carrying amount of the asset.

Profit for the year in Terald is D$20,000 (Revenue L$150,000 - cost of sales D$112,000 - operating expenses D$15,000 - tax D$3,000) before accounting for the fair value increase in respect of the financial asset, all of which is attributable to the post-acquisition period. Of the D$20,000 profit half is attributable to the pre-acquisition period (first six months of the year) and half is attributable to the post-acquisition period. Therefore, equity at the date of acquisition, 1 December 2013, was D$160,000 (Share capital D$10,000 + retained earnings at 1 June 2013 D$140,000 + pre-acquisition profit: D$10,000).

The amounts to be consolidated by Snedd are therefore as shown in the table below. In compliance with IAS 21, The Effects of Changes in Foreign Exchange Rates, profit or loss items are translated at average rate, and financial position items are translated at closing rate.
Profit or loss:

	D$000	Rate	£'000
Revenue (150/2)	75	2.1	35.7
Cost of sales (112/2)	(56)	2.1	(26.7)
Gross profit	19	2.1	9.0
Operating expenses (15/2)	(7.5)	2.1	(3.6)
Other income (fair value increase in financial asset	5	2.1	2.4
Profit before tax	16.5	2.1	7.8
Tax (3/2)	(1.5)	2.1	(0.7)
Profit for the six months ended 31 May 2014	15.0	2.1	7.1

Statement of financial position:

	D$000	Rate	£'000
Non-current assets (160 + 5)	165	2.2	75.0
Current assets	50	2.2	22.7
Total assets	215		97.7
Current liabilities	40	2.2	18.2
Therefore: equity	175	2.2	79.5
	215		97.7

Reconciliation of exchange gain/loss

Opening net assets of £80,000 (D$160/2) plus profit of £7,100 = £87,100. Closing net assets at closing rate = £79,500. Therefore there has been an exchange loss of £7,600 (£87,100 - £79,500):

Exchange Loss

	£'000	£'000
Opening net assets of L$160 at opening rate of 2.0	80.0	
Opening net assets of L$160 at closing rate of 2.2	72.7	
		7.3
Profit for the six months ended 31 May 2014 of D$15.0 at average rate of 2.1	7.1	
Profit for the six months ended 31 May 2014 of D$15.0 at closing rate of 2.2	6.8	
		0.3
Exchange loss		7.6

Goodwill on consolidation is calculated as follows:

	D$000
Consideration transferred: £100,000 x 2.0	200,000
Less: net assets of Terald at date of acquisition	(160,000)
Goodwill	40,000

On 1 December 2013, the sterling equivalent of goodwill was D$40,000/2 = £20,000.

This is retranslated on 31 May 2014 at the closing rate of exchange of 2.2 = D$40,000/2.2 = £18,200 (to nearest £'000). There has therefore been a loss on exchange of £20,000 - £18,200 = £1,800.

The overall exchange loss of (£7,600 + £1,800) £9,400 is recognised in other comprehensive income.

3. Deferred tax

Temporary differences for Snedd at 31 May 2014:

	£'000
In respect of accelerated capital allowances	300
In respect of revaluation surplus	600
	900
Deferred tax liability to be recognised: £900,000 x 22%	198

At 31 May 2013 Snedd's deferred tax balance was £92,000. A further £106,000 is required to increase the deferred tax balance at 31 May 2014 to £198,000. The element of deferred tax relating to the revaluation surplus must be calculated and presented separately in other comprehensive income:

£600,000 x 22% = £132,000. This leaves a credit of £26,000 (£132,000 - £106,000) to be credited to income tax expense.

Temporary differences for Bellte at 31 May 2014 are £180,000. Calculated at 22%, the deferred tax liability to be recognised is £180,000 x 22% = £39,600. The deferred tax balance at 31 May 2013 was £46,000, and therefore the adjustment required is to debit deferred tax and credit income tax expense in profit or loss with £46,000 - £39,600 = £6,400.

The debit to other comprehensive income is £132,000
The total credit to consolidated income tax expense is £26,000 + £6,400 = £32,400.
The total credit to consolidated deferred tax is £106,000 - £6,400 = £99,600

4. Payment of a supplier in shares

The issue of shares to Whelkin Ltd falls within the scope of IFRS 2, Share-based Payment. It is an equity-settled transaction because, essentially, Snedd has received goods in exchange for an issue of shares. This type of transaction, with a third party, is normally measured at the fair value of goods and services received, and should be recorded when the goods are received. The fair value of the issue of 270 shares to Whelkin is therefore measured at £6,000 which is the value of the goods provided to Snedd. The consultant's estimate of the fair value of Snedd's shares at 31 May 2014 is not relevant.

The prescribed accounting treatment is to recognise the fair value of the goods provided in profit or loss, with a credit to equity. In this case, the fair value of the goods has already been recognised in profit or loss as part of purchases of goods for production. The adjusting entry is to derecognise the trade payable of £6,000 from current liabilities, with a corresponding credit to equity

Snedd Group – Consolidated statement of profit or loss and other comprehensive income for the year ended 31 May 2014

	£'000
Revenue	10,732.7
Cost of sales	(7,170.7)
Gross profit	3,562.0
Operating expenses and finance costs	(2,004.2)
Profit before tax	1,557.8
Tax	(350.3)
Profit for the year	1,207.5
Other comprehensive income	458.6
Total comprehensive income for the year	1,666.1
Profit attributable to:	
Owners of the parent	1,168.4
Non-controlling interests (W 1)	39.1
	1,207.5
Total comprehensive income attributable to:	
Owners of the parent	1,627.0
Non-controlling interests	39.1
	1,666.1

Snedd Group – Consolidated statement of financial position at 31 May 2014

	£'000
ASSETS	
Non-current assets	
Goodwill	141.7
Property, plant and equipment	5,058.0
	5,199.7
Current assets	2,973.7
Total assets	8,173.4
EQUITY AND LIABILITIES	
Equity attributable to owners of the parent	
Share capital	306.0
Retained earnings W2	4,225.4
Other components of equity	458.6
	4,990.0
Non-controlling interests	264.6
Non-current liabilities	
Deferred tax	237.6
Current liabilities	2,681.2
Total equity and liabilities	8,173.4

W 1 Non-controlling interests - Bellte

	£'000
At 1 June 2013 (as in revised goodwill calculation)	225.5
NCI share of profit for the year: (£112 + 40 (Contingent liability) - 2 (additional depreciation) + 6.4 (deferred tax – see section 3) x 25%	39.1
At 31 May 2014	264.6

W 2 Consolidated retained earnings

	£'000	£'000
Snedd: £4,075,000 plus deferred tax £26,000		4,101.0
Bellte: £1,014,000 less pre-acq of £902,000	112.0	
Adjustments: (£40,000 operating expenses – £2,000 depreciation + £6,400 deferred tax)	44.4	
	156.4	
Group share: 75%		117.3
Terald: post-acquisition (£75,000 - £67,900 see W4)		7.1
At 31 May 2014		4,225.4

W 3 Snedd Group - consolidation schedule at 31 May 2014

	£'000 Snedd	£'000 Bellte	£'000 Terald	£'000 Adj 1	£'000 Adj 2	£'000 Adj 3	£'000 Adj 4	£'000
Revenue	8,511.0	2,186.0	35.7					10,732.7
Cost of sales	(5,598.0)	(1,544.0)	(26.7)	(2.0)				(7,170.7)
Gross profit	2,913.0	642.0	9.0					3,562.0
Operating	(1,541.0)	(502.0)	(3.6)	40.0	2.4			(2,004.2)
PBT	1,372.0	140.0	5.4	38.0	2.4			1,557.8
Tax	(354.0)	(28.0)	(0.7)				32.4	(350.3)
Profit for the year	1,018.0	112.0	4.7	38.0	2.4		32.4	1,207.5
OCI	600.0				(9.4)		(132.0)	458.6
TCI	1,618.0	112.0	4.7	38.0	(7.0)		(99.6)	1,666.1
Assets								
Goodwill				123.5	18.2			141.7
PPE	3,512.0	1,463.0	75.0	8.0				5,058.0
Investments	900.0			(800.0)	(100.0)			–
Current assets	2,365.0	586.0	22.7					2,973.7
Total Assets	6,777.0	2,049.0	97.7	(668.5)	(81.8)			8,173.4
Equity & Liabilities								
Share capital	300.0	30.0	*4.5	(30.0)	(4.5)			300.0
RE	4,075.0	1,014.0	75.0	(902.0)	(67.9)		32.4	4,225.4
				38.0	(*W4*)			*(W5)*
				(39.1)				
Reserves	600.0				(9.4)	6.0	(132.0)	464.6
NCI				225.5				264.6
				39.1				*(W2)*
Deferred tax	92.0	46.0	–				99.6	237.6
Current liabs	1,710.0	959.0	18.2			(6.0)		2,681.2
Equity & Liabilities	6,777.0	2,049.0	97.7	(668.5)	(81.8)	–	–	8,173.4

* Share capital in Terald, translated at closing rate of 2.2 (10/2.2)

W 4 Elimination of pre-acquisition retained earnings in Terald

	£'000
Total equity in Terald at 31 May 2014 (see translation of statement of financial position in section 2 of answer)	79.5
Less: Share capital translated at closing rate of 2.2	(4.5)
Retained earnings at 31 May 2014	75.0
Post-acquisition retained earnings (see translation of statement of profit or loss in section 2 of answer)	(7.1)
Pre-acquisition retained earnings	67.9

Examiners' comments

General comment on candidates' performance

There are examples of overseas subsidiary consolidation in the learning materials and it also formed the basis of a question in the sample paper. Therefore this question should not have been unexpected for candidates preparing for this assessment. The question included a standard consolidation of a UK subsidiary, which is covered in the financial accounting and reporting paper at professional level. It was very often this basic knowledge which was missing in the weak candidates. There were plenty of marks to be gained from dealing logically with the specific financial reporting issues in advance of preparing the consolidation itself.

Detailed comments

Acquisition of Bellte

Well prepared candidates had little difficulty in setting out the required implications of the adjustments arising from the remeasurement of the liability and the subsequent determination outside of the measurement period of the fair value of the machine.

It was pleasing to see that candidates appreciated that these issues would impact on the measurement of goodwill. Although it was not uncommon for weaker candidates to make the wrong assumptions about the measurement period or to miscalculate the dates (30 June 2014 – is in fact 13 months after the acquisition date - 1 June 2013). Plenty of candidates also went on to calculate the extra depreciation charge arising on the adjustment to fair value but a significant minority did not appreciate that this adjustment was for consolidation purposes only. There were also some references to revaluation reserves which were poorly explained.

Overseas subsidiary.

Well prepared candidates were able to produce relevant workings to show how the financial statements of Terald were to be translated and the calculation of exchange losses and the appropriate accounting treatment. Goodwill was very often correct and the appropriate exchange adjustment calculated.

Common errors were:

- Taking a full year of results for Terald instead of 6 months
- Not adjusting for the fair value adjustment for the financial asset
- Using inappropriate rates
- Recognising exchange adjustments in profit for the year instead of OCI

Deferred tax

Candidates were aware of deferred tax which was a positive point. There seemed to be little difficulty in calculating the in-year timing differences and appreciating that these would impact on the profit or loss (and OCI in respect of the revaluation). However even the better candidates sometimes failed to spot the brought forward deferred tax liabilities on the respective balance sheets and therefore processed the whole timing differences as a movement to profit or loss and OCI instead of calculating the movement between the closing and opening liabilities. Also worrying to see was that sometimes all three companies were adjusted on a group basis instead of identifying deferred tax for the individual companies prior to consolidation. Deferred tax and current tax are key advanced level topics and the coverage in the learning materials is extensive. Candidates would be advised to prepare well for this topic.

Payment of a supplier in shares

Most well prepared candidates scored maximum marks for this and this issue presented little difficulty. Poorly prepared candidates scored very little.

Preparation of consolidation.

If the ground work was done carefully and with clear workings, some candidates produced consolidated SOFP and statement of profit or loss. Weaker candidates demonstrated large holes in prior knowledge. For example – it was not uncommon to see candidates taking a 75% share of Bellte's results and assets? Or fail to cancel cost of investments with pre-acquisition reserves and share capital. Questions at advanced level assume basic understanding of technical topics and will continue to progress from these skills and technical issues acquired in earlier studies.

Question 3 – ETP

Scenario
The candidate is the audit senior planning aspects of the audit of a listed company which supplies data storage and secure archiving systems.

The planning aspect of the scenario requires the candidate to identify and explain risks arising from a number of new and complex revenue streams and also from diminishing performance in other areas of the business. The candidate is also required to critique and raise review notes on a rather high level and inadequate preliminary analytical review prepared by an inexperienced assistant. The relevant information needs to be pulled together to draw conclusions and the explanations gained by the assistant should not be taken at face value.

The candidate is asked to comment on the benefits arising from an auditor's review of the interim financial statements. Key in this response is the candidate's ability to link errors identified in the current period and the potential recognition error of revenue in the next interim reporting period to identify that a key benefit for the company of the assurance review procedures would be to protect the directors from issuing incorrect financial interim financial reports

Requirement	Marks	Skills
(i) Prepare review notes on Joshi's work (Exhibit 2), explaining the weaknesses and limitations in the procedures he has performed and performing additional analysis where you think this is required. Set out clearly the additional audit procedures you would like him to complete and the queries you would like him to resolve.	12	• Identify weaknesses in the work performed by the assistant. • Link decline in sales to obsolescence issue. • Assimilate information regarding change in recognition of revenue in system sales to KPI. • Perform appropriate financial statement analysis to appreciate like for like comparison in systems revenue growth has fallen. • Identify the need for further information and analysis. • Recognise the gaps in the work performed on gross margin. • Explain the significance of potential cut off errors on services revenues and margins.
(iii) Identify and explain the further financial reporting issues and related audit risks you have identified from the information provided, and outline for each the implications for our audit approach	10	• Apply technical knowledge of IAS 18 to identify audit risks arising from client's change in recognition of revenue. • Explain the greater need for judgement and professional scepticism involved in the revenue recognition policy for systems projects • Identify potential prior year adjustment, explaining when such adjustment would be not be appropriate. • Appreciate that change required in audit approach in providing assurance over costs and % of completion. • Link fall in revenue growth to inventory obsolescence issues and identify appropriate risks. • Recommend a more appropriate revenue recognition policy for 'all in' advice packages to match against costs of providing the service. • Explain that the loss on the contract must be recognised in full. • Identify the audit risks arising from potential cut off errors on training revenue.

(iii) Explain how a review of the interim financial statements for the period to 31 March 2015 would differ from a statutory audit and set out the benefits of such a review for ETP.	8	• Apply technical knowledge to determine that revenue would be inappropriately recognised in the interim financial statements. • Explain benefits to review procedures on interim results: credibility, prevention of errors, and reassurance for directors. • Assimilate information from different parts of the question • Explain the scope and extent of procedures.
Maximum marks	**30**	

(i) Review notes on Joshi's work explaining weakness and limitation in his procedures; my additional analysis and additional audit procedures for Joshi to complete on analytical review

While it is relevant to look at the KPI's ETP has identified we also need to think about whether there are any other indicators we should be considering in our preliminary analytical review procedures. Would normally expect these to cover all significant balances as well as the key ratios so there is more work to be done.

Additional procedures

- Consider KPIs used in Board reporting and ensure that all relevant KPIs are included in our analysis
- Complete analytical review of all significant balances

Joshi has used comparator companies that were used in last year's audit working paper. We need to assess whether the comparator group of companies remains relevant and the best indicator of overall market performance. We should also consider whether the same group has been used for all revenue streams and, if so, whether this is appropriate or whether a more focused comparator group would give a better comparison against which to assess ETP's performance.

Additional procedures

- Using discussions with client and industry knowledge, determine whether there are other groups of comparator companies which would give a better comparison.

Explanations have only been sought from the financial controller, Julie Barwell who may not be in the best position to understand the performance of the company and the factors

Additional procedures

- Extend our discussions to other more senior management, including those responsible for the relevant area such as sales or divisional management.
- Seek to corroborate explanations received by looking at corroborative evidence wherever possible.

Declining sales in Stor-It devices may lead to an obsolescence problem and increased storage costs. Procedures will be required on inventory valuation.

Systems sales growth – your analysis shows a 25% growth rate, indicating that sales for the comparative prior year period which were recognised on a completed contract basis were £80.2million. Looking at current year sales on a comparable basis, they would amount to £70.3million (£100.3m -£30.0m (the revenue from part completed contracts)) which is a decline of 12%. This is against market trends and considerably poorer than the budgeted growth figure of 10% which does appear aggressive compared to market. Your analysis does not explain this decline at present.

Additional procedures

- Obtain further explanation and analysis

Excluding revenue from the new "all-in" package, sales of training and consultancy have declined. Possible that customers have switched from previous billing arrangements to "all-in" package but would be useful to have further analysis.

Additional procedures

- Obtain further analysis, showing, in particular, split between training and consultancy and how each revenue stream has moved as level of detail we have at present may not be sufficient to understand underlying trends and fluctuations. This applies to margin and debtor analysis as well.
- Ensure that the revenue recognition policy is appropriate and assess whether income should be prepaid.

In gross margin analysis there is no comment on the lower margin for hardware – this is out of line with budget and prior year and might imply that additional discounts are being offered.

Additional procedures

- Obtain explanation of fall in margin.
- Obtain management perspective on why margin achieved is so much lower than that for competitors – this may well be due to decline in market for ETP Stor-It products and / or mix of products sold. Prior year margin was also much lower so worth understanding reasons we were given last year.

Systems gross margin – analysis is incomplete at present would be helpful to show more detailed analysis between margins on completed and partially completed projects so can understand fully the extent of the distortion arising. Overall margin amounts to £100.3 @ 46% = £46.1m. Assuming margins on completed projects remained as in prior year at 44.8%, that accounts for 70.3 @ 44.8% = £31.5m, meaning that £14.6m relates to the partially completed projects. Of that a £1million loss was made on one project with revenue of £3.6million, meaning that a margin of £15.6million (59%) was made on the remaining new project revenue of £26.4million which appears high.

Additional procedures

- Request more detailed analysis from client.

Additional overall margin on services is £17.9m @ (63.9-50.1) = 13.8% = £2.5m, much higher than would arise on the £800,000 training revenue recorded in the wrong period explained by the assistant. It seems likely that some of this is due to up front recognition of revenue for "all-in" advice packages where costs may not be matched with revenue.

Additional procedures

- Obtain further explanation / investigation of the margin from the client

DSO analysis is for overall company only and therefore gives limited information. It is not clear on what basis the budget has been prepared. There has also been no attempt to explain the impact on the budget of the change in revenue recognition policies. Therefore the comparison to the budget is of little value.

Additional procedures

- Request more detailed divisional analysis to support the explanations given?
- Discuss the basis of preparation of the budget with management and if necessary prepare further analysis to enable valid comparisons to be made.

(ii) Further financial accounting issues and associated audit risks identified from planning work performed and implications for audit approach.

Revenue recognition – systems projects

The historical revenue recognition policy for system projects has been very prudent with all revenue and margin recognised only on customer acceptance. Accounting standards require recognition based on the stage of completion where the outcome can be assessed reliably. Hence the historic policy adopted by ETP must have been on the basis that reliable assessment of the outcome was not possible.

The new revenue recognition policy adopted in the 6 months to 31 March 2014 is more in line with expected practice but is inherently more judgmental and has had a very significant effect. It is concerning that the margins anticipated on partially complete projects exceed those on completed projects and this could be indicative of over optimism, deliberate distortion of results or simply the continuing difficulty in estimating the outcome with any certainty.

The fact that debtor days have lengthened due to delays in payment of stage invoices suggests that customers may not be happy that they have received deliverables for which they are not happy to pay or that the stage payments are not a true reflection of the stage of completion and therefore not a valid basis for revenue recognition.

There is therefore an audit risk that:
- the new basis for revenue recognition is not appropriate
- judgments made in assessing out-turn margins and stage of completeness are not correct or appropriate.

In addition, if the new policy is found to be appropriate, there is a financial reporting issue in that a change in revenue recognition policy would normally give rise to a restatement of prior year revenue and margin. This would however not be the case were the company to argue that it is their ability to assess the outcome which has changed rather than the policy.

The new policy will mean changes to our audit approach in that our controls work will need to focus on new control objectives around estimating costs and assessing percentage completion. In addition our substantive work will need to consider carefully the judgments made and the evidence available as to progress on the projects and customer acceptance of obligations for the invoices issued. Immediate discussions should be held with the client around the reasons for the change in policy and ETP's own consideration of the impact, if any, on the prior year.

Declining sales of Stor-It devices
The declining sales and margins on Stor-It devices give rise to a number of risks:

- The risk that there is excessive inventory of the products and obsolescence provisions need to be increased. The financial controller's comments make it clear that inventory levels are increasing significantly.
- The risk that more attractive sales terms will need to be offered to ensure that the devices are sold. To some extent this may already be happening at least in practice as distributors are delaying payment for the product on the basis that they have not sold it on. In addition margins are lower which may indicated additional discounts.
- The risk that the carrying value of the associated brand and/ or tooling may be overstated given future anticipated sales and margin to be earned from the product.
- The risk that even if the carrying values can be supported, the useful economic lives may need to be reassessed as a shorter life may be more realistic.

Implications for our audit approach are that we will need to include additional procedures to address the impairment and useful lives risks and to look carefully at judgments in these areas and around inventory obsolescence. We will also need to consider carefully whether there have been changes in formal sales terms or those allowed in practice, such as increased acceptance of returns from distributors or volume incentives, and to ensure that all such matters are accounted for correctly.

"All in" advice packages – revenue recognition
Revenue for the "all in" advice packages is being recognised up front. While such revenue is not refundable, it seems likely that ETP has an ongoing obligation to provide a service throughout the period and that a more appropriate revenue recognition model would be to recognise revenue ratably throughout the relevant period. In addition, we need to consider whether revenue is being deferred to cover the right to future discounts on training programmes. The fact that margins have increased considerably also suggests that the present recognition model may not be achieving appropriate matching of costs and revenues. There is therefore a risk that the policy adopted for revenue recognition on these projects is inappropriate and considering it further must be a focus area for our audit.

Accounting for loss on Government contract
Whilst a loss has been recognised on the Government contract there is a risk that the element recognised relates only to the proportion of the contract completed to date as it appears to include only incurred costs. Provision should be made for the entire anticipated loss and we should include audit procedures to ensure that this is the case.

Cut-off error on training revenue
Error identified to date is not material but it is possible that the total extent of the error has not been identified. Our audit will need to include procedures to look in detail at cut-off at both the beginning and end of the year as, if the prior year error were material, a prior year adjustment would need to be made. In addition we need to revisit our work on controls as the controls operated in the previous year were clearly not operating effectively. Unless significant changes to controls have been made, we may conclude that controls reliance in this area is no longer possible.

(iii) Response to email – assurance on interim financial reporting.

A review of ETP's interim financial statement would provide a lower level of assurance than an audit but is still designed to provide assurance to the board on the company's published financial statements. The amount of work performed by J & K would be less than that for a statutory audit and would involve primarily analytical review procedures rather than detailed substantive testing.

Performing an interim review would mean that we, as auditors, performed analytical review procedures and other procedures prior to the publication of your interim financial statements rather than after that publication as part of our planning procedures. Many of the procedures would be similar to / the same as those we would perform as part of our audit – eg review of minutes etc. but they would be performed on a more timely basis allowing us to let you know of any errors / omissions before the data is made public.

This would be of benefit to the whole Board who take responsibility for the financial statements in providing assurance that those statements have been subjected to a review process. This would help to avoid issues / errors coming to light at a later date – our review for planning purposes has identified a number of potential risks and issues which should have been considered as part of the interim reporting.

Interim review procedures also provide additional assurance to investors about the degree of reliance they can place on the interim financial information and thus is of value in investor relations and also potentially attracting additional investment. Mari is therefore correct in her assertion that the review procedures would add credibility to the figures for the shareholders.

While an interim review is an additional report and there will be an additional fee, the extent of this can be mitigated as some of the procedures are ones which would have been performed in any event and it is only the timing which will change. Other procedures such as review of the reporting document itself and reporting to management will be additional and some, such as analytical review, will be extended.

Revenue recognition – Interim financial statements
J & K's procedures would prevent ETP publishing misleading interim financial statements which would be the case if the revenue for the new overseas contract is recognised evenly over the year as Mari proposes. It appears that the loss on the government contract has been understated in the interim financial statements for the period to 31 March 2014. In addition the interim financial statements for this period may have been incorrectly stated due to cut off and revenue recognition policy changes in respect of systems and 'all-in' packages for service revenues. These errors would have been identified by J&K if review procedures had been carried out on the interim results for the period to 31 March 2014 on a timely basis prior to publication of the results

IAS 34.37 requires that revenue should not be anticipated at the interim date if anticipation would not be appropriate at the year-end date. The revenue from the new overseas contract should not therefore be included in the interim results to 31 March 2015.

Examiners' comments
General comment on candidates' performance

Requirements 1 and 2
A significant majority of candidates failed to appreciate that there were in fact three requirements to this question and ignored the requirement to review and identify weakness in the analytical procedures performed by the junior member of staff. At this level candidates are required to demonstrate the ability to review the work of others and identify the weaknesses in the procedures performed. Similar style questions are available in the learning materials and in the sample paper.

The good candidates followed the format of the question and identified weakness in the work performed to date. Doing so provide gateway points to then drill down further into the errors in the financial reporting treatment for revenue, and also identifying other financial reporting implications in relation to potential impairments of patents and inventory. Technically the topics are not challenging; in terms of interpreting the information by applying fairly straight-forward analysis, most candidates demonstrated severe weaknesses in this area. Very little was offered in terms of analysis - financial statement analysis is a key part of the syllabus for this paper and candidates need to be prepared to analyse and interpret financial information in different scenarios including in the auditing context of analytical procedures.

The question was often not attempted by weak candidates.

Good candidates identified the impact of the changes in revenue recognition policies although it was not uncommon for candidates to fail to appreciate that these had changed from the file note presented in exhibit 1 which related to the year ended 30 September 2013.

Requirement 3
Unfortunately for some candidates who copied out IAS 34 requirements instead of answering the question which asked for how a **review** of the interim financial statements would differ from an audit and the benefits of such a review, there were limited marks available for this section. Candidates who discussed the value of interim financial statements were not answering the question. Candidates are expected to apply to the scenario and not use the open book policy as an opportunity to write out sections of the standards.

For the better candidates this section presented no difficulties and many scored maximum marks.